“Public” not selective reporting - towards a fair & efficient listed company disclosure framework in Australia

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“Public” Not Selective Reporting - Towards A Fair & Efficient Listed Company Disclosure Framework in Australia

Gill North

A thesis submitted in accordance with the requirements for the award of the Degree of Doctor of Philosophy
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Abstract

I investigate the extent and quality of information provided by listed companies through the Australian Securities Exchange (ASX), and the likelihood of additional private or selective disclosure. This is important because markets benefit greatly from public transparency and accountability. The global financial crisis has starkly reminded us that modern markets, real economies and people's lives are closely interconnected. Effective company disclosure in the public arena is especially vital in Australia, because the equity market operates with the highest retail investor participation in the world and a large proportion of savings is invested through compulsory superannuation.

Policy statements on company disclosure and insider trading regulation emphasise the importance of equal access to company information. They also acknowledge the links between equal access, investor confidence in the integrity of the market and efficiency outcomes. I therefore review the conceptual bases and empirical attributes of fairness and efficiency within markets, and consider the fairness and efficiency of the listed company disclosure framework in Australia.

I find the level of public transparency across the equity market is highly variable; access to listed company information in Australia is far from equal; and the content and quality of ASX disclosures are sometimes insufficient for well-informed decisions. Commentary from companies, regulators and investors reveals a large gap in expectations between listed companies and their stakeholders relating to disclosure practices and enforcement. Moreover, scholarly studies and original research suggest that a significant proportion of information required for informed decisions and broader managerial accountability is disseminated on a private, selective or tiered basis. I conclude that reforms to the disclosure framework are needed to enhance its fairness and long-term economic efficiency.

Specific reforms to the periodic disclosure, continuous disclosure and company briefing rules and processes are proposed. These reforms, if implemented, would enable more equitable access to information and reduce the scope for trading on inside or selectively disclosed information. In addition, general policy recommendations are outlined to promote a disclosure framework founded on a solid theoretical basis, with clearly identifiable goals, and a bold and effective regulatory and enforcement structure.

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ABSTRACT

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outlined to promote a disclosure framework founded on a solid theoretical basis, with clearly identifiable goals, and a bold and effective regulatory and enforcement structure.

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A large proportion of the thesis content has been published in refereed journals as outlined below:

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- Gill North, 'The Australian Insider Trading Regime: Workable or Hopelessly Complex?' (2009) 27 *Company and Securities Law Journal* 310
- Gill North, 'A Theoretical Basis for Selective Disclosure Regulation' (2009) 32 *University of New South Wales Law Journal* 143
- Gill North, 'The Insider Trading Generally Available & Materiality Carve-Outs: Are They Achieving Their Aims?' (2009) 27 *Company and Securities Law Journal* 234
- Gill North, 'The Corporate Disclosure Co-Regulatory Model: Dysfunctional and Rules in Limbo' (2009) 37 *Australian Business Law Review* 75
- Gill North, 'Periodic Disclosure Regulation: Enhancements To Enable All Investors To Make Informed Decisions?' (2009) 27 *Company and Securities Law Journal* 23
- Gill North, 'Efficiency, Fairness & Irrationality: Incompatible or Complementary?' (2009) 24 *Banking and Finance Law Review* 311
- Gill North, 'Closed and Private Company Briefings: Justifiable or Unfair?' (2008) 26 *Company and Securities Law Journal* 501

Permission was sought and given to include material subject to copyright restriction within the thesis. My thanks to Professor Ian Ramsay (who refereed the article on company briefings) and to the anonymous referees for their valuable feedback on articles submitted for publication. Thank you also to Professor Baxt, the general editor of the Company and Securities Law Journal and the Australian Business Law Review, and Associate Professor Paul Ali, the co-editor of the Company and Securities Law Journal, for their editorial support. The various publication processes resulted in considerable improvement to the thesis content. I am especially grateful to Professor Buckley for encouraging me to begin the publication process and for his mentoring support during most of the thesis period.

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LIST OF ABBREVIATIONS

ABN 60 Foundation (Foundation)

Annual General Meeting (AGM)

ASX Supervisory Review Pty Limited (ASXSR)

ASX Market Supervision (ASXMS)

Australian Accounting Standards Board (AASB)

Australian Competition and Consumer Commission (ACCC)

Australian Investor Relations Association (AIRA)

Australian Securities and Investments Commission (ASIC)

Australian Securities Exchange (ASX)

Australian Securities Commission (ASC)

Australian Shareholders Association (ASA)

Canadian Chartered Accountants of Canada (CICA)

Capital Asset Pricing Model (CAPM)

Carpenter Pacific Resources (C)

Chief Executive Officer (CEO)

Chief Financial Officer (CFO)

Citigroup Inc (Citigroup)

Corporate Law Economic Reform Program (CLERP)

Companies and Securities Advisory Committee (CASAC)

Company Announcement Platform (CAP)

Corporations Act 2001 (Cth) (The Act)

Corporations and Markets Advisory Committee (CAMAC)

Deed of Covenant and Indemnity (DOCI)

Earnings before interest and tax (EBIT)

Earnings before interest, tax and amortisation (EBITA)

Earnings before interest, tax, depreciation and amortisation (EBITDA)

Earnings per share (EPS)

Efficient Capital Market Hypothesis (ECMH)

Financial Services Authority (FSA)

James Hardie Industries Limited (JHIL)

James Hardie Industries NV (JHINV)

Management Discussion and Analysis (MD&A)

National Association of Securities Dealers (NASD)

National Investor Relations Institute (NIRI)

New York Stock Exchange (NYSE)

Position and Consultation Paper (PCP)

Regulation Analyst Certification (Reg AC)

Regulation Fair Disclosure (Reg FD)

Self-Managed Superannuation Fund (SMSF)

Standard and Poor (S&P)

Toll Holdings Ltd (Toll)

United Kingdom (UK)

United States (US)

United States Securities Exchange Commission (SEC)

* The empirical study variables are excluded from this list. See Table 2 of Chapter Five for a definition of the variables.

TABLES

CHAPTER ONE: INTRODUCTION

I BACKGROUND STATEMENT OF THESIS ARGUMENTS

The thesis investigates the extent and quality of information provided by listed companies through the Australian Securities Exchange (ASX), and the likelihood of additional private or selective disclosure. The research is designed around two hypotheses drawn from existing literature and market experience:[1]

1. Some investors in ASX listed securities do not have access to sufficient information to make rational[2] judgments on investment decisions under existing company disclosure regulation and practice.
2. Disclosure of a significant proportion of Australian listed company information is on a private or selective basis, resulting in information asymmetry.[3]

Linked to the primary question is the issue of how fair and efficient the listed company disclosure framework is in Australia. Policy makers and regulators worldwide consistently espouse the importance of equal access to fair and efficient markets.[4] For example, Australian policy makers suggest the 'continuous disclosure obligations are vital in maintaining market integrity and ensuring market efficiency through open and equal access to relevant information.'[5] However, questions that naturally arise are:

1. What do the goals of equal access, fairness and efficiency mean within the context of the listed company disclosure framework in Australia?
2. What do these concepts encompass?
3. And how should efficiency and fairness be assessed and enhanced?

I wrote the thesis to stimulate broad well-informed debate on Australian corporate disclosure issues. Most of the topics discussed in the thesis are not well covered within

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[1] I have had many years experience at senior levels in capital markets in Australia, London and Tokyo, including as a professional analyst. My law honours thesis focused on specific aspects of the periodic and continuous disclosure regimes in Australia.

[2] Rational investment is defined as investment made on a fundamental basis, or analysis that seeks to value companies and their securities based on the present value of the estimated future earnings and distributions.

[3] Information asymmetry arises when companies provide information to some individuals, which is not provided to other investors and stakeholders.

[4] See, eg, International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* (May 2003) 6.

[5] Commonwealth, *Review of the Operations of the Infringement Notice Provisions of the* Corporations Act 2001 *Consultation Paper* (March 2007) 2.

Australian scholarly material. For example, there is only minimal published commentary on the periodic and continuous disclosure obligations and processes, the policy efficiency and fairness rationales, private company briefings, selective disclosure, the role and status of institutional and retail investors, access to company information, the extent to which information released through the ASX is clear, concise and effective, and the operation and efficacy of the integrated listed company disclosure framework.

The thesis propositions matter because as Cooper, a prior Deputy Chairman of the Australian Securities and Investments Commission (ASIC), indicated at the ASIC Summer School in 2008, '[w]e're nearly all retail investors' in Australia because of compulsory superannuation, with only around 20 percent of consumers using financial advisors.[6] A 2008 ASX Survey indicated that nearly seven million Australians or 41 percent of the adult population participated in the Australian share market.[7] Within this sample, an estimated six million Australian adults or 36 percent of the adult population were invested in ASX listed shares directly.[8] This level of retail investor participation is very high in comparison with other developed markets.[9]

The Global Financial Crisis has diminished stock market returns and investor confidence in the short term. Nevertheless, the number of Australian retail investors and the amount of direct investment in ASX securities can be expected to increase over the medium term. Compulsory superannuation assets will inevitably rise due to continued ageing of the Australian population and increased coverage of the superannuation scheme across the population.[10] Over the last decade, growth in superannuation assets has been particularly strong within the self-managed

[6] Jeremy Cooper, Deputy Chairman, Australian Securities and Investments Commission (ASIC), 'Our Financial Markets: The Big Issues' (ASIC Summer School 2008 Report, 18-20 February 2008) 5.
[7] Australian Securities Exchange (ASX), *2008 Australian Share Ownership Study* (2009) 3. Total share ownership including direct and indirect participation declined from the 2006 survey figures. However, the proportion of investors who invested solely on a direct basis remained stable at 25% of the adult population. The survey does not measure share ownership through superannuation other than through self-managed superannuation funds.
[8] ASX, above n 7, 3.
[9] ASX, above n 7, 34. See also ASX, *International Share Ownership* (September 2005) 2.
[10] The Superannuation Guarantee Scheme requiring compulsory superannuation contributions was established under the *Superannuation Guarantee Charge Act 1992* (Cth) and *the Superannuation Guarantee (Administration) Act 1992* (Cth). The scheme commenced operation on 1 July 1992. Superannuation assets in Australia total more than a trillion dollars: Michael Lawrence, 'Boom Boys: Five Hot Fund Managers; Investment Funds are Awash With Cash From Super Funds and a Bull Market' (13 February 2007) 125 *Bulletin*..

superannuation fund (SMSF) segment, and this trend is likely to continue.[11] Investors who operate an SMSF seek to independently plan, manage and control their retirement savings, and tend to prefer to invest directly into ASX listed securities.

In addition, usage of the internet for obtaining investment and financial related information will increase as access to broadband facilities across Australia improves and more activities and transactions move online. The ease and speed of access to the internet for most of the Australian population and the well established pattern of online investing radically change the debate on equal access to information and assumptions on the role and use of intermediaries. Now is the time to consider how level the playing field is between institutions, intermediaries and other investor participants in Australia. There is general consensus among scholars that the advent of the internet and other digital technologies can potentially democratise securities markets.[12] Companies currently disseminate annual reports and administrative notices online, however, the use of digital technologies to broaden access to other company information remains discretionary.

One of the most significant barriers to the democratisation of the securities markets is fixed ideas held by companies, regulators, scholars and others 'of the proper distinctions between professional and non-professional, between sophisticated and unsophisticated, and between appropriate and inappropriate investment strategies for ordinary investors.'[13] Such ideas are reflected in other scholars' arguments throughout the thesis. Academic material often categorises stock market investors as institutional or individual participants.[14] Many commentators assume that individual investors require professional analysts to interpret company information and present it to them in

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[11] Sarah Rich, 'Local DIY Super Funds Are Snowballing', *The Australian* (Sydney), 11 December 2009; Bina Brown, 'DIY Super Revolution: How to Manage Your Money', *Australian Financial Review* (Sydney), 23 August 2008, 37; Glenda Korporaal, 'More Look to Handle Own Funds', *The Australian* (Sydney), 8 December 2007, 36.

[12] Donald Langevoort, 'Information Technology and the Structure of Securities Regulation' (1985) 98 *Harvard Law Review* 747, 749; John Coffee Jnr, 'Brave New World? The Impact(s) of the Internet on Modern Securities Regulation' (1997) 52 *Business Lawyer* 1195, 1196; Dimity Kingsford Smith and Kirsty Williamson, 'How Do Online Investors Seek Information, and What Does This Mean for Regulation?' (2004) 2 *Journal of International Law & Technology* 12; Nancy Libin and James Wrona, 'The Securities Industry and the Internet: A Suitable Match?' (2001) *Columbia Business Law Review* 601, 631; Caroline Bradley, 'Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets"' (2000) 26 *Journal of Corporation Law* 63, 81, 87, 96; Laura Unger, 'Corporate Communications Without Violations' (1999) 51 *Administrative Law Review* 1119, 1121.

[13] Bradley, above n 12, 96.

a way they can understand,[15] and as such, analysts are not in competition with individual investors. Others claim that individual investors can obtain the benefits of any private information by purchasing the analyst reports, investing with fund managers or trading at the market price and free riding on the presumption of market efficiency.[16]

In practice, there are Australian investors who require professional assistance because of a lack of skills, resources or time. This means there is a continued role for analysts or professional intermediaries that are genuinely skilled at spotting arbitrage opportunities or who can provide a valued service to clients. However, a significant proportion of the Australian population prefer to invest for many reasons on an independent basis, with or without assistance from third parties. Labels such as "widows and orphans" and "mums and dads" for all of these investors are hackneyed and patronising. Broad generalisations about institutional and individual investors inevitably mask the true spectrum of professionalism, competency and diligence across both groups. The investor categories I adopt in the thesis are institutional and retail. The division into these two categories depends only on whether the investment is made through, or involves, an intermediary. Institutional investors include fund managers and analysts[17] who make investment decisions on behalf of clients, and brokers and analysts[18] who provide security recommendations or investment research to clients. Retail investors invest directly on their own behalf.

I argue that many of the assumptions or generalisations on the role of market participants and access to company information are unduly simplistic or no longer valid within contemporary markets. There is no compelling evidence to support the claim that Australian retail investors benefit economically from using intermediaries. There is also little evidence for the many sweeping efficiency claims to support the privileged role of analysts.

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[14] It is not suggested that all academic material adopts simplistic generalisations. There are studies and commentary that present more nuanced investor categorisations.

[15] Scott Russell, 'Regulation Fair Disclosure: The Death of the Efficient Capital Market Hypothesis and the Birth of Herd Behaviour' (2002) 82 *Boston University Law Review* 527, 550; Linda Yi, 'Road Shows On The Internet: Taking Individual Investors For A Ride On The Information Highway' (2002) 52 *Duke Law Journal* 243, 259-261.

[16] Russell, above n 15, 550.

[17] Commonly referred to as buy-side analysts.

[18] Commonly referred to as sell-side analysts.

II THESIS FOCUS AND COMPONENTS

Most Australian scholars and legal and market practitioners appear to accept equal access to company information as an aspirational goal. However, there is no consensus among scholars, the judiciary, regulators, listed companies, investors and other company stakeholders on the nature and scope of the required regulation and processes to make such access a reality.

The main focus of the thesis is Australian listed company disclosure regulation and practice. However, international regulation and material is discussed to the extent that it usefully informs this discussion. It is assumed that company results, or more specifically, company earnings, drive company share prices over the longer term.[19] In other words, share prices of individual securities in a market generally converge around trend lines that equate with the underlying earnings or the potential earnings capacity of the relevant companies.[20] It is also assumed that investors search for information about companies, industries and economies in order to obtain a profitable informational advantage; the gathering of information is generally aimed at forecasting a company's future earnings in order to value the company's securities; and this is done in the belief that mispriced securities, or securities that are under or overvalued can be discovered, leading to direct or indirect profitable trading opportunities.[21]

Australia has had mandatory corporate disclosure rules in place for many years. The *Corporations Act 2001* (Cth)(the Act) provides a comprehensive disclosure framework encompassing ongoing company disclosure requirements, as well as disclosure rules that apply to one off events such as takeovers, acquisitions, buy-outs and fund

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[19] I am aware of the material within accounting literature, which examines the extent to which share prices incorporate information in a timelier manner than earnings. This debate is outside the scope of the thesis. However, readers that are interested in this topic should see SP Kothari and Richard G Sloan, 'Information in Prices About Future Earnings: Implications for Earnings Response Coefficients' (1992) 15 *Journal of Accounting and Economics* 143 and Sudipta Basu, 'The Conservatism Principle and the Asymmetric Timeliness of Earnings' (1997) 24 *Journal of Accounting and Economics* 3.

[20] D Craig Nichols and James Wahlen, 'How Do Earnings Numbers Relate To Stock Returns? A Review Of Classic Accounting Research With Updated Evidence' (Dec 2004) *Accounting Horizons* 263, 264 citing William Beaver, *Financial Reporting: An Accounting Revolution* (3rd ed, 1998). Beaver suggests there are links between earnings and share prices; current period earnings provides information to predict future periods' earnings; which provides information to develop expectations about dividends in future periods; which provides information to determine share value.

[21] In practice, the motivations of investors are many and varied.

raisings.[22] This disclosure regulation is supported by market misconduct regimes, including provisions dealing with insider trading and misleading and deceptive conduct.[23] Listed companies are also subject to ASX disclosure listing rules.

The disclosure regulatory model in Australia can be traced back to the Wallis Inquiry in 1997 and the general view that 'markets only need … quality disclosure and enforcement of proper market conduct for their operation.'[24] This model requires companies to provide "clear, concise and effective" information and presumes that those who use these disclosures are able to make well-informed investment decisions.[25] I agree with Kingsford Smith that

> [d]isclosure is like democracy: in some places it doesn't work very well, but it is the best we've got and we should strive to make it the best it can be. We also need to supplement it, where it reaches its limits.[26]

However, for the purposes of the thesis, I accept the premises of the Wallis Report. The thesis content is limited to whether listed company disclosure is the best it can be in Australia. In addition, the regulatory discussion is limited to the periodic and continuous disclosure regimes and the rules prohibiting insider trading and selective disclosure. Finally, some important corporate disclosure issues are not discussed or are only touched upon. For example, the corporate governance discussion is limited to public access issues, there is no substantive discussion on property or contractual rights to company information, and questions around how investors and other stakeholders use available company information are not addressed.[27]

The thesis focuses on the regulation governing ongoing disclosure, because all listed companies are subject to these rules, and information provided under the periodic and continuous disclosure regimes forms the largest body of company information provided in the public arena. Regulation prohibiting insider trading and selective disclosure is

[22] Chapters 6, 6A and 6B of the *Corporations Act 2001* (Cth) provide the disclosure rules relating to takeovers, compulsory acquisitions and buy-outs and Chapter 6D outlines the required disclosure when companies are involved with a fundraising.
[23] The market misconduct and insider trading provisions are located within Part 7.10 of the *Corporations Act 2001* (Cth).
[24] Belinda Gibson, ASIC Commissioner, 'Working In a Regulated Environment' (Speech delivered at the Law Society of Western Australia Summer School, 26 February 2010) 2.
[25] The Wallis Report model assumes that users of the information have sufficient capacity, knowledge and resources to process and apply available information to make decisions in their best interest.
[26] Dimity Kingsford Smith, 'Securities and Investments Regulation: Beyond the Crisis' (ASIC Summer School 2010 Report, 1-3 March 2010) 134.

discussed because this regulation supports the periodic and continuous disclosure rules. When listed companies fail to provide prescribed information to the market, this may constitute a breach of periodic or continuous disclosure regulation. In addition, trading on materially price-sensitive information that has not been disclosed to the market, or that has been selectively disclosed to some investors, may result in liability under insider trading regulation.

Selected empirical research is presented from legal, accounting, finance and economic scholars to provide critical links between the theoretical, policy and marketplace discussion. Empirical studies are open to varying interpretation, some studies may be outdated, overseas studies may not be generalisable to the Australian market, analysing large bodies of work is not easy, and many disclosure issues are not empirically verifiable. Nevertheless, the outlined research is intended to provide valuable pointers for policy makers and other interested parties.

Not surprisingly, the most significant company disclosure issues in Australia arise within the grey areas of the regulation and practice. To explore these complex issues in a meaningful way requires detailed discussion on the existing disclosure law, the theoretical bases for the regulatory framework, and market practices. It is also necessary to understand what company information is being provided to investors under the mandatory disclosure regimes, what additional information is provided on a voluntary basis, and the extent to which information is disseminated within the public arena or on a private basis.

Chapter Two introduces the listed company disclosure regulation and practice. Chapter Three discusses the theoretical and conceptual bases supporting this regulation. Chapter Four examines the legal context of the disclosure regulation in more depth. These chapters on a combined basis describe, discuss and critique the listed company disclosure framework in Australia. Original empirical research on listed company disclosure practices is provided in Chapter Five. Chapter Six reviews and critiques the thesis content and arguments on an integrated basis, highlights issues for policy consideration, and provides specific reform proposals. Chapter Seven is the conclusion.

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[27] Research on the use of available company information is a discrete but complementary area of research to the thesis topic.

At a more detailed level, Chapter Two introduces periodic disclosure, continuous disclosure, insider trading and selective disclosure regulation and processes. Listed Australian companies disclose information to the market under the mandatory disclosure regimes and on a voluntary basis. Voluntary disclosure by companies is provided in the public arena and on a private basis. The Chapter highlights informational deficiencies in the periodic and continuous disclosure regulation and practices. I argue that some of the “missing” company information under the mandatory disclosure processes is provided at closed or private company briefings. Open investor access to briefings can be enabled easily and cheaply using webcasting or conference calls. However, many listed Australian companies have not voluntarily adopted these technologies. Many companies continue to hold briefings on an invitation only basis, with the invitee list generally restricted to large institutional investors. I suggest that issues and ambiguities resulting from the company disclosure co-regulatory structure add to the disadvantaged position of retail investors. The Chapter concludes that there is information asymmetry across the market, and some investors do not have timely access to valuable company information needed to make rational decisions.

Chapter Three discusses the theoretical basis for corporate disclosure regulation. Initially, it focuses on the broad question of whether mandatory disclosure regulation is justified. This leads into the narrower debates on whether trading on private information by persons related to the company, or by persons outside the company, should be permitted or prohibited. The efficiency, fairness and rationality concepts underpinning these debates are also examined. However, the thesis is written within a law doctorate program, limiting the space available for commentary on these broad concepts and issues. Much of the thesis argument by necessity assumes rational decision-making (or decisions based on an individual’s economic interest). Nevertheless, the policy discussion takes into account that as human beings, we sometimes act irrationally, on an emotional basis, and beyond prescribed boundaries, both legal and otherwise.

Policy documents indicate that the rationales supporting Australian company disclosure regulation are fairness and efficiency. There are many notions and measures of efficiency in capital markets. "Price efficiency" is defined in the thesis as an individual security price that accurately reflects the underlying economic value; "optimal market efficiency" as a market in which the prices of the market securities most closely reflect their underlying economic values; and "optimal economic efficiency" as an economy that produces the optimal allocation of real resources or capital. I argue that the appropriate efficiency rationale for company disclosure and insider trading policy is long-term economic efficiency.[28] The fairness concept that I primarily focus on is equal access to information that listed companies choose to disclose to some investors.[29] Discussion on broader fairness issues is intentionally left for future research and other forums.[30] The empirical research reviewed suggests that sustainable economic growth created through efficient capital markets depends on the promotion of investor confidence and a perception by the broader public that markets operate on a fair basis.[31] Chapter Three concludes that mandatory public disclosure of company information and regulation prohibiting insider trading and selective disclosure are justifiable on efficiency and fairness grounds.

Chapter Four examines the legal context for the company disclosure regulation in more depth, including a review of the regulatory and enforcement regimes, relevant case law and policy reviews. I argue that a primary focus by the regulators on compliance with, and enforcement of, the periodic and continuous disclosure obligations is likely to be the most credible risk based approach to achieve equal access and long-term economic efficiency. However, there is significant uncertainty around the scope of the disclosure

[28] This approach precludes policies that seek to optimise efficiency for ten minutes, one quarter or even a decade if they ultimately diminish long-term economic efficiency. For example, some of the growth created from market activity during the 1990s was not economically efficient in light of the enormous economic and human costs flowing from the global financial crisis.

[29] Other market fairness concepts that are commonly acknowledged within disclosure policy documents and scholarly material such as investor protection, fraud minimisation and investor confidence are discussed. However, I suggest in Chapter Three that these concepts or goals largely depend on achieving equal access. Investor protection and investor confidence are diminished when company information is provided privately or selectively rather than on an equal and timely basis. Moreover, when company information is not provided in the public arena and management can select what and to whom information is disclosed, critical market and public scrutiny controls and balances that deter corporate fraud or mitigate losses resulting from fraud cannot fully operate.

[30] I view ready access to company information, and policies or measures to assist investors to use and apply the available information in their best interest, as discrete stages in the evolutionary process towards fair and efficient markets. Measures to assist investors to make investment decisions in their best interest rely on parties having: (i) sufficient information; (ii) clear, concise, complete and accurate information; and (iii) information that is formatted on a comparable basis. Without ready access to such information, investors are not able to make credible choices across the investment spectrum, regardless of skills, initiative and diligence.

[31] The studies suggest that equal access, investor protection and investor confidence are necessary preconditions to optimise long-term economic returns achieved through efficient capital markets.

provisions. Case law and policy reviews are outlined to highlight the legal uncertainties around the requirements in the insider trading and continuous disclosure provisions that the information is material but not “generally available”. The relationship between the continuous disclosure and insider trading regimes is also explored to determine the extent to which selective disclosure is prohibited or enforceable. However, I find little consensus among policy makers, the judiciary and academics on the interpretation of the legal terms and linking relationships across the company disclosure and insider trading regimes. The Chapter concludes that enforcement, legal and regulatory uncertainties leave many investors with potentially minimal protection under the comprehensive disclosure framework, particularly in relation to systemic professional trading on inside or selectively disclosed information.[32]

Chapter Five outlines original empirical research on listed company disclosure practices. The study reviews the efficacy of the continuous disclosure regime by examining the extent to which listed companies complied with Guidance Note 8 to ASX Listing Rule 3.1 on disclosure of earnings expectations, during the 2007 and 2008 financial years. Guidance Note 8 requires a company to disclose an expected change in earnings, when the variation from a prior forecast or the previous corresponding period becomes material. Timely disclosure on prospective earnings is needed to ensure timely and equal access to company information, to enable well-informed investment decisions, to reduce potential opportunities for trading on inside or selectively disclosed information, and to enhance long-term economic efficiency. However, the study finds evidence suggesting systemic non-compliance with Guidance Note 8. The regression analysis finds no consistent associations between absolute changes in annualised earnings levels and the provision of earnings forecasts prior to the financial year-end. The number of companies that updated the market of a material expected

[32] When behaviour is “systemic”, it is spread throughout the entire system. That is, it affects the market as a whole. The Securities Exchange Commission in the United States highlights that individuals engaged in misconduct are increasingly securities professionals, gatekeepers or high ranking corporate officials. Further, recidivist insider trading cases and serial illegal trading have become more common. In such cases, insider trading may be carried out by a number of defendants, involving multiple trades over a number of months, using sophisticated approaches: Linda Thomsen, SEC, ‘Opening Remarks’ (Speech delivered at the Securities Industry and Financial Markets Association Regulatory Symposium on Insider Trading, 19 May 19 2008). See SEC, ‘SEC Charges Wall Street Lawyers and Traders in $20 Million Insider Trading Scheme’, <http://www.sec.gov/news/press/2009/2009-236.htm> at 17 March 2010 for an example of an enforcement action involving systemic professional insider trading.

change in earnings was low. In addition, I argue that a significant proportion of the earnings forecasts were incomplete or ambiguous, making analysis of the announcements difficult even for the most experienced and diligent investors. My succinct summary of the overall disclosure standards observed is “ad hoc and messy – could do better”.

Chapter Six finds that the combined thesis evidence is consistent with the initial hypotheses. Accordingly, I provide specific policy proposals and highlight issues for policy consideration to reduce legal and regulatory uncertainties, to promote equal access, and to encourage companies to provide more comprehensive and useful company information. The reform proposals seek to:

1. Strengthen the ASX Listing Rules relating to when continuous disclosure is required, and the form of the required disclosures;
2. Include the preliminary final reporting regime within Chapter 2M of the *Corporations Act 2001* (Cth);
3. Introduce a statutory quarterly reporting regime;
4. Extend the management discussion and analysis requirements that currently apply to annual reports, to the preliminary final, half year, and proposed quarterly reports;
5. Introduce mandatory risk disclosures in the periodic reports;
6. Introduce ASX listing rules relating to online periodic reports; and
7. Extend the ASX continuous disclosure listing rules to require open access to general company briefings.

Chapter Seven is the conclusion.

III THESIS FINDINGS

The consistent argument running through the thesis is that equality of access and transparent corporate disclosure are necessary preconditions to economically efficient markets over the long-term. Equal access goals are not merely about protecting “mums and dads”. While the thesis at one level promotes the interests of retail investors, the core argument is that capital markets operate most efficiently when regulation and market practices emphasise and promote equal access and public transparency. Empirical studies using many different designs and measures present a consistent story about the potential economic benefits for countries that promote investor confidence in the integrity of their markets through transparent corporate disclosure in the public arena. They suggest or infer links between the strength and enforceability of a country's disclosure system, transparency, the breadth and depth of investor participation, protection of minority shareholder rights, and economic growth.

Transparent corporate disclosure in the public arena is needed to enable essential market and institutional checks and balances to operate, to discourage institutional and individual excesses that history and recent experience tell us arise when human greed runs rampant, and to promote genuinely competitive markets. Whatever else may change in the world, our human frailties do not. The glare of public disclosure is required for corporate governance and accountability processes to operate effectively. As Justice Owen indicated in the HIH Royal Commission Report, good corporate governance is about the 'fundamental notions of openness, integrity and accountability'.[33] 'Whatever the [corporate] model [adopted], the public must know about it and about how it is operating in practice …'[34]

The combined thesis material suggests that access to company information in Australia is far from equal and public transparency is deficient. A significant amount of company information required for well informed decision-making by investors and other corporate stakeholders is still disseminated on a private, selective or tiered basis. However, markets can no longer be a place for the favoured or wealthy few. It has been said that 'we need to take the "crony" out of … capitalism.'[35] This is particularly the case in Australia, where people's life savings are invested in compulsory superannuation, and the market operates with the largest proportion of direct investors in the world. Equal access policies and practices in the Australian market need to move beyond rhetoric in policy documents. The Global Financial Crisis starkly reminds us that the health of modern markets, real economies and people's lives are closely interconnected.

[33] Commonwealth, HIH Royal Commission, *The Failure of HIH Insurance* (2003) Vol 1, Pt 3, s 6.6.
[34] Commonwealth, above n 33, Vol 1, Pt 3, s 6.6.
[35] Russell Roberts, 'How Little We Know: The Challenges of Financial Reform' (November 2009) 6(11) *The Economists' Voice* 1, 4.

CHAPTER TWO: LISTED COMPANY DISCLOSURE REGULATION AND PRACTICE: AN INTRODUCTION

‘[*A*] *market where there is inequality of information is an unfair market and an inefficient market and a disorderly market … Good corporate disclosure practices form part of a virtuous circle, in which greater market integrity build investor confidence, which in turn builds market depth and liquidity; this in turn lowers the cost of capital raising which, in a competitive global market is the next best thing to an improved share price valuation.*’[36]

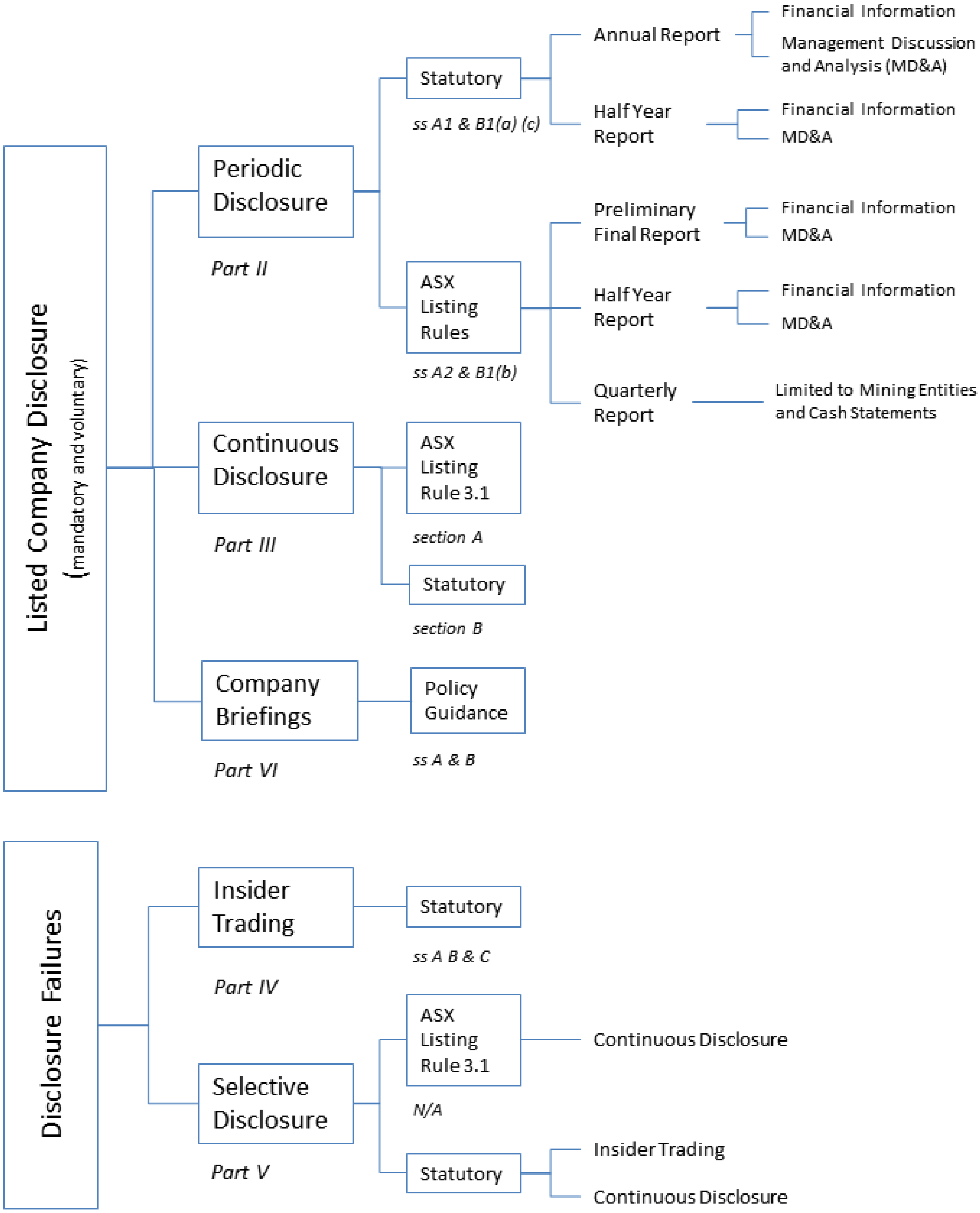
The aim of Chapter Two is to introduce the reader to the disclosure regulation and practices that apply to listed companies in Australia on an ongoing basis. The Chapter considers company disclosure from the perspective of an investor or stakeholder using company information to make well-informed decisions. Investors must consider company information on a holistic basis. As argued more fully in Chapter Four, users of company information are not generally concerned with the discrete disclosure regime under which information is provided, or any provisions that may have been breached when required disclosures have not been made.

The Chapter introduces periodic disclosure, continuous disclosure, insider trading and selective disclosure regulation, and the policy rationales supporting this regulation. It also outlines and discusses company briefing processes, disclosure in the digital era, and the company disclosure co-regulatory structure. The breadth of this content is extensive and the boundaries between areas are blurred. The periodic and continuous disclosure obligations applying to listed companies include statutory and listing rule provisions. Some of the statutory and listing rule obligations overlap, while others operate on a standalone basis. For example, the ASX listing rules governing preliminary final and quarterly reports are not replicated in statute. Most information provided on a voluntary basis is disclosed at company briefings. However, information additional to that required under the mandatory disclosure regimes may also be voluntarily disclosed through the ASX company announcement platform (CAP). ASIC has clear responsibility for monitoring and enforcing the statutory provisions. However, the regulatory structure around the listing rules provisions is less clear. To assist the reader to follow the outlined material, page 14 presents a guide to the

[36] Karen Hamilton, ‘Launch of “Enhanced Disclosure”’ (Speech delivered at the Committee for Economic Development of Australia, Sydney, 19 July 2002).

regulatory areas covered in Chapter Two, including the locations in the Chapter where the individual topics are discussed.

Chapter Two Regulatory Guide



Initially, I discuss regulatory developments and policy commentary on the rationales supporting the company disclosure and insider trading regimes. It is important to understand why the existing regulation was introduced in Australia, including some historical context and the regulatory rationales. Policy documents confirm that the primary rationales are market fairness and efficiency. The concept of market fairness consistently emphasised in the documents is equality of access. The market efficiency rationale is poorly defined, but is most commonly linked to equal access and investor confidence in the integrity of the market.

An outline of the periodic and continuous disclosure regulation follows. This includes a brief introduction on regulation prohibiting insider trading and selective disclosure, with more detailed discussion provided in Chapters Three to Five. The periodic reports provide investors with the foundational information on a company, including financial information and management discussion and analysis (MD&A).[37] The continuous disclosure regime is intended to keep investors informed between reporting periods. The information provided on a continuous basis also includes financial information and MD&A. The primary continuous disclosure obligation applying to listed companies is ASX Listing Rule 3.1, with support from a statutory regime. I outline the listing rule and statutory provisions independently because the nature and scope of these provisions, and the relationship between the two regimes, are critical issues highlighted throughout the thesis.

Next, I introduce the regulation and processes around company briefings, followed by discussion on changes to equal access issues and company disclosure processes in the digital era. From an investor's perspective, most of the periodic reports and continuous disclosures are only accessible online. Access to information provided at company briefings may also be accessible through webcasts.

Finally, the regulatory structure governing listed company disclosure in Australia is outlined. Australia uses a co-regulatory model for company reporting with the ASX and ASIC as joint regulators. While some of the market supervisory functions were recently transferred to ASIC, the ASX remains responsible for the supervision of listed

[37] The rules on management discussion and analysis reporting are important to the thesis arguments, so this material is presented as a separate topic.

companies and the disclosure listing rules.[38] The co-regulatory model used in Australia for listed company disclosure is not replicated overseas. Issues flowing from this model are highlighted in this Chapter, with discussion on broader regulatory issues and enforcement provided in Chaper Four.

I argue that there are deficiencies in the periodic and continuous disclosure requirements and processes that result in important company information not being disclosed in the public arena. I suggest this “missing” information is often disclosed at closed or private company briefings. While open access to these briefings can be enabled easily and cheaply using webcasts or conference calls, many listed Australian companies have not voluntarily adopted these technologies. Consequently, investors without invitations to the briefings do not have access to the information provided. Issues and ambiguities resulting from the co-regulatory structure and the conflicted position of the ASX further add to the disadvantaged position of retail investors.

Chapter Two concludes that access to listed company information in Australia is a long way from equal, and there is significant information asymmetry across the market. Reforms to the regulation and practices are needed to promote public rather than selective disclosure of information, and to underpin investor confidence in the integrity of the market. All company investors and stakeholders (including existing investors, potential investors, analysts, employees, regulators, the media, scholars, policy makers, professional bodies and other interested parties) should have ready and timely access to the information that companies choose to disclose to some investors.

Chapter Two is in nine parts:

1. Part I summarises the policy rationales supporting the periodic disclosure, continuous disclosure and insider trading regulation.
2. Part II outlines the periodic disclosure regulation.
3. Part III outlined the continuous disclosure reguation
4. Part IV introduces the regulation prohibiting insider trading
5. Part V introduces the regulation governing selective disclosure.
6. Part VI discusses the company briefing processes.

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[38] ASIC, Regulatory Guide 214: *Guidance on ASIC Market Integrity Rules for ASX and ASX 24 Markets* (July 2010) 4.

7. Part VII reviews how company information is disseminated in the digital era.
8. Part VIII introduces the company disclosure co-regulatory framework.
9. Part IX provides critique and concludes.

I COMPANY DISCLOSURE REGULATION POLICY RATIONALES

'[The 1980s were a] decade of greed … [The government needs to] redress the damage done to … the confidence of investors in our markets'[39]

This section provides historical context for the periodic disclosure, continuous disclosure and insider trading regimes in Australia, including the stated policy rationales. The regulatory rationales are reviewed further in Chapters Three and Four within discussion on the theoretical bases, legal context, and efficacy of the regulation.

Corporate disclosure regulation has existed in varying formats for many decades in Australia.[40] However, Australian policy makers and regulators concluded that Australian investor losses arising from a series of company collapses during the 1980s were due, at least in part, to poor corporate disclosure practices.[41] This led to a general review and strengthening of the corporate disclosure regulation.

The 1991 Companies and Securities Advisory Committee (CASAC)[42] report on an enhanced statutory disclosure system made three key recommendations:

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[39] Commonwealth, *Parliamentary Debates*, Senate, Second Reading of *Corporations Legislation Amendment Bill 1991*, Hansard 4231 (29 May 1991)(Senator Duffy).

[40] Richard Morris, 'Corporate Disclosure in a Substantially Unregulated Environment' (1984) 20 *Abacus* 52.

[41] Commonwealth, *Parliamentary Debates*, Senate, Second Reading, *Corporate Law Reform Bill 1993* (2 February 1994)(Senator Faulkner); John Crow, Christian Aubin, Olivia Kirley, Kosuke Nakahira, Ian Ramsay, Guylaine Saucier, Graham Ward, 'Rebuilding Public Confidence in Financial Reporting: An International Perspective' (Report Commissioned by the International Federation of Accountants, July 2003) 5-7; Michael Kirby, 'Securities Regulation – Business Rules, or the Rules of Law?' in Charles Rickett and Ross Grantham (eds), *Essays on Insider Trading and Securities Regulation* (1997) 155. In the second reading of the Corporate Law Reform Bill introducing the continuous disclosure regime, Senator Faulkner indicated that the late 1980s damaged Australia's reputation as a safe place to invest and too 'many people lost money in circumstances that could have been avoided by timely and adequate disclosure of relevant information to investors. He stated that 'timely disclosure of relevant information is essential for investors to have confidence in the integrity of the market place, and to make informed investment decisions. This must be the central feature of an efficient and fair market.'

[42] During the 1980s the National Companies and Securities Commission (NCSC) was the regulator of Australian company law and securities markets. In 1989, the Australian Securities Commission (ASC) was established under the *Australian Securities Commission Act 1989* (Cth). In 1998, the ASC was superseded by the Australian Securities and Investments Commission (ASIC) under the *Financial Sector Reform (Consequential Amendments) Act 1998* (Cth).

1. The introduction of a statutory continuous disclosure regime;
2. The introduction of half yearly or interim company reporting; and
3. More comprehensive annual disclosure requirements.[43]

Two months later, the Lavarch Committee report also recommended the introduction of a statutory continuous disclosure regime.[44] In 1994, the statutory continuous disclosure obligations were included within the *Corporations Law,* the statutory half yearly reporting requirements were introduced as part of the *Corporate Law Reform Act*, and the structure for setting of accountings standards was included within the Corporate Law Economic Reform Program (CLERP).[45]

Since the mid 1990s, there have been ongoing policy reviews of, and legislative amendments made to, corporate disclosure regulation. Relevant developments are outlined and discussed throughout the thesis.

The policy rationale discussion is presented under the following sections:

A Periodic disclosure regulation

B Continuous disclosure regulation

C Insider trading regulation

D Disclosure regulation policy rationales conclusion

In September 1989, the Companies and Securities Advisory Committee (CASAC) was established under Part 9 of the *Australian Securities and Investments Commission Act 1989* (Cth)(ASIC Act) to advise the Minister on matters concerning corporations law or improving the efficiency of securities and futures markets. CASAC was superseded by the Corporations and Markets Advisory Committee (CAMAC) with the introduction of the *Financial Services Reform Act 2001.*
A Legal Committee was established in September 1991 to provide expert legal analysis, assessment and advice to CAMAC. The chairman of ASIC is a member of CAMAC and under the ASIC Act, the Treasurer has the power to appoint other part-time members of the Advisory Committee and Legal Committee based on their relevant business, legal or corporate experience.
Section 148 of the ASIC Act empowers CAMAC to undertake reviews on its own initiative or at the request of the Minister.

[43] CASAC, Commonwealth, *Report on an Enhanced Statutory Disclosure System* (September 1991) 1.

[44] Standing Committee on Legal and Constitutional Affairs, House of Representatives, *Corporate Practices and the Rights of Shareholders* (November 1991).

[45] The Australian Accounting Standards Board (AASB) was created under s 226 of the *Australian Securities and Investment Commission Act 1989* (Cth) by amendments enacted in 1999. The AASB is empowered to establish accountings standards under s 334 of the *Corporations Act 2001* (Cth). The AASB also approves statements of accounting concepts as part of the conceptual framework for general purpose financial reporting but these concepts do not have legal status.

A Periodic Disclosure Regulation

The 1991 CASAC report on an enhanced statutory disclosure system argued that 'a comprehensive periodic reporting system would complement and enhance the benefits derived from continuous disclosure.'[46] Enhanced annual reporting requirements were introduced to 'complement the proposed changes to continuous and half-yearly reporting …'[47] The half-yearly reports were introduced to:

- act as a partial summary of, and a checking mechanism on compliance with, the continuous disclosure obligations;
- assist in assessing the longer-term implications of prior disclosure statements;
- promote a more informed assessment of the likely future financial performance of disclosing entities;
- require disclosing entities to disclose various facts which in combination, though not necessarily individually, may be material in assessing the value of their securities; and
- help investors to more accurately compare the performance of various disclosing entities through standardised reporting criteria.[48]

Senator Bolkus indicated in 1992 that

> [t]he 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 judgments on investment decisions, whether made by individual Australians or by large institutional investors … An effective disclosure system will often be a significant inhibition on questionable corporate conduct. Knowledge that such conduct will be quickly exposed to the glare of publicity, as well as criticism by shareholders and the financial press, makes it less likely to occur in the first place … In essence, a well-informed market leads to greater investor confidence and in turn, to a greater willingness to invest in Australian business.[49]

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[46] CASAC, above n 43, 8.
[47] CASAC, above n 43, 8.
[48] CASAC, above n 43, 8.
[49] Commonwealth, Parliamentary Debates, Senate, Second Reading Speech, *Corporate Law Reform Act (No 2) 1992*, Hansard 3581(26 November 1992) (Senator Bolkus, Minister for Administrative Services).

B Continuous Disclosure Regulation

The 1991 CASAC report argued that a statutory based system of continuous disclosure would promote investor confidence in the integrity of Australian capital markets, and would:

1. 'overcome the inability of general market forces to guarantee adequate and timely disclosure by disclosing entities;
2. encourage greater securities research by investors and advisors, thereby ensuring that securities prices more closely, and quickly, reflect underlying economic values;'[50]
3. ensure that capital is allocated efficiently thereby promoting capital market efficiency;
4. assist debtholders in monitoring and managing their financing;
5. provide signals to chargeholders of possible defaults;
6. assist capital providers to evaluate investment alternatives;
7. reduce speculative impacts on security pricing;
8. 'minimize the opportunities for perpetrating insider trading or similar market abuses;
9. improve managerial performance and accountability …
10. encourage the growth of information systems within disclosing entities … and
11. reduce the time and costs involved in preparing takeover and prospectuses documents.'[51]

The Explanatory Memorandum to the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003*[52] stated that

> [i]t is important that all investors should have equal and timely access to price sensitive information released by disclosing entities. Inadequate disclosure has the potential to discourage investor participation in securities markets. This in turn could reduce the liquidity of these markets and hence the efficiency of the price discovery process.[53]

C Insider Trading Regulation

Insider trading was first prohibited in Australia in 1970 when four states enacted a uniform *Securities Industry Act*. In New South Wales, the relevant provision was s 75A of the *Securities Industry Act 1970* (NSW). When a cooperative companies and

[50] CASAC, above n 43, 6.
[51] CASAC, above n 43, 6.
[52] Commonly referred to as CLERP 9.
[53] Explanatory Memorandum to the *Corporation Law Economic Reform Bill (Audit Reform And Corporate Disclosure) Bill* 2003 [4.219].

securities scheme was established in 1980, the main insider trading provision was s 128 of the *Securities Industry Act 1980* (Cth). An insider trading offence under s 128 required a connection between the individual trading and the relevant company. This included a position as an officer of the company, or a professional or commercial relationship with the company.

The insider-trading regime has undergone a series of major reviews since the late 1980s. The Anisman report in 1986 highlighted that insider-trading regulation is generally based on either fiduciary duty or informational advantage principles.[54] It recommended that Australia adopt equality of access to information as the primary rationale for insider trading regulation.[55]

Similarly, in 1989 the Griffiths Committee concluded that use of information, rather than any connection between a person and a corporation, should be the basis for determining insider-trading liability.[56] The report identified the benefits of insider trading regulation as

- equal access to securities information for all investors;
- improved compliance by officers of their fiduciary duties owed to shareholders;
- the promotion of economic efficiency through enhanced market integrity; and
- the minimisation of losses to companies, investors and shareholders.[57]

It emphasised the need to guarantee investor confidence in the integrity of the securities market.[58]

The legislators adopted the recommendations of the Anisman and Griffiths Committee reports. Section 1002G of the *Corporations Law* was enacted in 1991,[59] significantly

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[54] Philip Anisman, *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives* (1986)("Anisman Report") 11.
[55] Anisman, above n 54, 13.
[56] Standing Committee on Legal and Constitutional Affairs, House of Representatives, *Fair Shares for All: Insider Trading in Australia* (1989) ("Griffiths Report")[3.3.5, 4.3.5].
[57] Griffiths Report, above n 56, [3.3.4] 13. The Griffiths Committee rejected the notions that insider trading promotes market efficiency or is a legitimate reward for enterprise.
[58] Griffiths Report, above n 56, [3.3.6]. The Griffiths report states that the object of restrictions on insider trading is to ensure that the securities market operates freely and fairly, with all participants having equal access to relevant information. Investor confidence, and thus the ability of the market to mobilise savings, depends on the prevention of the improper use of confidential information.
[59] A survey by Tomasic and Pentony in the late 1980s concluded that insider trading in Australia was rife: Roman Tomasic, *Casino Capitalism in Australia? Insider Trading in Australia*, Australian Institute of Criminology, Canberra (1991); Roman Tomasic and Brendan Pentony, 'Crime and Opportunity in the Securities Markets: the Case of Insider Trading in Australia' (1989) 3 *Company and Securities Law*

widening the definition of insider trading and removing the need to show a fiduciary link or duty of care.[60]

The 2001 CASAC report on insider trading identified four rationales supporting insider-trading regulation based on fiduciary duty, misappropriation, market fairness, and market efficiency.[61] The fiduciary duty rationale stems from the duties imposed on those in a fiduciary relationship.[62] The misappropriation rationale is described in the report as encompassing and extending the fiduciary duty rationale.[63] A person who possesses price sensitive confidential information may owe a fiduciary duty to the owner of that information. Trading on the information may be a misappropriation of property rights in the confidential information[64] and may result in injury to the relevant company.[65] The report highlights that while directors and company officers may be in a fiduciary relationship with shareholders under corporate law in the United States (US), this is generally not the case in Australia.[66] The market fairness theory is defined in terms of the "unerodable information advantage" approach.[67] Under this approach, the insider trading prohibition does not seek to eliminate the risks or the trading advantages of participants due to superior skill or commitment. The prohibition only applies to trading on price sensitive information that all market participants cannot gain access to by 'ordinary research, skill or analysis.'[68] The market efficiency theory is described in terms that support the regulatory prohibition on insider trading; namely, insider trading may result in delayed disclosure, undermine investor confidence, and reduce the

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Journal 186; Roman Tomasic and Brendan Pentony, 'The Extent Of Insider Trading In Australia: A Socio-Legal Account' (1990) 23 *Australian and New Zealand Journal of Criminology* 125.

60 See *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd (No 2)* (1996) 14 ACLC 1514, 1519, 1522 (Rolfe J). Section 1043A is broadly the same as the prior s 1002G.

61 CASAC, Commonwealth, *Insider Trading Discussion Paper* (June 2001) 13.

62 CASAC, above n 61, 13-14. See also *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134. *Boardman v Phipps* [1967] 2 AC 46; *Green and Clara Pty Ltd v Bestobell Industries Pty Ltd* [1982] 2 Ch 421**;** *Exicom Pty Ltd v Futuris Corporation* (1995) 18 ACSR 404; *Chiarella v United States* 445 US 222 (1980).

63 CASAC, above n 61, 14. See also Carlos Cuevas, 'The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court' (1988) 14 *Journal of Corporation Law* 793.

64 CASAC, above n 61, 14. See also Griffiths Report, above n 56, [3.3.6]; *Chiarella v United States* 445 US 222 (1980); *Carpenter v United States* 484 US 19 (1987); *United States v O'Hagan* 521 US 642 (1997). See Chapter Three for further discussion on insider trading regulation in the United States and the misappropriation theories.

65 CASAC, above n 61, 14.

66 *Percival v Wright* [1902] 2 Ch 421; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134; Cf *Coleman v Myers* [1977] 2 NZLR 255; *Brunninghausen v Glavanics* (1999) 32 ACSR 294. See also Robert Valentine, 'The Director-Shareholder Fiduciary Relationship: Issues And Implications' (2001) 19 *Company and Securities Law Journal* 92.

67 This approach was first developed by Brudney in the United States: Victor Brudney, 'Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws' (1979) 93 *Harvard Law Review* 322, 346. See Chapters Three & Four for further discussion on the Brudney approach.

incentives for market participation with resulting adverse effects on market liquidity and capital supply.[69] The report concludes that the market fairness and efficiency rationales focus on the use of inside information, while the fiduciary duty and misappropriation rationales only apply when the insider has a fiduciary relationship with the relevant company or the owner of the information.[70]

The 2003 Corporations and Markets Advisory Committee (CAMAC) report on the insider trading regime[71] and the March 2007 Position and Consultation Paper (PCP) confirmed that the primary rationales supporting the insider trading regulation are market efficiency and market fairness.[72]

D Disclosure Regulation Policy Rationales Conclusion

Most of the Australian policy documents indicate that market efficiency and market fairness are the primary rationales supporting Australian insider-trading regulation. The market fairness concept emphasised in the insider trading reports and documents is equal access to information that market participants cannot gain access to by ordinary research, skill or analysis. Similarly, the market fairness concept most commonly referred to in the continuous and periodic disclosure reports and commentary is equal access to information to enable well-informed investment decisions. The policy commentary acknowledges that inadequate corporate disclosure, differential access to information, and insider trading may discourage investor participation in capital markets, with potentially negative consequences on market liquidity and efficiency.

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[68] CASAC, above n 61, 15.
[69] CASAC, above n 61, 15.
[70] CASAC, above n 61, 13-15.
[71] CAMAC, Commonwealth, *Insider Trading Report* (November 2003) ii.
[72] Commonwealth, *Insider Trading: Position and Consultation Paper* (March 2007) v.

II PERIODIC DISCLOSURE REGULATION

'When managers want to get across the facts of the business to you, it can be done within the rules of accounting. Unfortunately, when they want to play games, at least in some industries, it can also be done within the rules of accounting. If you can't recognize the difference, you shouldn't be in the equity-picking business.'[73]

To examine the thesis propositions concerning the sufficiency of available information to enable rational well-informed decisions, and the extent to which informational asymmetry exists across the market, it is necessary to understand the disclosure regulation that applies to listed companies in Australia. The most comprehensive company information is provided under the periodic disclosure regime.

The material on periodic disclosure regulation is presented under the following sections:

A Periodic disclosure regulation

B Management discussion and analysis regulation

A Periodic Disclosure Regulation

Australian periodic disclosure regulation as it applies to listed companies includes the statutory obligations under the Act and the reporting requirements under the ASX listing rules. The periodic disclosure rules are presented under the two regimes, with the full year, half year and quarterly reporting obligations outlined for each regime. The discussion in section A is presented under four headings:

1. Periodic disclosure statutory requirements
2. Periodic disclosure ASX listing rules
3. Empirical research on periodic disclosure
4. Periodic disclosure regulation critique and conclusion

1 *Periodic Disclosure Statutory Requirements*

(a) Annual Reports

Listed Australian companies must produce an annual report, including an audited financial report and a directors' report.[74] Listed companies must lodge the annual

[73] Janet Lowe, *Warren Buffett Speaks* (1997) 114.
[74] *Corporations Act 2001* (Cth) ss 295-301.

report with ASIC within three months after the end of the financial year.[75] The full set of reports or a concise report must be sent or available to members by the earlier of 21 days prior to the annual general meeting (AGM) or four months after the end of the year.[76] Electronic dissemination of the reports is now the default option. Shareholders wanting a hard copy of the reports must positively elect this option and notify the relevant company.[77]

The financial report within the annual report includes:

- the financial statements;
- notes to the financial statements; and
- a directors' declaration that the financial statements and notes comply with the accounting standards, give a true and fair view, and there are reasonable grounds to believe the company is solvent.[78]

The financial report must comply with relevant accounting standards,[79] and must give a true and fair view of the company's financial position and performance.[80] The required financial statements for listed companies generally include parent and consolidated profit and loss statements, parent and consolidated balance sheets, and parent and consolidated cashflow statements.[81] The notes within the financial statements must comply with corporate regulation[82] and accounting standards,[83] and must provide any other information necessary to give a true and fair view.[84]

The required general information in the directors' report within the annual report includes:

- a review of operations;

[75] *Corporations Act 2001* (Cth) s 319.
[76] *Corporations Act 2001* (Cth) ss 314-315.
[77] *Corporations Act 2001* (Cth) s 314. Under ss 314(1AA)(1AB), companies must notify their members of the reporting options, including the right to elect to receive a hard copy or an electronic copy of the full or concise version of the annual report. Cost savings arising from the move to electronic dissemination are difficult to estimate but may amount to hundreds of thousands of dollars: Interview with Louise Amos, Executive Manager of Investor Relations, Commonwealth Bank of Australia (CBA) (Telephone Interview, 4 July 2008).
[78] *Corporations Act 2001* (Cth) ss 295, 295A. The declaration is effective on the day it is signed. Accordingly, directors must take events since the end of the financial year into account.
[79] *Corporations Act 2001* (Cth) s 296.
[80] *Corporations Act 2001* (Cth) s 297.
[81] Section 297(b) of the *Corporations Act 2001* (Cth) requires consolidated statements when required under accounting standards.
[82] *Corporations Act 2001* (Cth) s 295(3)(a).
[83] *Corporations Act 2001* (Cth) s 295(3)(b).
[84] *Corporations Act 2001* (Cth) s 295(3)(c).

- details of significant changes to the entity's position;
- details of any matters that have significantly affected or may significantly affect the entities operation or position;
- likely operational developments;
- environmental performance; and
- other information that company members would reasonably require to make an informed assessment of the entity's operations, financial position and future prospects.

Information that may unreasonably prejudice the entity may be omitted. However, the report must indicate if any of the prescribed material is omitted.[85]

The required specific information in the directors' report within the annual report includes:

- dividends or distributions paid to members;
- recommended dividends or distributions;
- details of options granted over unissued shares or interests, unissued shares or interests under option at the date of the report, and shares or interests issued during or since the end of the year resulting from the exercise of options over unissued shares or options; and
- details of entity directors, officers and auditors, including their names and options, shares or interests granted or issued to directors or the five most highly remunerated officers, and indemnities given and insurance premiums paid for officers or auditors.[86]

Listed companies must also include:

- discussion on board policy for determining the nature and amount of remuneration of directors, secretaries, group executives and senior managers, how this remuneration relates to company performance, and details of remuneration and performance conditions;

[85] *Corporations Act 2001* (Cth) ss 298-299, 299A.
[86] *Corporations Act 2001* (Cth) s 300.

- an outline of how company earnings and performance have impacted shareholder wealth over the last five years, including returns from dividends, capital gains and capital returns;[87] and
- information on the director and company secretary qualifications and experience, director responsibilities, board meetings attended, interests in and contracts with the company, details of the auditor service, audit fee and non-audit services, and an auditor independence statement.[88]

(b) Half Year Reports

Mandatory half year reporting for a listed company currently includes an audited financial report and a directors' report.[89] The financial report must include:

- financial statements in accordance with existing accounting standards;
- notes to the financial statements in accordance with existing regulation and accounting standards, including information necessary to give a true and fair view of the financial position and performance of the entity; and
- a directors' declaration on the statements and notes stating whether the financial statements and notes comply with the Act and accounting standards, whether they provide a true and fair view of the position and performance of the entity, and whether the directors reasonably believe that the entity is solvent.[90]

The directors' report must provide a review of the entity's operations and results, the name of directors during the period, a copy of the auditors' report and a declaration, and any additional information required to provide a true and fair view of the company's position and performance.[91] The report must be confirmed by director resolution, dated, and signed.

Companies must lodge the half year report with ASIC within 75 days after the end of the half year.[92] The report may be posted to shareholders, however, listed companies are expected to increasingly rely on online dissemination.

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[87] *Corporations Act 2001* (Cth) s 300A.
[88] *Corporations Act 2001* (Cth ss 300(10)-(15).
[89] *Corporations Act 2001* (Cth) s 302-306.
[90] *Corporations Act 2001* (Cth) ss 303-305.
[91] *Corporations Act 2001* (Cth) s 306. The detailed information and notes provided in the annual reports are not required in the half-year reports.
[92] *Corporations Act 2001* (Cth) s 320.

(c) Quarterly Reports

In 1976, the *Companies and Securities Industry Bill* was introduced into Federal Parliament requiring companies to provide quarterly reports. However, this bill lapsed due to a lack of support. In 1990, the ASX sought submissions on mandatory quarterly reporting, but this proposal also failed to gain support.[93] The CASAC report on an enhanced statutory disclosure system in 1991 indicated that while there was some merit in companies providing quarterly reports, it was not appropriate to make such reporting mandatory.[94] A subsequent CASAC report in 1996 on continuous disclosure found that statutory quarterly reporting was not warranted.[95] In a related survey, 60 percent of respondent companies opposed the introduction of quarterly reporting, citing excessive time and cost involved in the preparation of the reports, feared overload of investor information, and undue investor focus on short-term performance.[96]

Nevertheless, some parties argue that the question of mandatory quarterly reporting in Australia should be reconsidered.[97] For example, Gallery et al suggest that Australian policy makers 'have increasingly relied on the continuous disclosure regime at the expense [of] a more structured reporting framework such as quarterly reporting'.[98]

Listed companies in the US have provided mandatory comprehensive quarterly reports (Form 10-Q) since 1970. In addition, quarterly regimes have been adopted in most developed international markets over the last decade.[99] The quarterly reporting proposals have been generally welcomed by investors, but opposed by the business community. For example, institutional investors in Europe voiced strong support for comprehensive unaudited quarterly reporting including financial statements.[100]

93 ASX June 1991 Paper.
94 CASAC, above n 43, 13, 27.
95 CASAC, Commonwealth, *Report on Continuous Disclosure* (1996) 6, Appendix 3 note 30.
96 CASAC, above n 95, 6.
97 Andrew Main, 'Disclosure Regulations Are Being Ignored: Australian Regulations', *The Australian* (Sydney), 6 Mar 2010; Garry Carnegie, 'Quarterly Reporting has its Merits', *Australian Financial Review* (Sydney), 15 July 2004, 58. See also Gerry Gallery, Natalie Gallery and Carolyn Gilchrist, 'Are Australian Corporate Disclosures "Continuous" or Opportunistic?' (Working Paper, University of New South Wales, University of Sydney, 2002).
98 Gallery et al, above n 97, 25.
99 Including in North America, Europe and Singapore.
100 Chartered Financial Analysts Institute, *European Investment Professionals Back Quarterly Reporting* (20 November 2003) <http://www.cfainstitute.org/aboutus/press/release/03releases/03quarterly_reporting.html> at 13 July 2008.

However, the European Union Parliament rejected this proposal following strong lobbying from business.[101] A compromise position was reached, and since 2007 European Community companies have been required to provide either quarterly reports or management statements.[102] Thus, listed companies in the United Kingdom (UK) that do not report on a quarterly basis must provide interim management statements during the period between the annual and half yearly reports. These statements must provide an outline of the material events and transactions that have taken place during the period and their impact on the financial position, as well as a general description of the financial position and performance of the company.[103] Director liability in relation to these additional periodic disclosures only arises when the reporting is dishonest, misleading or reckless.[104]

2 *Periodic Disclosure ASX Listing Rules*

(a) Preliminary Final Reports

Listed Australian companies must report their full year results to the ASX within two months after the end of the accounting period.[105] A small number of companies report within this timeframe using their audited annual report. However, most listed companies report initially on a preliminary basis, with the annual report released about a month later. Companies must provide the required periodic information to the ASX

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[101] 'For and Against - Cost and Benefit Study Needed' (2003) 12 *Accountancy Age* 12; 'Europe Drops Quarterly Reporting' (2004) 23 *International Financial Law Review* 12; 'Quarterly Reporting System' (2008) 27 *International Financial Law Review* 8. The arguments made in Europe against the introduction of quarterly reporting were similar to those made in Australia, namely cost and undue investor focus on short-term results. Some parties also argued that quarterly reporting in the US had not prevented fraud. Notably, Singapore introduced comprehensive quarterly reporting in 2003/4 despite resistance from the business community: Singapore Stock, *Listing Manual*, Ch 7, 'Continuing Obligations' [7-7].

[102] Directive 2004/109/EC. The European Community Market Abuse and Transparency Directives were implemented in the United Kingdom through new disclosure rules and transparency rules ("DTR") with effect from 20 January 2007. The United Kingdom Listing Authority Listing Rules 9.2.5- 9.2.6B require companies to comply with the disclosure rules and transparency rules.

[103] Financial Services Authority Handbook, *Disclosure and Transparency Rules,* DTR 4.3 requires listed companies that don't report on a quarterly basis to provide interim management statements during the six monthly periods between annual and interim reporting. See Paul Meller, 'Europe Moves to Require Quarterly Financial Reports', *The New York Times* (New York), 27 March 2003. The LSE initially lobbied against mandatory quarterly reports arguing that the requirement for a half-year report and continuous disclosure was sufficient, but withdrew its objections when the European Commission dropped its demand for the report to be audited.

[104] *Financial Services and Markets Act 2000* (UK) s 90.

[105] ASX Listing Rule 4.3B; ASX Guidance Note 14 *Company Announcement Platform* 2.

electronically. This allows the exchange to disclose the information to the market on a timely and reliable basis.[106]

Companies are required to report to the ASX on a preliminary basis in accordance with Appendix 4E.[107] Appendix 4E includes 14 prescribed items. Items 3-5 cover the required financial statements. Item 3 requires a statement of financial performance in compliance with AASB 1018. Item 4 requires a statement of financial position together with notes to the statement. This statement 'may be condensed but must report as line items each significant class of asset, liability, and equity element with appropriate sub-totals'.[108] Item 5 requires a statement of cash flows in compliance with AASB 1026.[109] Companies may report the required content using any format they choose.

Preliminary final reports must comply with all relevant accounting standards. From 2006, these standards are the Australian equivalents of the International Financial Reporting Standards.[110] The content of the preliminary final and annual reports differ, so the extent to which individual accounting standards apply to a preliminary final report is uncertain.[111] The ASX suggests that it is not responsible for monitoring and enforcement of the accounting standards. However, the Australian Accounting Standards Board (AASB) indicates that the preliminary final reports are beyond its jurisdiction.[112]

The ASX must be given a copy of a company's annual report when this differs from the preliminary final report.[113] The annual report requires disclosures on corporate governance policies, and must incorporate more detailed management discussion and analysis and financial notes or explanation than is required in the preliminary final report. Listed companies must also provide the ASX with a corporate governance statement or report at the same time as their annual report, indicating the extent to which the company has followed the ASX Corporate Governance Council best practice

[106] ASX Guidance Note 14 *Company Announcement Platform* 2; ASX Chapter 3 Continuous Disclosure Explanatory Note.
[107] ASX Listing Rule 4.3.
[108] ASX Appendix 4E Item 4.
[109] Foreign entities may satisfy the equivalent foreign accounting standard.
[110] ASX Listing Rules 4.2A3, 4.2B, 4.3A.
[111] ASX Appendix 4E.
[112] Email from Angus Thompson, technical director of the AASB, to Gillian North, 3 September 2004.
[113] ASX Listing Rule 4.7.

recommendations during the reporting period.[114] Where a recommendation has not been followed or has been only partially followed, a company must highlight this and must provide explanation as to why the recommendation was not fully complied with.

(b) Half Year Reports

Under ASX Listing Rule 4.2 listed companies other than listed mining exploration entities must report their half year results in the format of Appendix 4D[115] within two months after the end of the accounting period.[116] Appendix 4D does not mandate a set format for the report but outlines nine items to be included.[117] The half year report must comply with all relevant accounting standards, with the primary standard being AASB 134.[118] In practice, Australian listed companies report to the ASX using the statutory half year report.

(c) Quarterly Reports

Most listed Australian companies are not required to provide quarterly reports under the listing rules. However, some companies voluntarily provide quarterly trading updates.[119] In addition, mining producing entities and mining exploration companies are required to provide specialised quarterly reports under Listing Rules 5.1-5.18. A mining entity must report under Appendix 5A. A mining exploration company must also complete Appendix 5B. Appendix 5A is a report of exploration results. Appendix 5B is a mining entity quarterly cashflow report that informs 'the market how the entity's activities have been financed for the past quarter and the effect on its cash position.' Other entities must provide quarterly cash flow reports in the format of Appendix 4C to show cash adequacy under Listing Rule 4.7B.[120]

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[114] ASX Listing Rule 4.10.3.
[115] ASX Listing Rule 4.2A.3.
[116] ASX Listing Rule 4.2B.
[117] ASX Listing Rule 4.3B.
[118] ASX Listing Rules 4.2, 4.2A.3, 4.3A.
[119] See, eg, Commonwealth Bank of Australia, *Third Quarter Update- Press Release* (15 May 2005) ASX <http://www.asx.com.au/asx/statistics/announcementSearch.do?method=searchByCode&issuerCode=cba&timeFrameSearchType=D&releasedDuringCode=> at 4 July 2008;
Leighton Holdings Limited, *Quarterly Update November 2007* (4 December 2007) ASX <http://www.asx.com.au/asx/statistics/announcementSearch.do?method=searchByCode&issuerCode=lei&timeFrameSearchType=Y&year=2007 > at 6 July 208. Interview with Louise Amos, Executive Manager of Investor Relations, Commonwealth Bank (Telephone interview, 4 July 2008). Louise indicated that the marginal cost to provide this quarterly trading update is minimal.
[120] ASX Listing Rule 4.7B. Companies are required to report under Listing Rule 4.7B(d) when required to comply with Listing Rule 1.3.2(b), or when the ASX requests a cash flow statement. ASX Listing Rule 1.3.2(b) applies the assets test such that when half or more of the company's total tangible assets

Appendices 5A, 5B and 4C are intended to provide reassurance to investors that the companies have enough cash to continue their business development or exploration. However, the information provided in the Appendices is significantly more limited than that required in comprehensive quarterly reports in the US.

3 *Empirical Research on Periodic Disclosure*

'You can't fool the market all the time. If you don't have [results underpinning the share price]… you will get caught out'.[121]

There are many empirical studies examining the impact of earnings announcements and other factors on stock returns. This research is valuable for an understanding of the operation and drivers of capital markets. The outlined studies are relevant to the thesis because they provide compelling evidence on the links between company earnings and share price movements, and the importance of timely disclosure to investor returns.

(a) Result Announcements

Seminal research by Brown and Ball in the 1960s found that the market anticipated company earnings throughout an entire year.[122] By the time the actual profit was announced, about 85 percent of the adjustment was incorporated within the share price, and by the time the annual report was released, the share price fully reflected its content.[123] These findings have been confirmed in subsequent studies. An updated study found a pattern of adjusting share prices over the year, with a strong correlation between annual stock returns and income changes.[124]

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are cash or in a cash equivalent form, the company must provide business objectives and a plan for use of the cash.

[121] David Uren, *The Transparent Corporation* (2003) 196 citing Professor Philip Brown.

[122] Ray Ball and Philip Brown, 'An Empirical Evaluation of Accounting Income Numbers' (1968) 6 *Journal of Accounting Research* 159, 176.

[123] Ball et al, above n 122, 176. See also William Beaver, 'The Information Content of Annual Earnings Announcements' (1968) 6 *Journal of Accounting Research* 67; William Beaver, Richard Lambert and Dale Morse, 'The Information Content of Security Prices' (1980) 2 *Journal of Accounting and Economics* 3; Dale Morse, 'Price and Trading Volume Reaction Surrounding Earnings Announcements: A Closer Examination' (1981) 19 *Journal of Accounting Research* 374.

[124] Nichols et al, above n 20, 263, 265. See also Stewart Brown, 'Earnings Changes, Stock Prices, and Market Efficiency' (1978) 33 *Journal of Finance* 17, 27.

A Brown study in the 1970s found the Australian market also anticipated earnings,[125] and more recent international research confirms that price to earnings responses in the Australian market are similar to those in the US.[126] In the 1990s, Aitken et al found that most of the stock price adjustments from earnings announcements for both large and small stocks were impounded within 15 minutes.[127] The authors suggested some leakage or anticipation of earnings. 'Good news [was] associated with significant buying activity approximately 2 hours prior to and 1 hour following the announcement, and bad news [was] associated with significant selling activity for the first two hours after the earnings announcement.'[128] In 1996, Brown et al found evidence suggesting that the mean level of anticipation in share prices prior to the release of half year and preliminary final reports was 51.8 percent in the pre-enhanced disclosure period compared to 48.6 percent in the post-enhanced disclosure period.[129]

(b) Company Reports

In the US, Foster et al found that the 10K preliminary final report provided incremental information content and resulted in price response. However, there was no incremental information content in the annual report and no price response to its release.[130] Similarly, Cready and Mynatt found no evidence of price response and little volume response to the release of annual reports of listed companies on the New York Stock Exchange.[131] This evidence is consistent with the ASX practice of tagging the preliminary report releases (but not the annual reports) as price sensitive.

In 2003, the Association for Investment Management and Research surveyed investment professionals, including portfolio managers, research analysts, financial

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[125] Philip Brown, 'The Impact of the Annual Net Profit Report on the Stock Market' (1970) 60 *Australian Accountant* 277. See also Wendy Beekes and Philip Brown, 'On the Timeliness of Price Discovery' (Working Paper, University of New South Wales, Lancaster University, October 2006).

[126] Andrew Alford, Jennifer Jones, Richard Leftwich and Mark Zmijewski, 'The Relative Informativeness of Accounting Disclosures in Different Countries' (1993) 31 *Journal of Accounting Research* 183.

[127] Michael Aitken, Philip Brown, Alex Frino and Terry Walter, 'Price Reaction and Order Imbalance Surrounding Earnings Announcements' (1995) *ASX Perspective* 85, 85.

[128] Aitken et al, above n 127, 89.

[129] Philip Brown, Stephen Taylor and Terry Walter, 'The Effect of the Enhanced Disclosure Regime on the Efficiency of the Australian Share Market' (Working Paper, Securities Industry Research Centre of Asia Pacific, May 1996) 6.

[130] Taylor Foster and Don Vickrey, 'The Incremental Information Content of the 10-K' (1978) 53 *Accounting Review* 921, 931; Taylor Foster, D Randall Jenkins and Don Vickrey, 'The Incremental Information Content of the Annual Report' (1986) 16 *Accounting and Business Research* 91, 98.

[131] William Cready and Patricia Mynatt, 'The Information Content of Annual Reports: A Price and Trading Response Analysis' (1991) 66 *Accounting Review* 291, 292.

advisors and investment company chief executive officers (CEO) on the introduction of quarterly reporting in Europe. A total of 89 percent of the European investment professionals and 85 percent of the UK respondents indicated that mandatory comprehensive quarterly reporting, defined as un-audited financial statements with supporting notes and assumptions, would improve the quality of financial information to investors.[132] In contrast, only 26 percent of those surveyed saw the management statement option as a significant improvement.

4 *Periodic Disclosure Regulation Critique and Conclusion*

Mandatory periodic disclosure reporting by Australian listed companies includes an online audited half year report within two months of the end of a half-year, an online preliminary final report within two months of the end of the financial year, and an audited annual report within four months of the end of the financial year. Sections 206-301 of the Act and Chapter 4 of the ASX listing rules mandate the content of the annual report. The content required in the half year report is outlined in ss 302-306 of the Act and Appendix 4D of ASX Listing Rules 4.2A.3 and 4.3B.

By contrast, the content of the preliminary final report is governed solely by Appendix 4E of ASX Listing Rule 4.3. The scope of Item 4 of Appendix 4E of Listing Rule 4.3 and the applicability of specific accounting standards are unclear. For example, AASB 133 requires the presentation of the numerators and denominators used in the basic and diluted earnings per share (EPS) calculations and AASB 101 requires an entity to disclose the number of shares issued for each class of share capital. However, some listed companies consistently fail to provide the period end or weighted average number of shares within their half year or preliminary final reports, making accurate calculations of EPS and diluted EPS difficult.[133] The ambiguities in the periodic disclosure listing rules are reflected in the thesis empirical study outlined in Chapter Five, which found significant variability in the content and informativeness of the preliminary final reports.[134]

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[132] Chartered Financial Analysts Institute, above n 100.
[133] I suggest in Chapter Five that diluted EPS is the best indicator of a company's performance because it includes all forms of dilution.
[134] See Chapter Five.

In Australia, the annual reports of most listed companies are generally provided a month after the release of the preliminary final report. International empirical research suggests there is minimal price response to the release of annual reports due to the delay in publication. However, the preliminary final report is price informative to the extent that the released earnings result has not already been impounded into the relevant security price, either through analysis of generally available information or advance private disclosure. The global research accords with the ASX practice of tagging the announcements of preliminary final reports as price sensitive on the ASX website, but not the annual report releases. The empirical studies suggest the component of the earnings announcements not anticipated in the security price by the time the preliminary final reports are released may allow abnormal profits, but generally only for the first few hours, and predominantly in the first 15 minutes of trading.

B Management Discussion and Analysis Regulation

A company's 'financial results provide only a limited indication of the health and worth of the company. There is a wealth of additional information that both managers and investors turn to when valuing a company and determining how well it is managed'[135]

The information that Australian listed companies provide to the market under the mandatory periodic and continuous disclosure regimes, and on a voluntary basis, includes quantitative and qualitative information. The qualitative information is commonly referred to as MD&A. MD&A is, as the terms suggest, discussion and analysis by company management about the past, current and prospective position or outlook of the company. Australian managers provide MD&A through mandatory reporting, ASX announcements, and public and private company briefings.

MD&A is an 'integral component of financial reporting, [and] an essential companion to the financial statements.'[136] MD&A includes explanation and interpretation of the publicly announced results and financial reports, as well as explanation and commentary on non-financial or qualitative issues such as strategy, growth opportunities, industry trends and issues, competitive advantages, business risks, and

[135] Michael Guttentag, 'An Argument for Imposing Disclosure Requirements on Public Companies' (2004) 32 *Florida State University Law Review* 123, 171.
[136] Canadian Chartered Accountants of Canada (CICA), *Building a Better MD&A, A Guide for Smaller Issuers* (November 2007) 1.

financial parameters and targets. The purpose of MD&A is to allow investors to see the company through the 'eyes of management.'[137]

This section presents the discussion on MD&A under four categories;

1. MD&A reporting in Australia
2. MD&A reporting internationally
3. Empirical research on MD&A
4. MD&A critique and a conclusion

1 *Management Discussion and Analysis Reporting in Australia*

(a) MD&A in Annual Reports

Mandatory MD&A reporting by listed Australian companies in the annual report is generally confined to the information required under ss 298-300A. As already outlined, s 299 requires the directors' report to include:

- a review of operations;
- details of significant changes to the entity's position;
- details of any matters that have significantly affected or may significantly affect the entities operation or position;
- likely operational developments;
- environmental performance; and
- other information that company members would reasonably require to make an informed assessment of the entity's operations, financial position and future prospects.

In 2003, the HIH Royal Commission recommended the mandatory inclusion of an operating and financial review within annual reports.[138] Section 299A was subsequently introduced under the *CLERP 9 Act 2004* (Cth). Under s 299A, the directors' report must contain information that shareholders would reasonably require for an informed assessment of the company's financial position, its operations, its business strategies, and its prospects for future financial years.

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[137] Regulation S-K Item 303 ('Management's Discussion and Analysis of Financial Condition and Results of Operations').

ASX Listing Rule 4.10.17 requires entities to provide a review of operations and activities within their annual report.[139] This rule is broadly equivalent to ss 299 and 299A. The ASX also reproduces the Group of 100 Incorporated 'Guide to the Review of Operations and Financial Conditions' as an attachment to ASX Guidance Note 10.[140] The ASX suggests that companies may wish to consult this Guide in complying with Listing Rule 4.10.17. The Group of 100 Guide indicates that the best practice minimum threshold for the provision of narrative information within the annual report includes company disclosures on strategy, a review of operations, investments for future performance, a review of financial conditions, risk management and corporate governance.

(b) MD&A in Preliminary Final Reports

MD&A in Australian preliminary final reports must provide sufficient commentary on the results 'for the user to be able to compare the information presented with equivalent information for previous periods'.[141] The commentary must include 'any significant information needed by an investor to make an informed assessment of the entity's activities and results' in relation to: the earnings per security and dilution, returns to shareholders including distributions and buy backs, operating performance, segmental results, performance trends, and other factors that affected the results.[142]

(c) MD&A in Half Year Reports

The required MD&A in Australian half-year reports is even more limited. Section 306 requires a directors' report, but this report is restricted to a review of the entity's operation during the half year period, the results of these operations, and the name of the entity's directors.

2 *Management Discussion and Analysis Reporting Internationally*

Non-financial disclosures such as MD&A have been recognized as an important component of company reporting in the US for many years. In its 1974 Guides, the US

[138] Commonwealth, above n 33, Recommendation 13.
[139] ASX Listing Rule 4.10.3; ASX Guidance Note 9 *Disclosure of Corporate Governance Practices:* Listing Rule 4.10.
[140] ASX Guidance Note 10 *Review of Operations and Activities:* ASX Listing Rule 4.10.17.
[141] ASX Appendix 4E, 2.
[142] ASX Appendix 4E, 2-3.

Securities Exchange Commission (SEC) indicates that MD&A 'is necessary to enable investors to compare periodic results of operations and to assess the source and probability of recurrence of earnings (losses).'[143] The financial statements alone are often insufficient for an investor to judge the quality of earnings and the likelihood that past performance is indicative of future performance. MD&A is required to provide

> a narrative explanation of companies' financial statements; … to provide the context within which financial statements should be analyzed; and to provide information about the quality … and potential variability of a company's earnings and cashflow.[144]

The SEC suggests that the aim of MD&A reporting is to level the informational playing field by giving market participants an opportunity to look at a company 'through the eyes of management by providing an historical and prospective analysis.'[145]

Item 303 of Regulation S-K requires listed companies in the US to include extensive MD&A in their quarterly and full year reports.[146] Disclosures on critical accounting policies are mandatory.[147] Listed US companies must also provide information on liquidity, capital resources,[148] operational results,[149] off-balance sheet arrangements,[150] and contractual obligations. Forward-looking disclosures are required for 'known

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143 Securities Act Release No 5520, 39 Fed Reg 31,894 (3 Sept 1974) 31,895. See also John Poole, 'Improving the Reliability of Management Forecasts' (1989) 14 *Journal of Corporation Law* 547, 635; Joel Seligman, 'The SEC's Unfinished Soft Information Revolution' (1995) 63 *Fordham Law Review* 1953, 1968.

144 United States Securities and Exchange Commission (SEC), Securities Release 33-8098, (10 May 2002) International Series Release No 1258, Proposed Rule: *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies.*

145 Regulation S-K Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (2005).

146 Regulation S-K Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (2005); SEC, Securities Release 33-8350 (29 December 2003) Financial Reporting Release 72, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Conditions and Results of Operations.*

147 SEC, Securities Act Release 33-8040 (12 December 2001) Financial Reporting Release No 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Polices.* The SEC indicates that companies need to describe their critical accounting policies, the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

148 SEC, Securities Act Release 33-8056 (22 January 2002) Financial Reporting Release 61, *Disclosure Relating to Liquidity and Capital Resources, Off-Balance Sheet Arrangements, Trading Activities and Related Party Transactions.*

149 SEC, Securities Act Release No 33-6835 (18 May 1989) Financial Reporting Release No 36, Final Rule: *Disclosure in Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures.*

trends, demands, commitments, events or uncertainties' in relation to these matters.[151] Other forward-looking statements are also encouraged on a voluntary basis.[152]

In the US, the full year reports (Form 10-Ks) are formatted in three parts under standard item headings. Part I includes an overview including a description of the business and an outline of any legal proceedings. Part II presents the financial statements, notes, management discussion and analysis on the results, quantitative and qualitative disclosures about market risk, an outline of controls and procedures, and any changes or disagreement with the accountants in relation to disclosure. Part III covers the director, executive and professional advisor matters.[153] The quarterly reports (Form 10Qs) are formatted in two parts; part one contains the financial information and part two, other information. The financial information includes condensed financial statements, MD&A on the financial conditions and results, and disclosures on market risks.[154]

The SEC regularly monitors and enforces the MD&A standards.[155] It also provides companies with guidance on disclosures that satisfy the MD&A objectives. The SEC indicates that the capital markets could reach a higher level of efficiency and investor confidence if companies provided 'high-quality, more insightful financial information'.[156] It suggests that companies focus on and identify and address those key variables and other qualitative and quantitative factors that are peculiar to and

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[150] SEC, Securities Act Release No 33-8182 (28 January 2003) Financial Reporting Release No 67, Final Rule: *Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations.*

[151] Cathy Cole and Christopher Jones**,** 'Management Discussion and Analysis: A Review and Implications for Future Research' (2005) 24 *Journal of Accounting Literature* 135, 138-139.

[152] Cole et al, above n 151, 138-139.

[153] See, eg, Oracle Corporation, *Form 10-K For the Fiscal Year Ended May 31 2008*, United States Securities Exchange Commission (SEC) <http://www.sec.gov/Archives/edgar/data/1341439/000095013408012257/f41477e10vk.htm> at 11 July 2008.

[154] See, eg, Oracle Corporation, *Form 10-Q For the Quarterly Period Ended February 29, 2008*, SEC <http://www.sec.gov/Archives/edgar/data/1341439/000089161808000197/f38202e10vq.htm,> at 11 July 2008.

[155] See, eg, *In the Matter of Sony Corporation and Sumio Sano:* Release No. 40305 (5 August 1998) SEC < http://www.sec.gov/litigation/admin/3440305.txt> at 12 July 2008; *In the Matter of Bank of Boston Corporation,* Administrative Proceeding File No. 3-8270 1995, SEC < http://www.sec.gov/litigation/aljdec/id81bpm.txt> at 12 July 2008. See also Orie Barron, Charles Kile and Terrence O'Keefe, 'MD&A Quality and Analysts' Earnings Forecasts' (1999) 16 *Contemporary Accounting Research* 75; Peter Clarkson, Jennifer Kao and Gordon Richardson, 'The Voluntary Inclusion of Forecasts in the MD&A Section of Annual Reports' (1994) 11 *Contemporary Accounting Research* 423.

necessary for an understanding and evaluation of the individual company.[157] The SEC highlights the need for clear language and presentation with an emphasis on material information.[158] It advises that disclosures must address known material events and uncertainties. There must be genuine analysis of key material items and not simply discussion or boilerplate explanation.[159]

The rest of the world is increasingly recognizing MD&A as an integral part of corporate reporting.[160] For example, in the UK, the annual, preliminary final, half-yearly and quarterly reports must at a minimum include an outline of the important events and the impact on the financial results, with a description of the principal risks and uncertainties.[161] Regulators and expert commentators emphasise the need for tailored reports that focus on material issues and communicate the results effectively rather than mechanically produced reports with long disclosures of immaterial matters.[162]

3 *Empirical Research on MD&A*

Empirical studies confirm the importance of MD&A to the assessment of a company's prospects and future earnings. A study by the American Association for Investment Management and Research reported that investment professional and financial

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[156] SEC, above n 144.
[157] Regulation S-K Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (2005).
[158] Regulation S-K Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (2005).
[159] Regulation S-K Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (2005).
[160] See, eg, International Accounting Standards Board, *Exposure Draft: An Improved Conceptual Framework for Financial Reporting* (2008); CICA, *Building a Better MD&A, Risk Disclosure* (March 2008); CICA, above n 136; CICA, *CFO Beyond-GAAP Briefing: Forward-Looking Information* (May 2008); CICA, *MD&A Guidance on Preparation And Disclosure* (July 2009)**.** The CICA emphasise six general principles for MD&A disclosures: through the eyes of management; integration with financial statements; completeness and materiality; forward-looking orientation; strategic perspective; and usefulness.
[161] Financial Services Authority Handbook, *Disclosure and Transparency Rules,* DTR 4.1.8, 4.2.5, 4.2.7.
[162] Arthur Radin, 'Have We Created Financial Statement Overload?' (2007) 77 *CPA Journal* 6; David Jutuah, 'Box Ticking Isn't Enough for Investors, warns PwC' (September 27, 2007) *Accountancy Age* 8; Carol Baker, 'Company Report- Written to Order' (2008) 29 *Credit Control* 6. A PricewaterhouseCoopers survey in 2007 of the FTSE 350 companies found that 75% communicated key performance indicators and also clearly set out their principal risks and uncertainties within the enhanced business review. However, only 35% of companies provided strategic statements with qualitative or quantitative targets. A Deloitte survey of company reports found that while annual reports had got longer, individuality had lost out to uniformity. The study authors' suggested that company disclosures should be broken up into small chucks aimed at specific users.

statement users ‘wanted companies to disclose more internal management information’.[163] A study by the American Institute of Certified Public Accountants concluded that ‘the information that investors consider most useful in valuing a company’s securities is essentially the same as the information that managers use within the firm’.[164] Similarly, a research project by the Financial Accounting Standards Board reported that ‘users value disclosure of non-financial information’ and ‘sophisticated investors want access to the business operating information generated and used within the firm’.[165]

Scholarly studies confirm these views. Bryan found that MD&A disclosures, particularly prospective disclosures, assist in assessing company’s future prospects over the following year.[166] Clarkson, Kao and Richardson suggested that while MD&A is an important source of information to analysts covering companies listed on the Toronto Stock Exchange, there was considerable variation in the MD&A disclosure quality across firms.[167] Vanstraelen et al found that continental European companies that provided higher levels of forward-looking non financial disclosures were associated with lower dispersion and higher accuracy in analyst’s earnings forecasts.[168] Similarly, Fox et al suggested that share prices in the US are more informed as a result of enhanced MD&A disclosure requirements.[169]

A study by PricewaterhouseCoopers of Australian institutional and broking analysts found that analysts were relatively satisfied with core financial disclosures. However, there was insufficient disclosure of more qualitative issues.[170] Another Australian study on the important factors used in making investment decisions indicated that institutional *and* retail investors emphasise the importance of qualitative factors such as

[163] Guttentag, above n 135, 173 citing a study entitled *Financial Reporting in the 1990’s and Beyond.*
[164] Guttentag, above n 135, 173.
[165] Clarkson et al, above n 155.
[166] Stephen Bryan, ‘Incremental Information Content of Required Disclosures Contained in Management Discussion and Analysis’ (1997) 72 *Accounting Review* 285, 285, 298.
[167] Clarkson et al, above n 155, 116, 130-131.
[168] Ann Vanstraelen, Marilyn Zareski and Sean Robb, ‘Corporate Nonfinancial Disclosure Practices and Financial Analyst Forecast Ability Across Three European Countries’ (2003) 14 *Journal of International Financial Management and Accounting* 249.
[169] Merritt Fox, Randall Morck, Bernard Yeung and Artyom Durnev, ‘Law, Share Price Accuracy, and Economic Performance: The New Evidence’ (2003) 102 *Michigan Law Review* 331, 368-379.
[170] Uren, above n 121, 85-86.

'growth prospects, confidence in the CEO, management's ability to make sound acquisition and divestment decisions and confidence in the board'.[171]

4 *MD&A Critique and Conclusion*

Timely disclosure of information about the financial position and prospect of companies is necessary for all Australians to make informed judgments on investment decisions.[172] Empirical studies consistently indicate that investors consider MD&A or qualitative management information such as growth prospects to be valuable information in assessing the sustainable earnings or returns of a company.[173] As Guttentag highlights,

> [a] company's financial results provide only a limited indication of the health and worth of the company. There is a wealth of additional information that both managers and investors turn to when valuing a company and determining how well it is managed.[174]

The directors' and chief executive reports in Australian annual reports generally provide some, but not all, of the MD&A included in the reports in the US. In addition, most half year and preliminary final reports include only condensed notes to the financial statements and limited MD&A. The thesis empirical study outlined in Chapter Five found that some periodic reports contained very little discussion, analysis or explanation of either financial or non-financial matters. As outlined more fully in Chapter Six, improved MD&A in company reports and disclosures is needed to enable more informed decision-making, to close the information gap between institutional and retail investors, and to reduce the opportunity for selective disclosure.

While some parties may argue that the 10-K and 10Q reports in the US are too prescriptive, their standardised formats have significant advantages.[175] The prescribed format requires companies to address all of the mandated sections, including commentary on the recurring and non-recurring elements of the reported result.[176]

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171 Uren, above n 121, 122-123.
172 Commonwealth, above n 49.
173 Barron et al, above n 155, 78; Guttentag, above n 135, 171.
174 Guttentag, above n 135, 171, 175.
175 See SEC, *SEC Filings And Forms (EDGAR)* <http://www.sec.gov/edgar.shtml> at 8 July 2008.
176 SEC, Securities Act Release 33-8039 (4 December 2001) Financial Reporting Release 59, *Cautionary Advice Regarding the Use of "Pro-Forma" Financial Information in Earnings Releases.*

III CONTINUOUS DISCLOSURE REGULATION

The continuous disclosure obligations in Australia are intended to enhance the periodic reporting regime by requiring companies to keep investors informed of any materially price-sensitive information between reporting periods. The 'continuous disclosure framework is founded on the principle that all investors have equal and timely access to material information which is relevant to the taking of investment decisions.'[177] The primary continuous disclosure obligation applying to listed companies is ASX Listing Rule 3.1. Listing Rule 3.1 was strengthened by the introduction of supporting statutory provisions in 1994.

The material on continuous disclosure regulation is presented under the following sections:

A Continuous disclosure ASX listing rules

B Continuous disclosure statutory regime

A Continuous Disclosure ASX Listing Rules

1 *ASX Listing Rule 3.1*

Under ASX Listing Rule 3.1, a listed Australian company must keep its security holders fully informed of any price sensitive information immediately it becomes aware of such information.[178] Unless an exception applies, a listed company that

> is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the … securities, the … [company] must immediately tell ASX that information.[179]

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[177] ASX, Guidance Note 8 *Continuous Disclosure Listing Rule 3.1* (June 2005) 11. See also ASIC, "*Heard It On The Grapevine…" Draft ASIC Guidance And Discussion Paper. Disclosure Of Information To Investors And Compliance With Continuous Disclosure And Insider Trading Provisions* (November 1999) 4, 7; Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth, CLERP (Audit Reform and Corporate Disclosure) Bill 2003 *PART 1 Enforcement, Executive Remuneration, Continuous Disclosure, Shareholder Participation And Related Matters* (2004) 103; Commonwealth, Department of Treasury, *Corporate Disclosure: Strengthening The Financial Reporting Framework* (2002) 130.

[178] ASX Listing Rule 3.1; *Corporations Act 2001* (Cth) s 674. Unlisted public companies and large proprietary companies in Australia may also be subject to continuous disclosure as "disclosing entities": *Corporations Act 2001* (Cth) ss 675(1), 675(2)(a), 111AP, Pt 1.2A, Div 2. However, the scope of the thesis is restricted to listed companies and entities.

[179] ASX Listing Rule 3.1.

A company must also disclose the necessary information to the ASX to correct, or prevent, a false market in its securities.[180] This obligation arises when there is a 'reasonably specific rumour or media comment'[181] that is likely to have an impact on the security price.[182] However, an exception to ASX Listing Rule 3.1 may arise [i] when 'a reasonable person would not expect the information to be disclosed; [ii] the information is confidential … ; and [iii] one of more of the following applies:

- It would be a breach of a 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 internal management purposes of the entity.
- The information is a trade secret.[183]

The exception only applies when all three limbs have been satisfied. In addition, the information must be confidential as a matter of fact.[184] Confidentiality may be lost if the relevant information, or part of it, becomes known either selectively or generally, whether inadvertently, or deliberately.[185] Disclosure is required when confidentiality is breached, speculation is accurate, or share price movements indicate a breach of confidentiality.[186] If it is inappropriate for a company to disclose certain information immediately or the company is concerned that confidential information has been, or may be, leaked, the company may request a trading halt in its securities for up to two days.[187] If it is still inappropriate to release the information at the end of the two days, the company can request a voluntary suspension in the trading of its securities for an indefinite period.[188]

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[180] ASX Listing Rule 3.1B.
[181] ASX Listing Rule 3.1B Note.
[182] ASX Listing Rule 3.1B Note.
[183] ASX Listing Rule 3.1A.
[184] ASX, above n 177, 25-28.
[185] ASX Listing Rule 3.1A.3 notes.
[186] ASX, above n 177, 26.
[187] ASX Listing Rule 16.4.2(a)(ii); ASX Guidance Note 16*: Trading Halts No 7;* ASX, above n 177, Nos 53, 54.
[188] ASX Listing Rule 16.4.2(a)(ii); ASX Guidance Note 16*: Trading Halts* No 14.

2 *ASX Guidance on Listing Rule 3.1*

The continuous disclosure obligation under ASX Listing Rule 3.1 involves interpretative issues. ASX Guidance Note 8 to ASX Listing Rule 3.1 provides guidance on what constitutes notifiable information, when a company becomes aware of information, what immediate notification means, and what information is likely to be sufficiently material to require disclosure under ASX Listing Rule 3.1. Guidance Note 8 states that Listing Rule 3.1 applies even when the relevant information may be otherwise generally available.[189] It advises that a listed company "becomes aware" of information '[when] … a director or executive officer … has, or ought reasonably to have, come into possession of the information in the course of the performance of their duties'.[190] Notification of information to the ASX cannot be delayed pending a formal sign off or decision by the company board.[191]

Guidance Note 8 indicates that a variation in expected earnings in excess of 10 to 15 percent in comparison with a previously released earnings forecast or a previous corresponding period will generally be considered material.[192] Other examples of information that Note 8 indicates generally require disclosure under the ASX Listing Rule 3.1 include: a transaction for which the consideration payable or receivable is 5 percent or more of the value of the company's consolidated assets; a recommendation or declaration of a dividend or distribution; information about the beneficial ownership of securities; or a notice of intention to make a takeover.[193] However, the final decision on what is material remains with the company.[194]

The empirical study outlined in Chapter Five uses the Note 8 guidance on disclosure of earnings expectations[195] as a basis to examine the efficacy of the continuous disclosure regime.

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[189] ASX, above n 177, 5.
[190] ASX, above n 177, 4. See also *Corporations Act 2001* (Cth) s 1042G.
[191] ASX, above n 177.
[192] ASX, above n 177, 19.
[193] ASX, above n 177, 19.
[194] David Barnett, General Manger Issuers Department ASX Limited, 'Continuous Disclosure: Key Issues for Companies and their Advisors' (Speech delivered at the Centre for Corporate Law and Securities Regulation of University of Melbourne Seminar, Sydney, 16 July 2008).
[195] ASX, above n 177, 19.

3 *Other Continuous Disclosure Listing Rules*

ASX Listing Rules 3.2 to 3.19 require specific information to be continuously disclosed. For instance, ASX Listing Rule 3.19A.2 requires directors of listed companies to notify changes in interests in the company's securities within five business days. Companies are required to put arrangements in place to enforce their directors' compliance with ASX Listing Rule 3.19A.[196]

B Continuous Disclosure Statutory Regime

1 *Continuous Disclosure Provisions*

A statutory continuous disclosure regime was introduced in September 1994 to reinforce the ASX listing rule obligations.[197] The statutory provisions are in Chapter 6CA of the Act. The main provision in relation to listed companies is s 674, which applies when a listing rule requiring notification of information to the market operator is breached, the undisclosed information is materially price-sensitive,[198] but not 'generally available',[199] and the *mens rea* element is satisfied. The "generally available" and materiality elements are outlined and discussed further in Chapter Four.

No fault element is specified for an offence under s 674, so a default element of either intent or recklessness may apply under s 5.6 of the *Criminal Code Act 1995* (Cth). In addition, a negligent failure to disclose under s 674(2) may result in a pecuniary penalty or compensation order.

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[196] Directors are required to notify changes in their interests in securities of the company within 14 days under s 205G of the *Corporations Act 2001* (Cth). Sections 205G(1),(3) & (4) are strict liability offences. In addition, company directors are prohibited from trading on information that is not publicly available under s 1043A of the *Corporations Act 2001* (Cth) s 1043A, or from using information gained in their capacity as directors and executives to their own advantage under s 1042G of the *Corporations Act 2001* (Cth). In March 2007 the government announced that it accepted a CASAC recommendation and proposal to reduce the notification period to two business days in line with regulation in the US: Commonwealth, above n 72, 25. However, no legislative amendments have been made to date.

[197] *Jubilee Mines NL v Riley* [2009] WASCA 62 [55].

[198] *Corporations Act 2001* (Cth) ss 674(2)(c)(ii), 677.

[199] *Corporations Act 2001* (Cth) ss 674(2)(c)(i), 676.

2 *Continuous Disclosure Liabilities, Penalties and Remedies*

ASIC has a range of continuous disclosure related enforcement powers and options.[200] A failure to comply with the statutory continuous disclosure provisions may be an offence[201] or subject to civil proceedings[202] including the infringement notice process for minor offences.[203] ASIC may also seek an injunction[204] or enforceable undertaking,[205] or may initiate a public interest proceeding.[206]

In 2002, the continuous disclosure provisions were included within the civil penalty regime in the Act.[207] Section 674(2) is a financial services civil penalty provision,[208] allowing the court to make a 'declaration of contravention, a pecuniary penalty order or a compensation order'.[209] In 2004, an infringement notice procedure was introduced for relatively minor breaches of continuous disclosure law,[210] and the maximum penalty for a corporate breach of the financial services civil penalty provisions was increased to $1 million.[211] A person that is 'involved'[212] in a contravention of s 674(2) may also be liable to criminal or civil penalties.[213]

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200 When the statutory continuous disclosure regime was introduced in 1994, the only enforcement option available to ASIC was litigation seeking criminal sanctions.
201 *Corporations Act 2001* (Cth) ss 674 Note 1, 678, 1311(1).
202 *Corporations Act 2001* (Cth) ss 674 Note 2, 1317E, 1317S.
203 *Corporations Act 2001* (Cth) ss 674 Note 3, 1317DAC.
204 *Corporations Act 2001* (Cth) s 1324.
205 *Australian Securities and Investments Commission Act 2001* (Cth) s 93AA. In 1996, ASIC argued in its submission to a CASAC review of continuous disclosure regulation that the availability of enforcement options other than litigation would encourage compliance with the continuous disclosure. In response, CASAC recommended that ASIC should have the power to demand enforceable undertakings. Section 93AA was introduced in July 1998. Section 93AA allows ASIC to accept a written undertaking on any matter within the ambit of its functions and powers. There is considerable flexibility in the drafting of such undertakings and there is no limit to the civil penalty that may imposed. ASIC can enforce compliance with the undertaking by seeking a court order. See Chapter Four for an outline of agreed enforceable undertakings relating to continuous disclosure.
206 *Australian Securities and Investments Commission Act 2001* (Cth) s 50.
207 *Corporations Act 2001* (Cth) ss 674 Note 2, 675 Note 2, 1317E(1)(ja).
208 *Corporations Act 2001* (Cth) ss 1317DA, 1317E(1)(ja).
209 *Corporations Act 2001* (Cth) ss 674(2) Note 2, 1317E(1)(ja),1317G(1A), 1317HA, 1317J, 1317S, 1318, 1325, 1041H. A declaration, a pecuniary penalty or a compensation order under s 1317E may be sought by ASIC: s 1317J(1), or by the corporation: s 1317J(2). Further, any other person who suffers damage in relation to a contravention … of a financial services civil penalty provision may apply for a compensation order under s 1317HA: s 1317J(3A). An application for a compensation order may be made whether or not a declaration has been under s 1317E: s 1317J(3A). Relief from liability for contravention of a civil penalty provision may be granted under ss 1317S and 1318. Remedies may be sought under s 1041H for misleading and deceptive conduct.
210 *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth); *Corporations Act 2001* (Cth) Pt 9.4AA ss 1317DAA-1317DAJ.
211 *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth); *Corporations Act 2001* (Cth) ss 1317E(ja), 1317G(1B).

A 'person whose interests have been, are or would be affected' by a contravention of the continuous disclosure provisions may seek an injunction under s 1324. Entities or persons who have suffered loss may also seek compensation from a company that has failed to comply with the continuous disclosure obligations.[214] This may include a claim made through a class action funded by a litigation company.[215]

3 *Empirical Research*

The thesis empirical study, other studies on the continuous disclosure regime, and critique of the regime are outlined in Chapter Five. Most of the studies, including the thesis research, find evidence consistent with significant non-compliance with the continuous disclosure obligations.[216]

IV INSIDER TRADING REGULATION

'What is certain is that concerns about insider trading [or selective disclosure] will not go away, it relates to something very fundamental – human greed, and we can be morally certain that while we are still on this planet, we will always have insiders taking advantage, fairly or otherwise, of the rest of us'[217]

This part introduces the regulation in Australia prohibiting insider trading. Part V introduces the Australian regulatory framework governing selective disclosure. The insider trading regulation supports the periodic and continuous disclosure rules. A failure by a company to disclose required information may constitute a breach of the periodic disclosure or continuous disclosure regulation. In addition, company information that has not been disclosed through the ASX may constitute inside or selectively disclosed information, and trading on, procuring trading or communicating this information may result in liability under insider trading regulation.

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[212] Defined in s 79 of the *Corporations Act 2001* (Cth). See *Yorke and Anor v Lucas* (1985) 158 CLR 661.
[213] *Corporations Act 2001* (Cth) ss 674(2A), 674(2B), 1325.
[214] *Corporations Act 2001* (Cth) ss 1317HA, 1317J(3A).
[215] *Fostif Pty Ltd v Campbells Cash & Carry Pty Ltd* [2005] NSWCA 83; *Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd* [2006] HCA 41 (30 August 2006).
[216] As highlighted in Chapter Five, proxies must be adopted to measure compliance with the continuous disclosure obligations.

A Insider Trading Provisions

Section 1043A is the main insider trading provision currently. This provision has been in effect since 11 March 2002.[218] Section 1043A prohibits anyone who possesses inside information from trading,[219] procuring trading,[220] or communicating that information where trading is likely to take place,[221] in relation to relevant financial products, subject to various exceptions and defences.[222] The insider trading prohibitions involve information; in a Division 3 financial product; with a territorial connection; that is possessed; material; not generally available; and the defendant knows or ought reasonably to know that the information is not generally available, and if it were generally available, it might have a material effect on the price or value of the financial products.[223]

"Inside information" is defined as information that is not "generally available" and 'if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of the … financial products.'[224] The materiality and "generally available" elements are outlined and discussed further in Chapter Four. "Information" includes 'matters of supposition and other matters that are insufficiently definite to warrant being made known to the public, and matters relating to the intentions, or likely intentions, of a person'.[225] "Division 3 financial products" include securities, derivatives, interests in a managed investment scheme, government debentures, stocks or bonds, superannuation, and any other product able to be traded on financial markets.[226] Conduct that constitutes insider trading may occur within

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[217] Barry Rider, 'The Control Of Insider Trading – Smoke And Mirrors!' (2000) 19 *Dickson Journal of International Law* 1, 45.
[218] Section 1043A is broadly the same as s 1002G of the *Corporations Law.*
[219] *Corporations Act 2001* (Cth) s 1043A(1)(c).
[220] *Corporations Act 2001* (Cth) s 1043A(1)(d). Procure is defined in s 9 of the *Corporations Act 2001* (Cth) to include 'cause'. Similarly, s 1042F(1) states that to "procure" means that 'a person incites, or encourages an act or omission by another person . . . '
[221] *Corporations Act 2001* (Cth) s 1043A(2). The communication offence is generally referred to as the "tipping" offence. No association is required between the tipper and tippee.
[222] *Corporations Act 2001* (Cth) ss 1043B-1043O.
[223] Section 1043A has been in effect from 11 March 2002.
[224] *Corporations Act 2001* (Cth) s 1042A.
[225] *Corporations Act 2001* (Cth) s1042A. The courts have interpreted the definition of "information" widely. In *R v Rivkin* (2004) 59 NSWLR 284, the court indicated that the source of information is relevant to the question of its reliability and materiality.
[226] Sections 1042A and 1042E of the *Corporations Act 2001* (Cth). The *Financial Services Reform Act* 2001 (Cth) amended the *Corporations Act 2001* (Cth) and extended the application of the insider trading

Australia or when there is a connection to Australia by the person or corporate who issued the relevant product.[227] A corporation "possesses" information that an officer of the company possesses and which came into the person's possession in the course of the performance of duties as an officer.[228]

The requisite *mens rea* may be established on either an objective or subjective basis. However, in *Boughey v R*[229] the High Court indicated that for an individual, the words 'ought reasonably to know' are based on what the accused knew in the particular circumstances.[230]

B Insider Trading Liabilities and Penalties

Liability for breach of s 1043A may arise on a criminal basis under s 1311 or on a civil basis under ss 1043L and 1317HA.[231] The insider trading provisions were included within the civil penalty regime by enactment of the *Financial Services Reforms Act 2001* (Cth), with effect from 11 March 2002.[232]

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prohibition to transactions involving a broader range of financial products, including derivatives and financial products able to be traded on a financial market. These changes, which took effect on 11 March 2002, reflected the general objective behind the financial services reforms of harmonising the regulatory treatment of financial markets and financial products.

[227] *Corporations Act 2001* (Cth) s 1042B.

[228] While "possession" is not defined in the *Corporations Act 2001* (Cth), s 1042G(1)(a) provides that a corporation possesses any information which an officer of the company possesses and which came into his or her possession in the course of the performance of duties as an officer.

[229] (1986) 65 ALR 609, 622 (Mason, Wilson & Deane JJ).

[230] Similarly, in *R v Rivkin* [2004] NSWCCA 7 (5 February 2004), the Court of Appeal said [at para 94] that these words are assessed subjectively, having regard to all the relevant circumstances, including the appellant's mental state. A body corporate is presumed to know that the information was inside information through the operation of ss 1043A(1)(b) and 1042G.

[231] The *Criminal Code Act 1995* (Cth) applies to contraventions of Commonwealth statutes. Under this Code, a person who aids, abets, counsels or procures an insider trading offence is also liable. An accessory to a person contravening s 1043A may be liable, in addition to, or independently from, the person with the primary liability.

[232] Section 1043A of the *Corporations Act 2001* (Cth) may be a civil penalty provision under ss 1317DA, 1317E(jf)(jg). Liability can be imposed on the person procured to trade and any other person involved in the contravention under s 1043A. Under the civil regime, the standard of proof is the balance of probabilities. The maximum penalty is currently $200,000 for a person and $1 million for a body corporate: s 1317G(1B). ASIC supported the inclusion of the provisions within the civil penalty regime arguing that some actions had not been pursued under the criminal standard due to difficulties in proving the defendant's state of mind. They suggested that civil penalty sanctions would provide a useful prosecution option that might result in an increased number of insider trading prosecutions in the future.

C Insider Trading Prohibition Exceptions and Defences

There are a number of exceptions[233] and defences[234] to the insider trading prohibitions in s 1043A. An insider trading action may be defended by proof of the existence of relevant facts or circumstances[235] or proof of publication.[236] The publication defence may apply to the trading or communication offences, where information was acquired after publication, or where both parties knew, or ought to have known, the same information prior to entry into the relevant transaction.[237]

D Insider Trading Empirical Research

Further discussion on insider trading regulation, practices and empirical research is provided in Chapters Three to Five. While it is difficult to theoretically or empirically ascertain the economic efficiency of insider trading and insider trading regulation, the empirical research outlined in Chapter Three suggests a credible economic basis for regulation prohibiting insider trading.

V SELECTIVE DISCLOSURE REGULATION

There is no specific selective disclosure regulation in Australia. The disclosure of company information to selected investors is only prohibited to the extent that it breaches continuous disclosure or insider trading regulation. A listed Australian company may breach continuous disclosure regulation by failing to disclose materially price-sensitive information to any market participants or selectively disclosing information to some market participants without disclosure through the ASX. Those in possession of "selectively" disclosed information may also breach the insider trading

[233] *Corporations Act 2001* (Cth) ss 1043B-1043J. The five statutory exceptions to the insider trading prohibition are: withdrawal from a registered scheme (s 1043B); an underwriting agreement (s 1032C); purchases pursuant to legal requirements (s 1043D); communication pursuant to legal requirements (s 1043E); and Chinese walls (ss 1042F, 1042G). In addition, the legislation provides an exception from liability in respect of knowledge of intention of: a person (s 1043H); bodies corporate (s 1043I); and officers or agents of body corporates (s 1043J).

[234] *Corporations Act 2001* (Cth) s 1043M. There are also exceptions under the Corporations Regulations for a director obtaining a share qualification, acquisitions of securities under a superannuation or pension fund scheme, specified insolvency transactions in good faith; and a sale under a mortgage, charge, pledge or lien.

[235] *Corporations Act 2001* (Cth) s 1043M(1).

[236] *Corporations Act 2001* (Cth) s 1043M(2)(3).

provisions if they trade, procure trading, or communicate the information where trading is likely to take place.[238]

This scenario contrasts with the US, which introduced Regulation Fair Disclosure (Reg FD) in 2000.[239] Reg FD is outlined and discussed in more detail in Chapter Three. In summary, when a company chooses to disclose material information, the information must be disclosed broadly to the investing public. Companies or those acting on the company's behalf are prohibited from selectively disclosing material non-public information to securities industry professionals, institutional investors, and specified other persons. Reg FD applies to closed-door meetings, conference calls with analysts,[240] and any situations where material information is communicated, verbally or in writing.[241]

Further discussion on selective disclosure regulation, practices and empirical research is provided in Chapters Three to Five.

VI COMPANY BRIEFINGS

Companies manage private meetings around the publicly announced result announcements and slides to be able to claim that they are saying the same thing in private and public. However, in practice 'the information content of … [the published material] is very much less than that of the private exchange'[242]

Listed Australian companies disclose information to the market under the mandatory disclosure regimes and on a voluntary basis. As previously outlined, mandatory information required under the periodic and continuous disclosure regimes is generally

[237] The defendant bears the burden of proof: *Corporations Act 2001* (Cth) ss 1043M(1)(2)(3) notes.
[238] *Corporations Act 2001* (Cth) ss 1042A-1044A. The defences to insider trading are provided in ss 1043B-1043J and 1043M.
[239] SEC, *Selective Disclosure and Insider Trading, Exchange Act Release Nos 33-7881 2000 WL 1201556*. The new rules and amendments took effect on 23 October 2000.
[240] The courts in the United States have ruled that conference calls with analysts that have been recorded and transcribed are admissible as evidence: *Wenger v Lumisys, Inc,* 2 F Supp.2d 1231 (ND Cal, 1998).
[241] Liability under Regulation Fair Disclosure (Reg FD) only arises when an issuer's personnel either knows, or is reckless in not knowing that the information he or she is communicating is both material and non-public.
[242] John Holland, 'Private Voluntary Disclosure, Financial Intermediation And Market Efficiency' (1998) 25 *Journal of Business Finance & Accounting* 29, 49.

provided through the ASX CAP. Company information disclosed on a voluntary basis is typically provided at briefings.[243]

The boundary between voluntary company disclosure and information that must be disclosed on a mandatory basis is blurred. In practice, some companies provide information beyond that required by regulation through the ASX. On the other hand, I argue in this Chapter and in Chapter Five that some companies provide the most valuable information required for security valuation purposes at briefings.

Company briefings are an important means by which Australian listed companies provide information to investors. However, access to these briefings and to company information provided outside of the mandatory disclosure processes remains discretionary. Companies are not required to arrange open access to general analyst meetings or to provide the market with a transcript or summary of the information content discussed at private one-on-one meetings. ASIC advises companies that, to comply with the continuous disclosure obligations, material price-sensitive information must not be disclosed to analysts that has not been disclosed to the rest of the market.[244] Nevertheless, companies are encouraged to maintain an "open door" policy with analysts.[245] Analysts and other selected investors remain free to obtain information from companies for the purposes of filling in their analysis interstices or information mosaics. Australian regulators, companies and other parties indicate or imply that the content discussed at closed or private company briefings is restricted to immaterial background information or to assumptions underlying earnings forecasts but not forecasts per se.[246]

The discussion on company briefings is presented under the following sections:

A ASIC draft proposals on company disclosure

B ASIC final paper on company disclosure

C Company briefings in practice

D Company briefings empirical research

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[243] "Briefings" are defined as any means by which companies disclose information to investors that has not been disclosed through the ASX.

[244] *Corporations Act 2001* (Cth) ss 674-678; ASX Listing Rule 3.1; ASIC, above n 177, 6; ASIC, *Better Disclosure for Investors - Guidance Rules* (23 August 2000) 2.

[245] ASIC, above n 177, 6, 8; ASIC, above n 244, 2.

E Ongoing debate on company briefings

F Company briefings critique and a conclusion

A ASIC Draft Proposals on Company Disclosure

In November 1999, ASIC wrote a draft guidance and discussion paper on the disclosure of information to investors and compliance with the continuous disclosure and insider-trading provisions.[247] ASIC proposed that directors and senior executives of companies conducting informal briefings take 'careful notes or record discussion'.[248] 'There can [then] be no dispute about what was said … [and] the corporate disclosure manager can review the tape ... to see whether any information was disclosed that is not publicly available'.[249] The discussion paper further suggested that companies should '[h]ave a procedure for reviewing briefings and discussion with analysts and ensuring that shareholders are not denied access to any significant background information given to analysts'.[250] 'Even if no inside information is disclosed at selective briefings, those present have a chance to ask questions and gain a fuller understanding of publicly released information'.[251] 'Documents lodged with the stock exchange are often supplemented by more comprehensive background information given to analysts at private briefings'.[252] The discussion paper highlighted that

> [t]here is not always a clear line between what is price sensitive and what is not … A particular piece of information may, when fitted together with other information in the possession of those present at a private briefing, affect the company's share price.[253]

ASIC concluded that it 'would like to see companies exploring ways of improving investor access … to information provided at private briefings',[254] in order to ensure 'full and timely public disclosure'.[255] ASIC proposed that 'companies … choose to

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[246] ASIC, above n 177, 20; Uren, above n 121, 65; Australian Investor Relations Association (AIRA), *Snap Poll: One-on-One Meetings with Analysts & Fund Managers* (15 June 2005).
[247] ASIC, above n 177, 1.
[248] ASIC, above n 177, 15.
[249] ASIC, above n 177, 18.
[250] ASIC, above n 177, 6.
[251] ASIC, above n 177, 7.
[252] ASIC, above n 177, 9.
[253] ASIC, above n 177, 13.
[254] ASIC, above n 177, 9.
[255] ASIC, above n 177, 14.

publish either a transcript or a summary'[256] 'of questions and answers given at private one-on-one briefings',[257] and suggested that

> [b]est practice for web site disclosure procedure for analyst briefings might include … advance notice [to shareholders] of proposed briefings … [u]sing the company web site … to give investors access to live broadcasts of analyst briefings … [and] [r]ecording analysts briefings and placing a transcript or summary of the briefing and questions and answers on the company web site as soon as possible after the briefing …[258]

B ASIC Final Paper on Company Disclosure

The final ASIC paper entitled 'Better Disclosure for Investors - Guidance Rules' bears little resemblance to the earlier discussion paper.[259] The final paper incorporates 10 broad principles for companies to consider in developing their disclosure policies. These principles are described as practical steps for companies to take to ensure they meet the letter and the spirit of the continuous disclosure regulation. Principle 6 states that '[p]rice sensitive information must be publicly released through the stock exchange before disclosing it to analysts or others outside the company'.[260] Companies are encouraged

- to have written policies and procedures on information disclosure;[261]
- to nominate a senior officer to oversee and coordinate disclosure;[262]
- to restrict the number of officers authorised to speak on behalf of the company;[263]
- to monitor disclosures;[264]
- to develop procedures in relation to rumours, leaks and inadvertent disclosures;[265]
- to review private discussions with analysts for inadvertent disclosure;[266]
- to take care that responses to analysts' questions include only information that has been released through the stock exchange;

[256] ASIC, above n 177, 12.
[257] ASIC, above n 177, 12.
[258] ASIC, above n 177, 21.
[259] ASIC, above n 244.
[260] ASIC, above n 244, Principle 6.
[261] ASIC above n 244, Principle 1.
[262] ASIC, above n 244, Principle 3.
[263] ASIC, above n 244, Principle 4.
[264] ASIC, above n 244, Principle 5.
[265] ASIC, above n 244, Principle 7.

- to confine comments on analysts' financial projections to errors in factual information and underlying assumptions;[267] and
- to use current technology to give investors better access to information.[268]

It is suggested that the way to manage earnings expectations is to publicly disclose a forecast earnings range, with any changes in these expectations announced through the ASX prior to any comment to a third party.[269] The principles or measures in the paper are not mandatory. Companies remain free to develop disclosure policies that meet their particular needs and circumstances.

C Company Briefings in Practice

'Whether right or wrong, if the instos want something they will get it. They will just get it privately.''[270]

Most company briefings in Australia are formatted as either general group or private individual meetings or conference calls.

1 *General Analyst Briefings*

The most important general briefings are typically those held on, or close to, the day on which financial results are announced.[271] While these meetings are generally referred to as "analyst" briefings, the invitee list is at the discretion of the individual company. The invitation list typically includes fund managers and large traders as well as broking analysts. Companies generally advise these investors of their result and briefings dates when invitations to the briefings are sent out by email approximately two to four weeks in advance of a result release. At a result briefing, a company's CEO, chief financial officer (CFO) and other top executives make an oral presentation based on a PowerPoint presentation. These presentations provide details and commentary on the

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[266] ASIC, above n 244, Principle 8.
[267] ASIC, above n 244, Principles 9 and 10.
[268] ASIC above n 244, Principle 2.
[269] ASIC, above n 244, Principle 10.
[270] Michael Westfield, 'ASIC Loses To Law Of Jungle', *The Australian* (Melbourne), 12 December 2003 citing Matt Williams, a high profile fund manager at Perpetual Limited.
[271] Stephen Wisenthal, 'Brokers Say Reporting Season Too Short', *Australian Financial Review* (Sydney), 15 September 2004, 14; 'Investors Tie Up Time', *Townsville Bulletin* (Townsville), 16 June 2005, 25.

company result and future outlook.[272] Following the executive presentation, there is normally a question and answer session. The PowerPoint summary of the management presentation made at a general analyst briefing is generally released through the stock exchange prior to commencement of the briefing.

2 *Private Briefings*

Most listed Australian companies also hold private briefings with selected investors, including fund managers, analysts, brokers, and wealthy individual investors.[273] These meetings are typically held either with the top executives of a company or with a representative from the company's investor-relations area. The format of the meetings is normally an oral question and answer session.[274] One top-rated Australian financial sector analyst has 12 to 15 private meetings a year with the chief executive or business heads of listed financial sector companies.[275] This pattern is typical. Most institutional investors are also in regular contact with company executives by telephone or email.

D Company Briefings Empirical Research

'The most useful information obtained from listed companies is obtained over the telephone from executives not authorized to speak to analysts'.[276]

During 1995 and 1996 Holland conducted interviews with executives of 33 of the largest listed companies in the UK on disclosure of company information to financial institutions and the broader market.[277] The private briefing content described in Holland's article is equivalent to that provided at Australian company briefings.[278]

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[272] See, eg, Aristocrat Leisure Limited, *CEO and CFO Presentation Transcripts* (26 February 2008) ASX <http://www.asx.com.au/asx/statistics/announcementSearch.do?method=searchByCode&issuerCode=all&timeFrameSearchType=D&releasedDuringCode=6> at 14 June 2008.

[273] Wisenthal, above n 271; Ben Power, 'Aristocrat Under Scrutiny After Results Release', *Australian Financial Review* (Sydney), 20 February 2003, 18; 'Investors Tie Up Time', above n 271; Geoffrey Newman, 'Private Briefings a Threat to Disclosure', *The Australian* (Melbourne), 16 June 2005, 24.

[274] The author has participated in hundreds of private briefings with top executives of Australian and international companies.

[275] Confirmed by a top-rated financial analyst at a meeting attended on 6 April 2006. The analyst requested anonymity.

[276] Stewart Oldfield and Fiona Buffini, 'Stockbrokers Face Tough Conduct Code', Australian Financial Review (Sydney), 29 August 2005, 1 citing an analyst who declined to be named.

[277] Holland, above n 242.

[278] Based on the content of publicly accessible briefings and my experience of briefings on a global basis. See also AIRA, above n 246.

The companies indicated to Holland that management cannot spend time with all shareholders, and they generally establish close relationships with twenty or thirty core institutions.[279] These close private relationships allowed an exchange of information on management quality, competitive information, research and development, and innovation. They also allowed the release of information to the major market influencers because this core set of financial institutions keeps the market informed through advisory or trading actions.[280] ‘The larger the financial institution, and its stake, and the more proactive its portfolio policy, the more proactive the company … [is in its relationship with that institution. The] investor relations staff [is used] as the primary contact and barrier for other non-core financial institutions and analysts’.[281]

The companies argued that the public and private channels for information dissemination were clearly differentiated.[282] While the numbers were reported publicly, the private discussion revolved around ‘how and why the results were achieved.’[283] The private information was the company’s interpretation and explanation of the publicly announced results and the financial reports. The companies suggested that the financial report was becoming more obscure, complex and technical, and required explanation.[284] Companies therefore met with analysts and institutions privately in batches after earnings announcements. This ensured that the financial reports were ‘properly construed’.[285] These institutional meetings included:

- an explanation of the operating and financial review and comment on the forward ‘top down, dynamics of [the] business’, discussion on the ‘[f]inancial parameters such as dividend policy, gearing and debt structure’ and financial targets in terms of profitability and shareholder returns;
- ‘further details behind public announcements and other public information’; and
- information on qualitative company variables such as quality of management, corporate strategy, management succession, capital investment, and technological change.[286]

[279] Holland, above n 242, 39.
[280] Holland, above n 242, 40.
[281] Holland, above n 242, 55-56.
[282] Holland, above n 242, 42.
[283] Holland, above n 242, 45.
[284] Holland, above n 242, 51.
[285] Holland, above n 242, 55.
[286] Holland, above n 242, 46.

One company summarised the content of its private meetings with institutions as being about the company's strategy for maximising returns, the execution of that strategy, the achievable returns, and what the company intends to do with the returns.[287] Another company indicated that institutions use the private meetings to 'hard ball the Chairman and see the whites of the eyes of the Chief Executive'.[288] 'All the nuances and little aspects of human behaviour are very important in conveying important information to the institutions'.[289] All of the companies indicated that they prefer private meetings rather than public meetings because anything said in private remains deniable, the meetings allow two-way exchanges, and qualitative information can be discussed.[290]

Holland highlighted that the companies were aware of the fine line between these dialogues and continuous disclosure and insider trading laws.[291] The companies recognised that earlier practices of 'steering earnings forecasts and helping analysts write their reports'[292] are risky in the new regulatory climate. While most companies argued that they stay within the legal limits, one company suggested that the approach of providing interpretation, explanation and commentary of the public facts in private was not well tested in law.[293]

Holland concluded that the quality of private disclosure was much higher than the public disclosure because the 'private discussion [is] much richer conceptually … [with] much deeper analysis'.[294] He indicated that he was left with a sense that the public voluntary disclosure is designed to merely satisfy minimum market pressures and regulations.[295] He argued that companies manage the private meetings around the public result announcements and slides to be able to claim they are saying the same thing in private and public. However, in practice 'the information content of … [the published material is] very much less than that of the private exchange.'[296] The private meetings 'signpost … the financial institutions or analysts to the key parts of complex

[287] Holland, above n 242, 47.
[288] Holland, above n 242, 48.
[289] Holland, above n 242, 51.
[290] Holland, above n 242, 52.
[291] Holland, above n 242, 50.
[292] Holland, above n 242, 56.
[293] Holland, above n 242, 52.
[294] Holland, above n 242, 49.
[295] Holland, above n 242, 64.
[296] Holland, above n 242, 49.

published documents'.[297] Alternatively, public disclosure is made up to the point 'where it [is] thought sufficient to legitimise additional private disclosure… to satisfy external communication benchmarks and legal requirements' and the need for 'liquidity and cost of capital'.[298]

A survey by Epstein and Palepu indicated that analysts rate private contacts and analyst meetings as the two primary sources of their information, with annual reports third in importance.[299]

In the US, a National Investor Relation Institute (NIRI) survey in July 2001 indicated that 99 percent of the respondent listed companies opened up their conference calls to all investors.[300] The 'primary purpose of conference calls [in the US] is to simultaneously disseminate to multiple analysts expanded information about recently disclosed earnings.'[301] The conference calls therefore have a similar function to general analyst briefings in Australia.

Australian research on briefings is limited. In June 2005, an Australian Investor Relations Association (AIRA) snap poll of the top 200 companies on one-on-one meetings found that 98 percent of the 68 respondents held one-on-one meetings and 76 percent held analyst conference calls.[302] Ninety seven percent of the respondent company CEOs attended the one-on-one meetings and 89 percent of the CFOs. Of the companies holding private briefings, 63 percent did not place any conditions on the meetings and 40 percent still hosted them during blackout periods.[303]

One company suggested in the AIRA poll that one-on-one meetings were the most frequently used communication tool and very effective. Another indicated that individual meetings were one of the best ways to ensure analysts understand the company properly. Others suggested they were a great way to build rapport with fund

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[297] Holland, above n 242, 49.
[298] Holland, above n 242, 64.
[299] Marc Epstein and Khrishna Palepu, 'What Financial Analysts Want' (1999) 80 *Strategic Finance* 48, 50. In my view, a survey of Australian analysts would likely result in similar responses.
[300] National Investor Relations Institute (NIRI), 'Most Corporate Conference Calls Are Now Open to Individual Investors and the Media' (Press Release, 29 Feb 2000).
[301] Jere Francis, Douglas Hanna and Donna Philbrick, 'Management Communications With Securities Analysts' (1997) 24 *Journal of Accounting and Economics* 363, 368.
[302] AIRA, above n 246.
[303] AIRA, above n 246.

managers and brokers, and investors like to get a sense of knowing management - this is difficult if restricted to group forums. One company indicated that the content was generally focused on broad strategy, growth opportunities and gaining a greater understanding of the nature of the industry and operations of the business.[304] It was suggested that it was difficult for investors to get a complete understanding of these basics in other forums.[305] AIRA confirmed these broad areas as the focus of discussion at private briefings but emphasised that only the assumptions underlying earnings forecasts are discussed and not the forecasts per se.[306]

A couple of respondents suggested that concerns about one-on-one meetings have been overdone. However, another company indicated that individual meetings are of questionable value for domestic institutions and analysts who know the company well and who are frequently just looking to get a competitive edge in a market where all material information should be lodged with the exchange. One company executive even suggested that if regulators really wanted to push the subject hard, the future of individual meetings might be short.[307]

The survey confirmed that expectations from institutional investors on the extent of access to one-on-one briefings continue to increase.[308]

1 *Company Briefings Case Studies*

Two case studies are outlined as examples of how continuous disclosure and equality of access principles can be undermined by closed briefings.

(a) BHP Billiton Limited

On 2 December 2005 BHP Billiton made a presentation to invited analysts on how its petroleum division had been affected by the hurricanes in the US. On 5 December 2005 two articles in the *Australian Financial Review* indicated that the presentation had

[304] AIRA, above n 246.
[305] AIRA, above n 246.
[306] Uren, above n 121, 65.
[307] AIRA, above n 246.
[308] AIRA, above n 246.

resulted in analyst write-downs of the company's forecast earnings.[309] One journalist argued that it was inappropriate for the presentation discussion to have been confined to an 'analysts-only briefing'.[310] Later on 5 December 2005 BHP Billiton made an announcement through the ASX advising that the analyst presentation summary could be found on the company web site.[311] The company referred to a prior ASX announcement dated 5 October 2005 that gave an update on the US Gulf of Mexico Operations.[312] Nevertheless, a newspaper editorial on 8 December 2005 reiterated that the BHP Billiton briefing should have been web cast with the presentation slides available on the company web site the day of the briefing to allay any suspicion of selective briefing.[313]

No action was taken by the ASX or ASIC in relation to these events.

(b) Telstra Corporation Limited

ASIC alleged that at the Telstra result briefing on 11 August 2005, company executives provided information to analysts that had not been released through the ASX.[314] ASIC further alleged that on 15 August a top executive privately informed selected parties that the company had been forced to borrow from its reserves to pay its dividends, it had significantly under invested in its public network, and revenues from the public switched telephone network would decline 30 percent within five years,[315] without releasing this information to the market.[316]

After investigating this series of incidents, ASIC announced that while it was concerned with some of 'Telstra's disclosure procedures [in relation to its] continuous

[309] Robert Guy, 'BHP Petroleum: A Sombre Time', *Australian Financial Review* (Sydney), 5 December 2005, 56; Yvonne Ball, 'BHP Staring at Typhoon Write-Off', *Australian Financial Review* (Sydney), 5 December 2005, 12.

[310] Guy, above n 309.

[311] BHP Billiton Limited, *Petroleum Gulf of Mexico Operations* (5 December 2005) ASX <http://www.asx.com.au/asx/statistics/announcementSearch.do?method=searchByCode&issuerCode=bhp&timeFrameSearchType=Y&year=2005> at 9 May 2006.

[312] BHP, above n 311; BHP Billiton Limited, *BHP Billiton Update on US Gulf of Mexico Operations* (13 October 2005) ASX <http://www.asx.com.au/asx/statistics/announcementSearch.do?method=searchByCode&issuerCode=bhp&timeFrameSearchType=Y&year=2005> at 9 May 2006.

[313] 'BHP Briefings Sets A Bad Example', *Australian Financial Review* (Sydney), 8 December 2005, 54.

[314] ASIC, 'ASIC Warns Telstra on Disclosure Procedures' (Press Release, 14 December 2005) 05/391.

[315] ASIC, above n 314; Tony Boyd and David Crowe, 'ASIC Gives Telstra a Yellow Card', *Australian Financial Review* (Sydney), 15 December 2005, 4.

[316] Rhys Haynes, 'Telstra Sued for not Revealing Numbers', *The Daily Telegraph* (Sydney), 21 January 2006, 67.

disclosure obligations [these practices] fell short of being appropriate for court proceedings'.[317] However, the Telstra Board was advised in writing of ASIC's concerns 'to serve as a warning … [to] lift their game on continuous disclosure'.[318] Late in 2007, a class action by shareholders against Telstra alleging a failure to continuously disclose was settled.[319] This class action is discussed further in Chapter Four.

E Ongoing Debate on Company Briefings

A CASAC report in 2001 suggested that private briefings to corporate analysts should be the subject of future debate because while they 'may not involve disclosure of inside information [they] still raise questions of fairness and equal access to corporate information.'[320]

In 2009 Senator Nick Sherry, the Minister for Superannuation and Corporate Law, initiated a debate on aspects of market integrity, including issues relating to corporate briefings. The CAMAC was asked to:

- examine the role that analysts' briefings play in Australia's financial markets, including whether their role is a positive one that leads to greater market efficiency
- advise whether changes may be required to Australia's regulatory framework and, if so, what form they should take.

The Committee concluded that no regulatory change was required. The CAMAC report indicated that

> [b]riefings can provide a useful supplement to formal disclosures by companies and help promote a more informed and efficient market, provided that they comply with relevant regulatory requirements, including the prohibition on insider trading.[321]

However, it suggested that

> there is an opportunity for the ASX Corporate Governance Council to build on existing guidance by introducing recommendations in its Principles and Recommendations to

[317] ASIC, above n 314.
[318] ASIC, above n 314.
[319] Susannah Moran, 'Telstra Settles Class Action', *The Australian* (Sydney) 12 November 2007. Class actions based on company disclosure issues are outlined and discussed in more detail in Chapter 4.
[320] CASAC, above n 61, 2.

> encourage more open practices in relation to briefings, including making them more accessible where possible, maintaining a record of their key aspects and restraining their use during times of market sensitivity.[322]

The Australian Shareholders Association (ASA) submission acknowledged that live broadcasting of analysts' briefings is relatively simple and inexpensive and indicated that it will encourage this as standard practice. Nevertheless, it saw 'this as an area where corporations have been willing to effect change and accordingly neither regulation nor further guidance are currently needed.'[323] The Association pointed out that ASIC have begun to attend briefings and ASA representatives are invited to attend some briefings.[324]

The Law Council of Australia Committee submission suggested that 'more information reaches the market as a result of analyst briefings than the market would otherwise get in the absence of those briefings'.[325]

The ASIC submission acknowledged that there may be real and perceived fairness issues 'in relation to the current practice of private briefings with well-connected analysts potentially having access to more detailed and higher quality discussion with management.'[326] Notably, in a speech to AIRA in December 2009, Gibson, an ASIC Commissioner, suggested that '[p]erhaps the most informative material … is provided at the investor analyst briefings that usually occur when the annual and half yearly

[321] CAMAC, Commonwealth, *Aspects of Market Integrity Report* (June 2009) 11.
[322] CAMAC, above n 321, 11. The ASX is currently consulting on proposed changes to the guidance.
[323] Australian Shareholders Association, *ASA Submission: CAMAC – Aspects of Market Integrity* (11 March 2009) 3.
[324] It is not clear how attendance by ASIC or an ASA representative at closed briefings assists excluded investors to obtain the information provided at briefings.
[325] Law Council of Australia, *Response to CAMAC's Issues Paper: Aspects of Market Integrity* (10 March 2009) 7. The Law Council does not explain how more information reaches the market as a result of closed rather than open analyst briefings. See also Representatives of the Australian Accounting Profession, *Aspects of Market Integrity* (31 March 2009) and Allens Arthur Robinson, *Submissions to the Corporations and Markets Advisory Committee in Response to its Issues Paper on Aspects of Market Integrity* (10 March 2009) 5. The accountants' body argues without further explanation that putting a regulatory framework in place around analyst briefings would not be impossible but counter productive. Allens Arthur Robinson argues that banning private briefings would have a negative effect on the market because it would reduce the amount and quality of informed opinion about Australian companies available to security holders and investors.
[326] ASIC, *ASIC's Submission on CAMAC's Issues Paper Aspects of Market Integrity* (March 2009) 20.

results are announced'.[327] She noted that the 'analysts briefings to investors released with the annual results are often more informative' than the annual reports.[328] The briefing material is 'usually approved by the board … [It] is usually prospective and looks over the company's business model and analyses the various segments'.[329] Nevertheless, the ASIC submission concluded that briefings provide a net efficiency benefit, 'provided the law is complied with'.[330] ASIC indicated that '[c]ompanies are best placed to determine what is the most effective and efficient disclosure mechanism in their particular circumstances.'[331] It also suggested that 'it is not practicable or appropriate to require all private briefings to be recorded.'[332]

The Australian Financial Markets Association submission argued that if an analyst 'chooses to focus on certain aspects of public information … or seek clarification on discrete points…[and this information] were made freely available to the public it would discourage the production and publication of any research'.[333] The Securities & Derivatives Industry Association submission asserted that only the largest of institutional investors have the resources to assess the true value of a company and its securities.[334] The Business Council of Australia submission claimed that webcasting is too costly and burdensome.[335] The Australian Investor Relations Association submission suggested that 'a majority of listed companies do use widely accessible webcasts and conference calls'.[336] It argued that private briefings 'ensure the accuracy of the data and assumptions underlying analyst valuations [and this is] essential if the market is not to be misled'.[337]

[327] Belinda Gibson, ASIC Commissioner, 'Playing by the Rules: A New Regulatory Environment is Changing the Way that Corporations Relate to Investors and the Finance Community' (Speech delivered at the AIRA Annual Conference 2009, 2 December 2009) 8-9.
[328] Gibson, above n 327, 11.
[329] Gibson above n 327, 8-9.
[330] ASIC, above n 326, 20. No evidence or argument is provided to support the net efficiency argument.
[331] ASIC, above n 326, 21.
[332] ASIC, above n 326, 22. No supporting argument is provided on why recordings are impracticable or inappropriate.
[333] The Australian Financial Markets Association, *CAMAC Market Integrity Paper Responses* (10 March 2009) 12-13.
[334] Securities & Derivatives Industry Association, *Submission on CAMAC Issues Paper – Aspects of Market Integrity* (11 March 2009) 6.
[335] Business Council of Australia, *Aspects of Market Integrity* (3 March 2008). See also Chartered Secretaries Australia, *Market Integrity* (10 March 2009) 11.
[336] AIRA, *Aspects of Market Integrity Issues Paper* (10 March 2009) 6. No evidence is provided to support this claim.
[337] AIRA, above n 336, 6.

None of the submissions on company briefings referenced or supported their arguments with research, explained what they meant by efficiency or net efficiency, discussed the potential negative effects of closed or private briefings, or highlighted the benefits of equal access and transparent disclosure.

F Company Briefings Critique and Conclusion

The outlined BHP Billiton and Telstra incidents reflect many of the key issues arising from general analyst briefings within Australia. Without a web cast or transcript of the Telstra analyst briefing on 2 December 2005, it is not possible to know whether material price-sensitive information was provided to analysts that was not included in the release made through the ASX on 13 October 2005. Instead, the onus is left on regulators or investors not present at the briefing to prove that this may have occurred, without access to any record of the briefing. The difficulty of this task was highlighted by the unsuccessful investigation by ASIC against AMP in 2001 relating to information disclosed at private briefings.[338]

A review of open access briefings and the empirical research suggests that the content provided at general analyst and private briefings includes detailed incremental information to assist investors with assessment of a company's prospective earnings. Discussion at private briefings is focused on management philosophy, strategy, growth opportunities, industry trends and issues, competitive advantages and risks. Company management confirm that they provide interpretation and explanation of the publicly announced results and the financial reports, explanation and comment on the forward 'top down, dynamics of the business',[339] discussion on the '[f]inancial parameters and financial targets',[340] and information on qualitative company variables such as quality of management, corporate strategy, management succession, capital investment, and technological change.[341] They suggest that financial reports are becoming more obscure, complex and technical, and briefings attendees therefore require management

[338] ASIC,'ASIC Concludes Investigation into AMP' (Press Release, 6 December 2001) 01/434. After a comprehensive investigation, ASIC concluded that AMP had breached the continuous disclosure listing rules in relation to the correction of analyst forecasts by the company at private briefings. However, there was insufficient evidence to establish that the breach was intentional, reckless or negligent under the Act.
[339] Holland, above n 242, 46.
[340] Holland, above n 242, 46.
[341] Holland, above n 242, 46.

explanation of these reports.[342] Consequently, it is difficult for investors to completely understand these issues based on publicly available information.

On this basis, favoured institutional investors or intermediaries require explanation of the publicly released reports to be able to construe and understand them, and closed general analyst and private briefings are necessary to provide the detail around the publicly released reports so that the invitees can understand the positioning of the company and its prospects. Arguably, most, if not all, of this information is material to an assessment of a company's sustainable or future earnings and its share price.

The AIRA consistently argue that issues and assumptions underlying earnings forecasts are discussed at private briefings, but not the forecasts per se.[343] However, in July 2009 Ries, the Research Director of E.L&C Ballieu, stated on the ABC program "Inside Business" that

> [m]ost [Australian] companies are very smart these days in massaging analysts' expectations. You know they give you a nod and a wink and stamp their feet on the floor three times so most of the numbers will be pretty close to what the companies report.[344]

The ASIC submission comment about 'well-connected analysts potentially having access to more detailed and higher quality discussion with management'[345] is also significant. These comments confirm the hierarchical nature of company information dissemination in Australia and reflect the real issues around closed and private briefings. The dissemination of company information based on nods, winks and connections is not optimally fair or efficient. The information asymmetry arising from closed and private briefings is not only between retail and institutional investors, but also between the best connected and not so well connected institutional investors. The role of analysts and the potential issues arising from favoured relationships between companies and investors such as analysts are discussed more fully in Chapter Three.

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[342] Holland, above n 242, 51.
[343] Uren, above n 121, 65; AIRA, above n 246.
[344] Australian Broadcasting Corporation Television, *Ivor Ries with a Reporting Season Forecast* (19 July 2009) Inside Business <http:/www.abc.net.au/insidebusiness/content/2009/s2629947.htm> at 2 August 2009.
[345] ASIC, above n 326, 20.

Listed companies can enable access or provide information to all investors and stakeholders easily and cheaply using digital technologies. By doing so, determinations on what information must be disclosed on a mandatory basis, and what is material or immaterial information can be avoided.

VII COMPANY DISCLOSURE IN THE DIGITAL ERA

'It is now trite commonplace that the advent of the Internet will in time revolutionize securities regulation'.[346]

Most scholars agree that the internet can potentially democratise securities markets.[347] For example, Debreceny and Rahman suggest that

> the Internet is rapidly becoming the most important information source for investors … [and information provided in the "new" forms are] much more powerful than the paper form of reporting … [because of] immediate dissemination and accessibility of information. These advantages have led to increased demand for information and the way information is provided.[348]

There is some disagreement about whether the vast amount of available information empowers or overwhelms investors.[349] Some parties suggest that increasing the amount of information available online and ready access to online trading facilities only makes investors worse off due to excess, overconfident and speculative trading.[350] However, as Lopez-Fernandini points out,

> [n]ot every investor will have the financial background to fully appreciate the new accessible information, however, this is not a reason to prevent disclosures to all

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[346] Coffee, above n 12, 1195.

[347] Coffee, above n 12; Langevoort, above n 12; Kingsford Smith et al, above n 12; Libin et al, above n 12, 631; Bradley, above n 12, 81, 87, 96; Unger, above n 12, 1121.

[348] Roger Debreceny and Asheq Rahman, 'Firm-Specific Determinants of Continuous Corporate Disclosures' (2005) 40 *International Journal of Accounting* 249, 276.

[349] Kingsford Smith et al, above n 12; Libin and Wrona, above n 12, 632.

[350] Terrance Odean, 'Volume, Volatility, Price and Profit When All Traders are Above Average' (1998) 53 *Journal of Finance* 1887; Brad Barber and Terrance Odean, 'Online Investors: Do the Slow Die First?' (2002) 15 *Review of Financial Studies* 455; Brad Barber and Terrance Odean, 'The Internet and the Investor' (2001) 15 *Journal of Economic Perspectives* 41; Yi, above n 15. See also Lynn Stout, 'Technology, Transaction Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?' (1997) 75 *Washington University Law Quarterly* 791, 813.

> investors. Companies cannot patronize investors by disseminating only analyst-filtered information for fear that investors may be overwhelmed.[351]

Libin and Wrona suggest the balance should ultimately be determined on the basis of investor rights 'to fair and equitable market treatment'.[352] Bradley highlights the fact that professionals engage in risky trading all the time and this is accepted.[353] She suggests there are two barriers to the democratisation of the securities markets: first, 'limits on access to technology' and resources; and secondly, preconceptions by the regulators 'of the proper distinctions between professional and nonprofessional, between sophisticated and unsophisticated, and between appropriate and inappropriate investment strategies for ordinary investors.'[354]

A Company Disclosure in the Digital Era Critique and Conclusion

Any limits on access to technology in Australia are now minimal, and the ease and speed of access to the internet will improve further as broadband facilities are rolled out nationwide. The advent of online investing radically changes the debate on equal access and assumptions on the role of intermediaries.[355] Now is the time to reconsider how level the playing field is between institutions, intermediaries and other investor participants in Australia.[356]

Disclosure policy distinctions need to be principled and not based on fixed ideas. It is not appropriate in contemporary markets for policy makers, regulators or companies to predetermine or limit the content and form of company information provided to some investors, while providing additional information to other investors. Companies should enable public access to the detailed information disclosed to some investors and provide summary and tailored information where this is seen as necessary or useful for some investors or stakeholders.

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[351] Camilia Lopez-Fernandini, 'Regulation FD of the SEC's Selective Disclosure and Insider Trading Rule: Finally, Full And Fair Disclosure' (2001) 53 *Administrative Law Review* 1353, 1371.
[352] Libin et al, above n 12, 681.
[353] Bradley, above n 12, 93-94.
[354] Bradley, above n 12, 96.
[355] Kingsford Smith et al, above n 12.
[356] Coffee, above n 12, 1233.

The ASIC Grapevine Paper recommends that companies provide live broadcasts of general analyst briefings to all investors with advance notice of the briefings. The final paper in 2000 entitled "Better Disclosure For Investors" encourages the 'use of current technology to give investors better access to information'.[357] The ASX also emphasises the key element relating to the voluntary use of current technology is 'equity of access to information'.[358] Since the release of these voluntary recommendations, there have been significant technological advances in the area of information dissemination.[359] Listed Australian companies now have many cheap and simple non-discriminatory disclosure mechanisms, including the ASX CAP, company web sites, open invitation meetings and teleconference calls.

Since November 2002, company announcements have been available to retail investors from the ASX web site on a real time basis.[360] In addition, listed Australian companies have rapidly embraced technologies that allow them to send annual reports and administrative notices to investors electronically.[361] However, companies have been slow to use similar technologies to broaden access and improve the quality of information provided to stakeholders. For instance, despite the minimal cost and effort required to provide open access to company briefings and advance notice of the access details through the ASX, only a minority of listed Australian companies are doing so.[362]

[357] ASIC, above n 244.
[358] ASX, above n 177, 15.
[359] Terry McCrann, 'Disclosure Skeleton Can't Go Back in the Closet', *Herald-Sun* (Sydney), 17 November 1999, 35.
[360] ASX Guidance Note 14 *Company Announcement Platform* 2.
[361] *Corporations Act 2001* (Cth) s 314. Consideration has also been given to the holding of shareholder meetings online, including voting facilities: Elizabeth Boros, 'Corporations Online' (2001) 19 *Company and Securities Law Journal* 492; Elizabeth Boros, 'Virtual Shareholder Meetings' (2004) *Duke Law & Technology Review* 0008; Elizabeth Boros 'Virtual Shareholder Meeting: Who Decides How Companies Make Decisions?' (2004) 28 *Melbourne University Law Review* 265.
[362] Fewer than ten listed Australian companies provided advance notice of their earnings related web casts through the ASX in the 2007 and 2008 financial years. The current costs to web cast a meeting with an audio stream, provide teleconferencing facilities or record a meeting are not significant, even for the smaller listed companies. Boardroomradio offers companies unlimited live and archived teleconferencing and web casting facilities for an annual subscription of $7000. The boardroomradio website is a reliable source for investors to confirm the result announcement, the AGM, and the dividend payment dates of listed companies. However, the number of company webcasts of result briefings is limited, and registered investors are only provided with the webcast access details on the morning of a briefing.

VIII THE CORPORATE DISCLOSURE CO-REGULATORY MODEL

'The motto of all good regulators … should be that of the proverbial three wise monkeys, "see no evil, hear no evil, speak no evil".[363]

The efficacy of the listed company disclosure framework depends to a significant extent on the credibility and performance of the regulatory and enforcement regimes. This part outlines and critiques the Australian co-regulatory model governing listed company disclosure. The regulatory enforcement records and critique on the integrated regulatory and enforcement regimes are provided in Chapter Four.

Discussion on the co-regulatory model is presented under the following sections:

A The co-regulatory model in practice

B Enforcement of the ASX listing rules

C Statutory support for the ASX listing rules

D The co-regulatory model critique and conclusion

A The Co-Regulatory Model in Practice

Australia uses a co-regulatory model for company reporting and disclosure with the ASX and ASIC as joint regulators. The partnership between the ASX and ASIC is underpinned by a memorandum of understanding.[364] Section 792D requires the ASX to provide ASIC with the assistance that it reasonably requires to perform its functions. In October 1998, the ASX demutualised and became a listed company.[365] However, the ASX has continued as the primary supervisor of listed companies.[366] Legislative approval of the co-regulatory structure was based on the advantages of the ASX's proximity to the market's operations, and its ability to respond quickly when required.[367] Business groups supported the co-regulatory structure on the grounds that

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363 Rider, above n 217, 33.

364 ASX, *Memorandum of Understanding Between Australian Securities and Investments Commission and Australian Stock Exchange Limited* (30 June 2004).

365 The stated objectives of the ASX include 'providing a fair and well-informed market for financial securities and providing an internationally competitive market': ASX Introduction to Listing Rules.

366 ASX, 'ASX Reinvigorates Market Supervision', (Press Release, 15 December 2005) 1.

367 Senate Economics References Committee, Commonwealth, *Inquiry into the Framework for the Market Supervision of Australia's Stock Exchanges* (2002) 9.

ASIC was too far removed from the market[368] and may have had too much power as the sole regulator.[369]

The ASX is required as a market operator licensee to ensure a fair, orderly and transparent market. There must be adequate operating rules and procedures and market supervision arrangements, including arrangements to handle conflicts of interest, monitor the market and participants conduct, and enforce compliance with the market operating rules.[370] In July 2006, the supervisory functions of the ASX were placed into a separate subsidiary company with external directors to improve the level of independence and to 'minimise further the perception of conflict between the ASX's regulatory and commercial functions'.[371]

The ASX vigorously defends its existing position. The ASX claims that '[b]usiness, Government and ASIC have confidence in the way ASX carries out its supervisory activities', and there is 'widespread support from participants and listed companies for ASX to retain the supervision role'.[372] Mayne, the chief supervision officer at ASX, suggests that critics who argue that supervisory decisions are made with 'one eye on the bottom line' are wrong.[373] He points out that the ASX Markets Supervision (ASXMS) area is independently managed, he personally reports to the ASXMS board and not to the ASX chief executive, and the remuneration of ASXMS staff is not tied to the ASX share price. Mayne emphasises that the conflict of interest policies and protocols at the ASX are strictly followed and enforced, the supervisory-related resources are not restricted to save money, the ASX is subject to regular assessment by the ASIC, and the ASX, ASIC, and the broking industry must work together to achieve the goals of market integrity. He concludes that the long-term sustainability of the ASX businesses are inextricably linked to a market that operates with maximum integrity.[374]

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[368] P Gill, 'A-G To Consider Disclosure Issue', *Australian Financial Review*, (Sydney) 4 March 1992, 13.
[369] Chartered Secretaries of Australia, CLERP 9 Response, Letter to Department of Treasury from T Sheehy, 22 November 2002, 3; Australian Institute of Company Directors, *Making Continuous Disclosure Work* 10.
[370] *Corporations Act 2001* (Cth) ss 792A, 796.
[371] ASX, above n 366, 2.
[372] ASX, above n 366, 1.
[373] Eric Mayne, 'No Conflicts in ASX's Market Role', *The Age* (Melbourne), 23 May 2008.
[374] Mayne, above n 373. See also Maurice Newman, Chairman ASX, 'Chairman's Address' (Speech delivered to ASX 2007 Annual General Meeting, 30 October 2007).

Ryde and Comerton-Forde, citing Pritchard in the US, agree that exchanges have strong incentives to self-regulate because exchanges that maintain high levels of market integrity enhance competitiveness and maximize turnover. Market abuses increase information asymmetry and deter uninformed investors, resulting in increased trading costs and falls in market efficiency and income.[375] However, academics,[376] market participants,[377] and media commentators[378] have become increasingly critical of the ASX for its performance as market regulator. The editor of the *Australian Financial Review* argues that the ASX should not be in this position.[379] Andrew, the President of the Australian Investor Association describes the ASX as the 'fox in the chicken coop'.[380] Curry, Chairman of the Australian Shareholders Association, argues that ASIC should assume full responsibility for monitoring of the market.[381] The ASX has been criticised for: inadequate responses to failed broker settlements, short selling, insider trading and market manipulation; failures to monitor and enforce director trades; the promotion of high risk investment products to retail investors; allowing poison pills to managers of subsidiary listed funds; and failures to enforce the listing rules.[382] Some market participants suggest that complaints to the ASX about disclosure breaches or insider trading are not acted upon.[383] Morgan, a well-respected fund manager, suggests that it is not good enough for ASIC to give the ASX a clean bill of heath given what has been happening in the industry.[384]

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[375] James Rydge and Carole Comerton-Forde, *The Importance of Market Integrity: An Analysis of ASX Self-Regulation,* Security Industry Research Centre of Asia-Pacific (1 September 2004) 12. See also Paul Mahoney, 'The Exchange as Regulator' (1997) 83 *Virginia Law Review* 1453.

[376] Roman Tomasic, 'Good Corporate Governance: The International Challenge' (2000) 12 *Australian Journal of Corporate Law* 142, 146; Entcho Raykovski, 'Continuous Disclosure: Has Regulation Enhanced the Australian Securities Market?' (2004) 30 *Monash University Law Review* 269, 297.

[377] Jacob Saulwick and Clancy Yeates, ' Regulator Forces Reforms on ASX', *Sydney Morning Herald* (Sydney), 15 August 2008; Gabrielle Costa, 'ASX Police Role Puts Lobbyists on a Dissenting Path', *The Age* (Melbourne), 31 May 2003, 2.

[378] Costa, above n 377; 'ASX Ought To Transfer Powers', *Australian Financial Review* (Sydney), 28 April 2005, 62; Terry McCrann, 'Undisturbed Sleep at the ASX', *Herald Sun* (Melbourne), 12 September 2008.

[379] Costa, above n 377.

[380] Costa, above n 377.

[381] Costa, above n 377. Curry suggests that 'the ASX …want to get as much trade as possible' and the criteria used to determine the references of trades to ASIC for investigation 'remain secret'.

[382] Saulwick et al, above n 377; John Durie, 'ASX Showdown', *The Australian* (Melbourne), 10 September 2008; Martin Collins, 'ASX Director Target of Activists', *The Australian* (Melbourne), 10 September 2008**;** Ian McIlwraith, 'At ASX, the Buck Stops Nowhere', *The Age* (Melbourne), 25 September 2008.

[383] Saulwick et al, above n 377.

[384] Saulwick et al, above n 377; ASIC, 'ASIC Releases Annual Assessment of Australian Securities Exchange' (14 August 2008) ASIC Press Release 08-186.

The ASX is subject to external review. The directors of the ASX Supervisory Review Pty Limited (ASXSR) review and report to the ASX Board on compliance by the exchange with its statutory license obligations.[385] In addition, ASIC is required to review the ASX as a licensee on an annual basis.[386] The scope of this review concerns whether the ASX 'management processes are adequate to ensure that ASX's commercial interests do not prevail over its supervisory function'.[387]

In 2007, AXE, Chi-X and LiquidNet applied to ASIC for Australian market operator licenses with the express intention to operate as rival exchanges or trading platforms to the ASX. During the subsequent consultation process, the Australian Competition and Consumer Commission (ACCC) suggested that competition would likely be welfare enhancing for the economy.[388] ASIC indicated in its submission that competition for market services is in principle desirable because of its potential to reduce transaction costs, create incentives for innovation, and to ensure that the trading preferences of different market participants are catered for.[389] They concluded that competition for market securities in relation to trading in listing securities 'is workable, provided that some rules are in place about the operation of the competing markets.'[390] Somewhat ironically, the ASX submitted that the proposed governance of AXE poses a serious conflict of interest because the regulator is part owned by the organisation it is regulating.[391]

Policy consideration of the market operator license applications is ongoing. However, the Government announced reforms to the supervision of Australia's financial markets on 24 August 2009 as an initial step in the process towards possible multiple operators. Chris Bowen, the Minister for Financial Services, Superannuation and Corporate Law indicated that

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385 ASX, above n 366. The ASXSR Annual Reports to the ASX Board since September 2003 have not been publicly released.

386 *Corporations Act 2001* (Cth) s 794C.

387 ASIC, above n 384; ASIC, Report 135: *Market Assessment Report* (31 July 2008). The assessment processes and standards used by ASIC to determine whether the ASX supervisory processes are adequate are not made public.

388 ASIC, *Consultation Paper 95: Competition for Market Services- Response to CP 86 and Further Consultation* (November 2007) 11.

389 ASIC, above n 388, 11.

390 ASIC, above n 388, 6.

391 ASX, *Regulating Price Discovery and Conflicts of Interest in a Multi-Operator Financial Market* (29 January 2008) 7.

> ASIC will become responsible for supervising trading activities by broker participants which take place on a licensed financial market, while individual markets – such as the … ASX – will retain responsibility for supervising the entities listed on them … [The Minister stated that] there is no need for the Government to supervise listed entities. ASIC and the ASX are working well together in performing this role.[392]

A handover of market supervisory functions occurred on 1 August 2010.[393] ASIC issued ASIC Market Integrity Rules to operate alongside revised ASX Operating rules and ASX 24 Operating Rules.[394] ASIC has an integrated market surveillance system in place and is responsible for overseeing most of the market surveillance previously carried out by the ASX. However, ASIC confirmed that Australian market licensees 'continue to be responsible for the operation of their markets and for monitoring and enforcing compliance with their market's operating rules, which include their listing rules.'[395]

B Enforcement of the ASX Listing Rules

The introduction to the ASX listing rules states that a listed company is contractually bound to comply with the listing rules under its listing agreement with the ASX. Companies are also contractually obligated to indemnify the exchange for any claim, action or expense arising from a breach of the listing agreement. The introduction confirms that the rules 'are to be interpreted: in accordance with their spirit, intention and purpose; by looking beyond form to substance; and in a way that best promotes the principles on which they are based'. However, the ASX has discretion to grant a waiver of a particular rule. ASX Listing Rule 18.5 also states that the ASX has 'absolute

[392] Chris Bowen, Minister for Financial Services, Superannuation & Corporate Law, 'Reforms to the Supervision of Australia's Financial Markets' (Media Release, 24 August 2009) 013.

[393] The *Corporations Amendment (Financial Market Supervision) Act 2010* (Cth) was enacted in March 2010. This Act inserted a new Pt 7.2A into the *Corporations Act 2001* (Cth). From 1 August 2010, ASIC has had responsibility for supervising trading activities and conduct of business by market participants in relation to domestic licensed markets.

[394] ASIC, 'ASIC Ready for Market Supervision' (Press Release, 8 July 2010) 10-151MR. The Market Integrity Rules and Regulatory Guidance are available on the ASIC website: ASIC, *ASIC Ready for Market Supervision* (8 July 2010). <http://www.asic.gov.au/asic/asic.nsf/byheadline/10-151MR+ASIC+ready+for+market+supervision?openDocument> at 10 July 2010. The ASIC Guide states that we anticipate that, from a market participants' perspective, the supervision of markets will not be significantly different after the transfer of market supervisory responsibilities to ASIC.

[395] ASIC, Regulatory Guide 214: *Guidance on ASIC Market Integrity Rules for ASX and ASX 24 Markets* (July 2010) 4.

discretion' on any regulatory or compliance action taken, including a right, 'to decide to take no action in response to a breach of [a] … listing rule.'[396]

The ASX has a hierarchy of powers that it can use to enforce compliance with the listing rules. Its informal powers of persuasion are considerable. Ultimately, the ASX may suspend or delist a company.[397]

The ASX compliance website confirms that on 1 August 2010, the supervision of trading on Australia's domestic licensed markets and trading participants was transferred from the ASX to ASIC. However, the ASX remains responsible for the supervision of its listed entities. The website states that

> The ASX Compliance (ASXC), formerly ASX Markets Supervision, is a wholly owned subsidiary company of ASX which fulfils ASX's oversight obligations as a market operator and clearing and settlement facility operator. This name change was effected to better reflect ASX's altered role.
>
> ASXC has responsibility for the oversight of listed entities under the ASX Listing Rules and for monitoring and enforcement of compliance with the operating rules by market, clearing and settlement participants.[398]

A speech in June 2010 by Lawrence, the general manager of surveillance at ASX, to the Annual Stockbroker's Conference confirmed that as market operator, the ASX is responsible for monitoring, investigating and enforcing compliance with the new ASX Market Rules and the SFE Operating Rules. However, Lawrence indicated that supervision of the listed entity area has not changed, no changes have been made to the listing rules, and the ASX remains responsible for the monitoring of compliance with Listing Rule 3.1, with suspected breaches of the listing rule referred to ASIC.[399]

The ASX issuers unit website states that

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[396] ASX Listing Rule 18.5.
[397] ASX Introduction to Listing Rules; ASX Listing Rules 17.2 and 17.3.
[398] ASX, *ASX Compliance* <http://www.asx.com.au/compliance/index.htm> at 2 August 2010.
[399] David Lawrence, General Manager Surveillance ASX (Speech delivered at the Stockbroker's Association of Australia Annual Conference Melbourne, 8 June 2010) 3-4. See also Eric Mayne and David Lawrence, 'Update on the Transfer of Market Supervision' (Presentation delivered at the 2010 Annual Stockbrokers Conference, 8 June 2010).

> The Issuers Unit raises continuous disclosure queries with listed entities when it has concerns that the entity may not be in compliance with its obligations as set out in Listing Rule 3.1.[400]

However, the actions outlined on the website are limited to (i) price queries, which are raised as a result of unusual movement in a listed entity's share price or trading volume that has been detected by ASX's market surveillance systems; (ii) aware letters following an announcement by a listed entity, where listed entities are asked for details of when they became aware of the material information contained in the announcement; and (ii) queries in relation to the lodgment of Directors' Interest Notices.[401]

C Statutory Support for the ASX Listing Rules

When a company lists on the ASX, it is contractually bound to comply with the listing rules on an ongoing basis. In *Kwiksair Industries Ltd v Sydney Stock Exchange Ltd*,[402] Justice Street confirmed that the rights of a listed company and the stock exchange are derived from the agreement reached between the parties in relation to the listing. His Honour reiterated this in *Ampol Petroleum Lt d v R W Miller Holdings Ltd*,[403] indicating that 'it was common ground that Miller was bound by contract to the stock exchange to observe the rule'.[404] On appeal to the Privy Council, Lord Wilberforce confirmed that the company was in contravention of rules with contractual force.[405]

The obligation of listed companies to comply with the ASX operating rules is given statutory force under ss 792A, 793C and 1101B of the Act. Where there is an infringement of a listing rule, ASIC, a licensee, ASX, or an aggrieved person may apply to the courts for an order directing compliance with the listing rules under ss 793C and 1101B. While s 1101B allows a fine to be imposed for a contravention

[400] ASX, *Monitoring and Enforcement Outcomes* <http://www.asx.com.au/compliance/issuers/monitoring_enforcement_outcomes.htm> at 2 August 2010.
[401] ASX, above n 400. The website doesn't explain what occurs when the price queries or aware letters suggest a breach of the listing rules disclosure obligations. The media release area of the exchange includes quarterly reports on the lodgement of director interest notices.
[402] *Kwiksair Industries Ltd v Sydney Stock Exchange Ltd* (1968) ACLC 30,701.
[403] *Ampol Petroleum Lt d v R W Miller Holdings Ltd* [1972] 2 NSWLR 850.
[404] *Ampol Petroleum Lt d v R W Miller Holdings Ltd* [1972] 2 NSWLR 850, 881.
[405] *Howard Smith v Ampol (PC)* [1974] AC 821, 838.

without reasonable excuse,[406] the Court can only make such an order if it is satisfied that the order 'would not unfairly prejudice any person'.

The existence of the statutory provisions has allowed the courts to broadly interpret the rights of the ASX to suspend trading in a company's securities or to delist a company. Justice Brisden suggested in *Harman v Energy Research Group of Australia Ltd*[407] that the statutory force of the listing rules is limited by the absolute discretion that the exchange has to waive compliance with the rules.[408] However, Justice Macrossan confirmed in *Hillhouse v Gold Copper Exploration NL* that the listing rules are more than just a flexible set of guidelines.[409] In *TNT Australia Pty Ltd v Poseidon Limited (No 2)*,[410] Justice Jacobs indicated that the courts ought to interpret and construe the listing rules in such a way as to give effect to the spirit and the purpose of the rule, because a company is bound by the statement in the introduction to the listing rules that the exchange looks to companies to comply with the spirit as well as the letter of the rules.

D The Co-Regulatory Model Critique and Conclusion

The co-regulatory model is deeply flawed. Academics, market participants and the media have all criticised the dual role status of the ASX. Even a perception of conflict arising from the regulatory structure weakens the integrity of the market and investor confidence.[411] Listed companies are the customers of the ASX, yet these are the same companies that the ASX monitors and supervises.[412] The ASX is therefore disincentivised to make necessary reforms and to take stringent action against its own clients, particularly its largest clients.[413] Indeed, the exchange has structural incentives

[406] Failure to comply with the subsection 1101B(1)) is an offence under s 1311(1). The penalty is 100 penalty units or imprisonment for two years or both. The penalty for a body corporate is five times the maximum: s 1312.
[407] (1985) 9 ACLR 897.
[408] *Harman v Energy Research Group of Australia Ltd* (1985) 9 ACLR 897, 901-902. The broad discretionary powers of the ASX were highlighted by Justice Bryson in *Peninsula Gold Pty Ltd v Sunbeam Victa Holdings Ltd* (1996) 20 ACSR 553, 558.
[409] *Hillhouse v Gold Copper Exploration NL* (1988) 14 ACLC 423, 433.
[410] *TNT Australia Pty Ltd v Poseidon Limited (No 2)* (1989) 15 ACLC 80.
[411] Senate Economics References Committee, above n 367, xv, xvi.
[412] ASX, *Addresses by the Chairman and Managing Director/CEO at ASX AGM* (29 September 2005) 16.
[413] Raykovski, above n 376, 299; Robert Prentice, 'Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future' (2002) 51 *Duke Law Journal* 1397; Rydge et al, above n 375, 12.

to refrain from investigating or discovering wrongdoing because this can create adverse publicity, harm the exchange's reputation and hurt its profits.[414] While some of the market supervisory functions have transferred to ASIC, the ASX continues to be responsible for the supervision of listed companies and the disclosure listing rules.[415]

Pritchard's arguments were written within the context of the markets in the US, where there is competition between exchanges to drive optimal conduct.[416] Competitive threats to the ASX are currently limited (although this may change if new market operators are approved). While listed Australian companies may theoretically decide to move their listings overseas, in practice this is unlikely to occur unless the underlying business is global. Hence, the ASX effectively operates as the monopoly market operator. And as Samuel, the Commissioner of the ACCC suggests, 'a monopoly rarely acts other than in its own interest'.[417] Arguably, the conduct of the ASX to date has been largely consistent with protection and growth of existing profit. Growth of the diluted earnings per share of the ASX for the twelve years since delisting in 1998 equates to more than 22 percent per annum, reflecting the dominant commercial position held by the company.[418]

The co-regulatory model and many of the ASX practices are not replicated overseas. Some countries with privately owned listed stock exchanges have insisted on a totally independent supervisory body.[419] For example, the Financial Services Authority (FSA) in the UK is an independent non-governmental body with statutory powers under *the Financial Services and Markets Act 2000* (UK).[420] The FSA is a company limited by guarantee and financed by the financial services industry. The Treasury appoints the FSA board and the FSA is accountable to Treasury Ministers. Some countries also

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[414] Prentice, above n 413, 1439-1440; Stavros Gadinis and Howell Jackson, 'Markets as Regulators: A Survey' (2007) 80 *Southern California Law Review* 1239, 1298.
[415] ASIC, above n 394.
[416] Adam Pritchard, 'Self-regulation and Securities Markets' (Spring 2003) *Regulation* 32.
[417] Channel Nine, 'The ACCC vs Telstra', *Business Sunday*, August 21 2005. The extent of competition from the Bendigo and Newcastle exchanges is minimal.
[418] Based on a stated diluted earnings per share result of 16.57 in 1998 and 190.4 in 2010.
[419] Stewart Oldfield and Fiona Buffini, 'ASX's Supervisory Review Nears End', *Australian Financial Review* (Sydney), 5 December 2005, 47; United Kingdom Financial Services Authority (FSA), *Review Of The UK Mechanism For Disseminating Information By Listed Companies*, (May 2001) 10-11.
[420] George Osborne, the Chancellor in the United Kingdom, has indicated there will be wide-ranging changes to the to UK's regulatory system, including the removal of some areas of responsibilities from the FSA. The new government has proposed the creation of a new economic crime agency and a new consumer protection and markets authority. **In addition, an** independent commission is reviewing the banking system and is due to report by September 2011.

require competition for the key commercial functions carried out by the exchange, for example, in the provision of company information.[421] In contrast, the ASX has a monopoly over the provision of market data and company announcements. This lucrative source of profits is protected by restricting online access to company announcements to personal investors and preventing the printing or copying of these rules from the online site.[422] The ASX also continues to hold a substantial stake in IRESS Market Technology,[423] a share market information systems company within the S&P/ASX 200. This investment is in direct conflict with the company's supervisory role, and competitors of IRESS are unfairly disadvantaged on competition grounds.[424]

The controls in place to minimise potential or actual conflicts of interest at the ASX are limited. The ASXSR is a subsidiary of the ASX. Possible issues of transparency and conflicts of interest therefore remain.[425] In the US, the SEC actively promotes diverse representation on the boards of exchanges to mitigate potential conflicts of interest.[426] However, there does not appear to be any specific representation on the ASX or ASXSR boards on behalf of retail investors. In addition, the scope of the ASIC review is restricted by law to whether the ASX 'management processes are adequate to ensure that the commercial interests of the ASX do not prevail over its supervisory function'.[427] Finally, ASIC may be reluctant to publicly criticise the ASX given the close relationship between the two organisations and the regular exchange of top executives.

The ability of ASIC, a licensee, ASX, or an aggrieved person to apply to the courts for an order directing compliance with the listing rules under ss 793C and 1101B of the Act is uncertain. These provisions have never been utilised, and the circumstances that

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[421] See, eg, FSA, above n 419, 10-11; Howard Davies, 'Investors Relations Conference', (Speech delivered at the Investors Relations Conference, London, 9 July 2001). Davies indicated that the London Stock Exchange accepted the need for competition; Uren, above n 121, 123.
[422] These restrictions make it very difficult for interested parties to find and read the linkages between the rules, appendices and guidance.
[423] These investments are to be retained: ASX, 'ASX Completes Reviews … and Sets Clear Strategies' (Press Release, 15 December 2005) 4.
[424] Raykovski, above n 376, 299; Senate Economics References Committee, above n 367, xix, 24-26.
[425] Jan Eakin, 'ASX Makes a Fist of Self-Regulation', *The Age* (Melbourne), 22 October 2002, 5; Rydge et al, above n 375, 13; Raykovski, above n 376, 299. The previous ASXSR Chairman D Hoare challenged this assertion, claiming the body is independent.
[426] Ruben Lee, *What Is An Exchange?* (1998) Ch 9.
[427] ASIC, above n 387.

might allow an applicant to secure a conviction or compensation are not known.[428] No material was found within the ASX supervisory documentation explaining that the exchange can enforce the ASX listing rules under ss 793C or 1101B and providing guidance on the circumstances or factors that may result in use of these powers.

[428] Anne-Marie Neagle and Natasha Tsykin, '"Please Explain": ASX Share Price Queries and the Australian Continuous Disclosure Regime' (Working Paper, The Centre for Corporate Law and Securities Regulation University of Melbourne Research Report, 2001) 14.

IX CHAPTER TWO: CRITIQUE AND CONCLUSION

'Sunlight is said to be the best of disinfectants; electric light the most efficient policeman. However, the law should not try to keep investors from making bad bargains.'[429]

Listed Australian companies disclose information to the market on a mandatory and voluntary basis. The mandatory disclosure framework includes the periodic and continuous disclosure regimes with support from the insider-trading regime. The periodic and continuous disclosure regimes on a combined basis are intended to provide investors with all ongoing materially price-sensitive company information on a timely basis.

Mandatory periodic reporting by Australian listed companies generally requires an online audited half-year report within two months of the end of a half-year, an online preliminary final report within two months of the end of the financial year,[430] and an audited annual report within four months of the end of the financial year. Among the periodic reports, the most substantive information is provided in the annual report. However, empirical studies and market practices suggest the content of the annual reports is not price informative due to its delayed release. Thus, the preliminary final report provides the most substantive disclosures to investors in Australia on a timely basis. However, companies have significant discretion over the information they provide in the report, because the required content under Item 4 of Appendix 4E of ASX Listing Rule 4.3 and the relevant accounting standards are ambiguous.

The directors' and chief executive reports in Australian annual reports generally provide considerably less MD&A than the equivalent reports in the US.[431] Some of the preliminary final reports provide little management discussion, analysis or explanation of either financial or non-financial matters.[432] In addition, the required notes and MD&A within the half yearly reports are minimal. Yet empirical studies consistently confirm that investors consider MD&A or qualitative management information such as growth prospects to be important information to assess the sustainable earnings or

[429] Louis Brandeis, *Other People's Money* (1914) 62.
[430] Listed companies may choose to report using the preliminary final format within the two months, with the annual report released later.
[431] No third party empirical studies on the MD&A content of Australian reports could be found. The thesis empirical study outlined in Chapter Five found only minimal MD&A content in many Australian periodic reports.
[432] Confirmed in the empirical study outlined in Chapter Five.

returns of a company when valuing a company’s securities. This is not a surprising outcome. Financial statements alone are often insufficient for investors to judge the quality of released earnings and the likelihood that the announced result is indicative of future performance.[433] MD&A on financial and non-financial items is particularly important during periods of significant economic, industry or business uncertainty.

Australian policy makers and legislators have historically considered and rejected a comprehensive quarterly regime on the basis that quarterly reporting is not necessary in addition to the continuous disclosure regime. However, the aims of periodic and continuous disclosure regimes differ. The regular and relatively standardised periodic reports provide the necessary investor framework from which investors can understand and assess one-off continuous disclosures. Both regimes must be operating effectively for investors to make well-informed investment decisions. A six month gap between the half year and preliminary final reports is a long time, and the continuous disclosure regime has limitations (as explained more fully in the empirical study outlined in Chapter Five). A comprehensive quarterly reporting regime is needed to enable investors to make well-informed decisions and reduce the likelihood of selective disclosure (as argued more fully in Chapter Six). Most listed companies in the US are subject to continuous disclosure listing rule obligations and the UK has broadly similar continuous disclosure requirements as in Australia. Nevertheless, these countries have established quarterly reporting regimes.

When the financial information and MD&A provided in the Australian half yearly and preliminary final reports is limited or ambiguous, the impact of a lack of access to company briefings is magnified because of an enhanced likelihood that any “missing information” will be selectively disclosed at closed or private briefings. Company briefings remain an important means by which listed Australian companies provide information to investors. Selected investors and analysts in Australia have regular access to company management through general and private briefings. Listed companies are required to publicly release the PowerPoint summary of the management presentations made at general analyst briefings. However, companies are not required to provide open access to the briefings or to provide any transcripts of the

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[433] Barron et al, above n 155, 78; Guttentag, above n 135, 171.

question and answer sessions at the general analyst briefings or the content discussed at private briefings.

Most Australian parties continue to argue or imply that closed or private briefings merely clarify information that has already been released to the market under the periodic and continuous disclosure regimes. This approach to company briefing access leaves the following important questions unanswered:

- What are the appropriate selection criteria for company briefing invitations?
- How are excluded investors supposed to confirm the assumptions underlying their forecasts or fill in their information mosaics?
- If briefing invitees require explanation of released information in order to understand it, how effective are the public disclosures, and how are excluded investors supposed to understand the information without such explanation?
- What information is material to share prices? and
- If information provided at briefings is not material even on a composite basis, why are closed briefings required?

In practice, the information set provided to investors with regular company briefing access is significantly richer than the information mosaic provided to excluded investors. Company management, the AIRA, and evidence from open access briefings confirm that closed briefings provide discussion on strategy, industry trends, competitive issues, growth opportunities, future targets, and interpretation of the announced financial results. A strong case can be made that much of this information is material to informed judgments on investment decisions. In any event, it remains unclear why company information needs to be disclosed on a private rather than public basis.[434] Most of the submissions to the parliamentary committee review argued that closed or private briefings add to the formal information provided to the market. However, they failed to consider whether the market would be more informed by open access to the briefings and the negative effects of selective disclosure and reduced public transparency and accountability. As Langevoort suggests, the issue of private contacts has been 'too quickly … assumed away in the prevailing rhetoric' and those advocating the continued use of private contacts 'must explain why a process of *private*

[434] Langevoort, above n 12, 1028, 1054.

contacts is preferable from a societal standpoint to one that forces disclosure into a more open setting …'[435]

Responsibility for surveillance of market misconduct, including insider trading, moved from the ASX to ASIC on 1 August 2010. However, it seems that the co-regulatory structure governing periodic and continuous disclosure regulation, including the listing rule and statutory provisions, has not changed. ASIC confirm that the ASX is responsible for monitoring and enforcing its listing rules. However, the ASX website indicates that enforcement of the disclosure listing rules is limited to informal persuasion, price queries and aware letters. Lawrence, general manager of surveillance at the ASX, confirms that the exchange continues to be responsible for monitoring compliance with Listing Rule 3.1, with any breaches of the listing rule referred to ASIC. There is no evidence of any formal enforcement of the periodic and continuous disclosure listing rules as standalone regulation.

The issues and ambiguities resulting from the co-regulatory structure add to the disadvantaged position of retail investors. The positioning of the ASX with absolute discretion on supervisory action taken, significant conflicts of interest, and a monopoly commercial position, is at odds with a market requiring the highest standards of integrity to ensure public confidence. Retail investors are in the most vulnerable position under the current regulatory structure. These investors are in a weak position to persuade the ASX and listed companies to comply with the listing rules, and are the most likely to be uninformed when the disclosure rules are not enforced. This scenario will not change under the proposed multiple operator reforms.

To summarise, the listed company disclosure framework provides selected institutional investors and analysts in Australia with regular access to company management during reporting periods and between reporting seasons. The information released through the ASX is explained and enhanced on a regular basis by company top executives at general analyst and private briefings. These briefings provide attendees with the opportunities to question company management directly and to receive immediate response. In contrast, retail clients or excluded institutional investors must generally rely on information that is released through the ASX website, and the only opportunity

[435] Langevoort, above n 12, 1028, 1054.

to communicate with company management is at the company AGM held up to five months after the end of the financial year.[436]

Under the disclosure framework just discussed, there is significant information asymmetry across the market, and investors and other stakeholders do not always have timely access to valuable company information needed to make rational decisions. Reforms to the framework are needed to enhance its fairness, efficiency and public transparency. It is sometimes difficult for listed companies to determine where the boundaries lie between mandatory and voluntary company disclosure, between material and immaterial information, between public and private disclosure, and between periodic and continuous disclosure. However, these decisions need not be made in a digital environment. Companies can easily provide public access to information using non-discriminatory disclosure mechanisms such as the ASX CAP, web sites, webcasts and teleconference calls. All parties acknowledge the potential of digital technologies to significantly reduce informational asymmetry. However, listed companies are not fully embracing available technologies to broaden access and improve the quality of information provided to all stakeholders.

[436] *Corporations Act 2001* (Cth) s 250N(2).

CHAPTER THREE: COMPANY DISCLOSURE REGULATION: THEORETICAL AND CONCEPTUAL BASES

'Those who know do not tell; those who tell do not know'[437]

Chapter Three examines the concepts of equal access, selective disclosure, public transparency and efficiency further within the longstanding theoretical debates on corporate disclosure regulation. The Chapter is primarily concerned with the theoretical and conceptual bases for corporate disclosure regulation in Australia. However, selected areas of the global debates are discussed because the Australian theoretical and regulatory framework have been, and continue to be, significantly influenced by global developments. Relevant empirical research is also outlined to reflect the links or threads across the individual debates, and from the theoretical debates to the real world. As other scholars suggest, a "theory" is a net 'cast to catch … "the world"; to rationalize, to explain, and to master it,'[438] and the 'important point is whether the assumptions that underlie … theories are more or less in accordance with reality. In other words, the question is an empirical one.'[439]

The theoretical debate at its broadest level centres on whether mandatory corporate disclosure is justified. Linked to the mandatory disclosure debate are the specific debates on whether trading on private information should be permitted or prohibited by insider trading or selective disclosure regulation. I review the general mandatory disclosure debate initially, followed by the debates on insider trading and selective disclosure regulation. In each part, relevant empirical research and critique is included.

I complete the theoretical discussion by reviewing the concepts, mechanisms and measures of efficiency and fairness that underpin the company disclosure and insider trading regulatory debates. Most scholarly commentary on efficiency in capital markets and the efficiency rationale refers to or derives from the Fama efficient market theory and the efficient capital market hypothesis (ECMH). The ECMH is discussed in detail, including discussion and empirical research on the rational investor assumption. Most

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[437] Nils Hakansson, 'Interim Disclosure and Public Forecasts: An Economic Analysis and a Framework for Choice' (April 1977) 52 *Accounting Review* 396, 396 citing Lao-Tse.
[438] Karl L Popper, *The Logic of Scientific Discovery* (1959) 59.
[439] Joel Seligman, 'The Historical Need for a Mandatory Corporate Disclosure System' (1983) 9 *Journal of Corporation Law* 1, 9.

scholarly literature on fair conduct within capital markets and the fairness rationale discusses notions of equal access, fraud minimisation, investor protection and investor confidence.

I argue that the appropriate efficiency rationale for company disclosure and insider trading policy is long-term economic efficiency, the primary fairness rationale is equal access, and these efficiency and fairness rationales are complementary. On this basis, the primary issues underlying the mandatory disclosure debate are:

(i) What levels of access to information and long term economic efficiency are achieved when company disclosure is discretionary?

(ii) Does regulation requiring company disclosure in the public arena result in improved access and enhance long term economic efficiency?

(iii) If so, what is the appropriate mandatory disclosure regulation to provide equal access (or close to equal acess) to company information and to optimise long term economic efficiency?

Similarly, the main issues underlying the insider trading and selective disclosure debates are:

(i) What levels of access to information and long term economic efficiency are achieved when insider trading and selective disclosure is permitted?

(ii) Does regulation prohibiting insider trading and selective disclosure result in improved access and enhance long term economic efficiency?

(iii) If so, what is the appropriate insider trading and selective disclosure regulation to provide equal access to company information and to optimise long term economic efficiency?

It is not easy to measure and assess the fairness and efficiency effects of company disclosure and insider trading policy decisions across entire markets or economies. Nevertheless, the empirical studies reviewed consistently suggest or infer links between the strength and enforceability of a country’s disclosure system, market transparency, the breadth and depth of stock market investor participation, investor confidence, effective legal protections for minority shareholders, and economic efficiency. The combined research suggests that equality of access and transparent corporate disclosure in the public arena are necessary preconditions to economically efficient markets over the long term. I conclude that mandatory company disclosure law and regulation prohibiting insider trading and selective disclosure are justifiable on efficiency and fairness grounds. The nature and scope of the appropriate regulation are discussed in Chapters Four to Six.

The Chapter is in five Parts:

1. Part I outlines the theoretical debate on the need for, and scope of, mandatory disclosure regulation.
2. Part II discusses the theoretical basis for insider trading regulation.
3. Part III reviews the theoretical basis for selective disclosure regulation.
4. Part IV explores the concepts of efficiency, rationality and fairness within capital markets, possible mechanisms to achieve and measure efficiency and fairness, and incorporation of these goals within policy decision-making.
5. Part V provides critique and concludes.

I MANDATORY CORPORATE DISCLOSURE: THEORETICAL BASIS

Most developed countries have some form of mandatory corporate disclosure. Companies are typically required to provide specified information to the market under periodic or continuous disclosure regulation. In addition, failures to provide mandated information, selective disclosure, or misleading disclosure may be governed by insider trading, selective disclosure, market abuse, or misleading and deceptive conduct regulation. Nevertheless, it is important to understand the theoretical basis for disclosure regulation and the rationales for specific regulation enacted.

Published Australian material on the theoretical basis for corporate disclosure regulation is limited. In 1992, Blair concluded that the benefits of a mandatory disclosure regime were 'by no means clear.'[440] In 1994, these arguments were reiterated and expanded by Blair and Ramsay in a textbook on securities regulation.[441] Blair and Ramsay concluded that while managers have incentives to withhold certain information, 'no definitive conclusions can be reached regarding the extent to which

[440] Mark Blair, 'The Debate Over Mandatory Corporate Disclosure Rules' (1992) 15 *University of New South Wales Law Journal* 177, 178.

the government should mandate the nature and amount of corporate disclosure.'[442] Other parties suggest the primary basis for regulation in Australia was the alleged crisis following high profile corporate failures in the 1980s, described as 'a lack of confidence in the timeliness of corporate reporting, leading to demands for legislative intervention.'[443]

The global literature focuses on the sufficiency of market information in a voluntary company disclosure environment, and the nature and scope of appropriate mandatory disclosure regulation.[444] Most parties seem to agree that some form of regulation is required. However, determining the appropriate regulation is complex because capital markets, disclosure environments, demands for company information, and empirical evidence are constantly evolving.

The mandatory company disclosure issues are encompassed within the broader debate on the need for capital market regulation. Those in favour of free markets generally argue that capital markets should be left to competitive forces with minimal regulatory interference.[445] Others argue that significant government intervention is needed to deal with market[446] or corporate failures or to temper some of the excesses of a laissez faire approach.[447] A spectrum of structures and regulations may be adopted as appropriate "market interference".[448]

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[441] Gordon Walker, Brent Fisse and Ian Ramsay, *Securities Regulation in Australia and New Zealand* (1st ed, 1994).
[442] Walker et al, above n 441, 87.
[443] Philip Brown, Stephen Taylor and Terry Walter, The Impact of Statutory Sanctions on the Level and Information Content of Voluntary Corporate Disclosure' (1999) 35 *Abacus* 138, 139.
[444] John Coffee Jr, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717, 722, 725-737; Merritt Fox, 'Required Disclosure and Corporate Governance' (1996) 62 *Law and Contemporary Problems* 113 (Disclosure); Merritt Fox, 'The Issuer Choice Debate', (2001) 2 *Theoretical Inquiries in Law* 563 (Issuer); James Cox, 'Premises for Reforming the Regulation of Securities Offerings: An Essay' (2000) 63 *Law and Contemporary Problems* 11; Stephen Bainbridge, 'Contemporary Issues in the Law of Business Organizations: Mandatory Disclosure: A Behavioural Analysis' (2000) 68 *University of Cincinnati Law Review* 1023.
[445] Frank Easterbrook and Daniel Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 *Virginia Law Review* 669; Christopher Donald, 'A Critique of Arguments for Mandatory Continuous Disclosure' (1999) 62 *Saskatchewan Law Review* 85.
[446] Coffee, above n 444, 722, 725-737; David Schulte, 'The Debatable Case for Securities Disclosure Regulation' (1988) 13 *Iowa Law Review* 535, 537; Fox, above n 444 (Issuer). See also Stuart Banner, 'What Causes New Securities Regulation? 300 Years of Evidence' (1997) 75 *Washington University Law Quarterly* 849, 850.
[447] Commonwealth, *Australian Financial System Inquiry Final Report* (March 1997) "Wallis Report" 175, 177, 196, 197; Bainbridge, above n 444; Sheen Kassouf, 'Towards a Legal Framework for Efficiency and Equity in the Securities Markets' (1974) 25 *Hastings Law Journal* 417, 418; Guttentag, above n 135, 129; Harry McVea, 'Financial Services Regulation under the Financial Services Authority: A Reassertion of the Market Failure Thesis?' (2005) 64 *Cambridge Law Journal* 413, 447-448. The

The theoretical arguments on mandatory disclosure are somewhat piecemeal and the discussion lacks coherence at times because of the lack of an overarching company disclosure theory. A comprehensive company disclosure theory must embrace 'efficiency, incentives and the endogeneity of the market process as it involves interactions among diverse investor agents.'[449] Corporate information is disclosed on mandatory, voluntary, periodic, and ad hoc bases, it is disclosed through public and private channels, and it includes numeric and qualitative content.[450] Development of a corporate disclosure theory is therefore an immensely challenging task.

The scholarly arguments on whether mandatory disclosure is required are reviewed initially. This is followed by an outline of relevant empirical research, and critique on the debate in light of the research findings.

A Summary of Arguments that Mandatory Disclosure is Not Required

Academics who oppose mandatory disclosure argue that companies have sufficient incentives and methods to ensure that information provided to investors is credible and accurate without the need for mandatory disclosure.[451] These include 'powerful incentives to disclose information [in order] … to compete successfully for funds against alternative investment opportunities.'[452] There is evidence that companies voluntarily disclose significant amounts of information beyond that mandated by securities regulators[453] when they raise capital,[454] to reduce information asymmetry,[455]

Wallis Report indicates that the 'general case for regulation is founded in market failure' and 'this occurs when factors are present that prevent efficient market outcomes'. '[S]pecialised regulation is required to ensure that market participants act with integrity and that consumers are protected … [However,] regulation requires that a careful balance be struck between effectiveness and efficiency'. Kassouf argues that 'ethical notions of equality [may] justify governmental intervention … to prevent the uneven distribution of wealth from proceeding beyond certain limits.' McVea argues for a paradigm shift in policy making away from the sham certainty of market failure to a more complex and textured approach, one that acknowledges that financial services regulation is rooted in citizenship.

[448] See, eg, Edmund Kitch, 'Proposals for Reform of Securities Regulation: An Overview' (2001) 41 *Virginia Journal of International Law* 629; Stephen Choi, 'Regulating Investors Not Issuers: A Market-Based Proposal' (2000) 88 *California Law Review* 279.

[449] Robert Verrecchia, 'Essays on Disclosure' (2001) 32 *Journal of Accounting and Economics* 97, 173.

[450] Michael Gibbins, Alan Richardson and John Waterhouse, 'The Management of Corporate Financial Disclosure: Opportunism, Ritualism, Policies, and Processes' (1990) 28 *Journal of Accounting Research* 121, 122.

[451] Easterbrook et al, above n 445, 673-676, 684, 694, 709; Roberta Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 *Yale Law Journal* 2359, 2373.

[452] Romano, above n 451, 2374.

[453] Romano, above n 451, 2375.

and to lower the cost of capital.[456] It is suggested that companies are forced to disclose unfavorable news, because otherwise sophisticated institutional investors will interpret no news as bad news,[457] and a failure to disclose adverse news may result in litigation.[458] Managers can protect themselves against this “information risk” by voluntarily providing and verifying information about themselves.[459]

Some parties argue that market forces work to reduce unnecessary and duplicated information production costs or research in the absence of mandatory disclosure. Companies have incentives to provide information at lower cost when investors discount the company’s valuation due to high information acquisition costs.[460] However, while ‘mandatory disclosure can reduce the costs of becoming informed … it does not follow that all investors will choose to become informed.’[461] Blair and Ramsay suggest that while mandatory reporting can assist with shareholder monitoring of management, it is not clear whether mandatory disclosure allows shareholders to detect breaches of fiduciary duties by managers.[462] Managers of poorly performing companies are not always dismissed[463] and shareholders often fail to exercise their right to vote due to apathy issues.[464]

Some scholars in the US argue that uninformed or unsophisticated investors don’t require the protection of mandatory disclosure because they are protected by the

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454 Richard Frankel, Maureen McNichols and G Peter Wilson**,** ‘Discretionary Disclosure and External Financing’ (1995) 70 *Accounting Review* 135, 141.

455 Maribeth Coller and Teri Yohn, ‘Management Forecasts and Information Asymmetry: An Examination of Bid-Ask Spreads’ (1997) 35 *Journal of Accounting Research* 181.

456 Christine Botosan, ‘Evidence that Greater Disclosure Lowers the Cost of Equity Capital’ (2000) 12 *Bank of America Journal of Applied Corporate Finance* 60.

457 Roberta Romano, ‘The Need for Competition in International Securities Regulations’ (2001) 2 *Theoretical Inquiries in Law* 387; Walker et al, above n 441, 60-62, 71-72.

458 Jennifer Arlen and William Carney, ‘Vicarious Liability for Fraud on Securities Markets: Theory and Evidence’ (1992) *University of Illinois Law Review* 691, 704. See also Jennifer Francis, Douglas Philbrick and Katherine Schipper, ‘Shareholder Litigation and Corporate Disclosures’ (1994) 32 *Journal of Accounting Research* 137; Douglas Skinner, ‘Earnings Disclosures and Stockholder Lawsuits’ (1997) 23 *Journal of Accounting and Economics* 249; Brett Trueman, ‘Managerial Disclosures and Shareholder Litigation’ (1997) 1 *Review of Accounting Studies* 181.

459 Walker et al, above n 441.

460 Walker et al, above n 441, 69.

461 Walker et al, above n 441, 68.

462 Walker et al, above n 441, 69-70.

463 Walker et al, above n 441, 70.

464 Walker et al, above n 441, 68, 70.

efficiency of the market.[465] Alternatively, they suggest these investors should seek professional advice because they don't understand mandated disclosures and cannot use it profitably.[466] It is suggested that information provided under mandatory disclosure regulation is not very useful anyway.[467] Mandatory disclosure provides predominantly historical information, which is significantly less important to share prices than projected future cash flows.[468] In any event, information is disclosed and factored into share prices regardless of the existence of mandatory disclosure regulation, via voluntary disclosure, selective disclosure by companies to analysts and major investors, insider trading, independent research, and the media.[469] Romano concludes that '[p]roponents of the third-party externality rationale have not specified what information requirements the rationale justifies, let alone whether that information is the focus of … disclosure requirements.'[470]

B Summary of Arguments that Mandatory Disclosure Is Required

Most scholars that support mandatory disclosure regulation seek to justify it on either efficiency or fairness grounds. However, some researchers acknowledge the linkages or interdependencies between the efficiency and fairness rationales.

1 *Mandatory Disclosure Enhances Market Efficiency*

Scholars in favour of mandatory disclosure on efficiency grounds argue that regulation is 'necessary because managers have incentives to conceal information that would be beneficial to investors in assessing company value and the performance of

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[465] Easterbrook et al, above n 445, 693-694; Homer Kripke, *The SEC And Corporate Disclosure: Regulation In Search Of A Purpose* (1979) 14-16, 284-286; Donald, above n 445, 112-115; Walker et al, above n 441, 63.

[466] Easterbrook et al, above n 445, 695; Kripke, above n 465, 14-16, 284-286; Walker et al, above n 441, 67.

[467] Homer Kripke, 'The SEC, The Accountants, Some Myths and Some Realities' (1970) 45 *New York University Law Review* 1151; Jonathan Macey, 'Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty' (1994) 15 *Cardozo Law Review* 909; Edmund Kitch, 'The Theory and Practice of Securities Disclosure' (1995) 61 *Brooklyn Law Review* 763; Romano, above n 451, 2359-2361, 2428; Romano, above n 457.

[468] Kripke, above n 467, 1197-1201; Easterbrook et al, above n 445, 703-704; Donald, above n 445, 116-117.

[469] Macey, above n 467, 928; Romano, above n 451, 2359, 2373, 2380, 2428; Romano, above n 457, 446-464.

[470] Romano, above n 451, 2380. An "externality" is an uncompensated cost or benefit that may be intentional, accidental, or incidental.

management'.[471] That is, in the absence of mandatory disclosure, some companies will fail to disclose, or will misrepresent, material information,[472] particularly when the news is adverse or the company is ailing.[473] It is suggested that company management can avoid negative investor response to poor disclosure practices by participating in a buy-out or private equity bid, avoiding new capital raisings or establishing takeover protections.[474] When this occurs, share prices may not fully reflect material information reducing the efficiency of the market and potentially increasing shareholder losses. Possible adverse consequences associated with voluntary disclosure of negative news include a takeover bid, a fall in the company share price and reduced executive management employment prospects. Some commentators conclude that '[f]ull voluntary disclosure … rarely seems to occur in reality, and [companies] typically do not disclose more than regulation requires.'[475]

It is argued that mandatory disclosure ensures the production of more accurate information at lower cost thereby improving the allocative efficiency of the market.[476] The marginal costs of producing and disseminating mandatory accounts and information are minimal, because financial accounts and the additional information that investors seek are already produced or in the hands of company management as part of their strategic and day-to-day management and operation of the company.[477] Moreover, mandatory disclosure lowers agency costs,[478] and can 'help reduce the cost of monitoring … and managers' use of corporate assets for self-interested purposes.'[479] The costs of trading that don't add to overall wealth creation may also be lessened.[480]

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[471] Walker et al, above n 441, 71. Australian policy makers confirm that the existence of a mandatory continuous disclosure regime recognises 'that entities will not always have incentives to voluntarily disclose such information, particularly when the information may have a negative impact on the share price.': Commonwealth, above n 176, 129.

[472] Brudney, above n 67, 334; Seligman, above n 439, 9; Baruch Lev, 'Toward a Theory of Equitable and Efficient Accounting Policy' (1988) 63 *Accounting Review* 1, 10-11.

[473] Coffee, above n 444, 752; Arlen et al, above n 458, 701; Bainbridge, above n 444, 1033; Marc Steinberg, 'Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis' (2001) 22 *University of Pennsylvania Journal of International Economic Law* 635, 658; Zohar Goshen and Gideon Parchomovsky, 'The Essential Role Of Securities Regulation' (2006) 55 *Duke Law Journal* 711, 760; Ian Ayres and Stephen Choi, 'Internalizing Outsider Trading' (Working Paper No 04, Yale Law School Public Law and Legal Theory) 63.

[474] Goshen et al, above n 473, 760-761.

[475] Anat Admati and Paul Pfleiderer, 'Forcing Firms to Talk: Financial Disclosure and Externalities' (2000) 13 *Review of Financial Studies* 479, 480.

[476] Brudney, above n 67, 328, 334; Goshen et al, above n 473, 757-758.

[477] Cox, above n 444, 17.

[478] Paul Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 *University of Chicago Law Review* 1047; Goshen et al, above n 473, 743-754.

[479] Mahoney, above n 478, 1048.

[480] Coffee, above n 444, 733; Goshen et al, above n 473, 757-758.

2 *Mandatory Disclosure Enhances Market Fairness*

Some scholars suggest the main purpose of mandatory disclosure requirements is investor protection.[481] Others argue that mandatory disclosure regulation is needed to deter fraud.[482] However, the fairness rationale most commonly discussed is equality of access. Some parties argue that a policy mandating the disclosure of financial information does not favour or defend a specific group of investors; rather it aims to benefit all.[483] Others suggest that regulation requiring equal access may make some investors worse off while improving the lot of others.[484]

The morality of trading on asymmetrical information has been the subject of spirited debate among philosophers and legal scholars for many centuries.[485] As outlined in Part IV of this Chapter, most of the equal access theories around company information are based on concepts of consent or the notion that rules are only fair if disinterested individuals who will be bound by them would agree to them in advance. [486] A narrower model developed by Brudney in the US argues for a ban when a party possesses an informational advantage that others cannot lawfully overcome, described as an unerodable information advantage.[487] The equal access approach adopted by Australian policy makers appears to be based on the Brudney model.[488]

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481 Harold Ford, RP Austin and Ian Ramsay, *Ford's Principles of Corporations Law* (13th ed, 2007) 519-502 [10.010]; Neagle et al, above n 428, 5-6.

482 Arlen et al, above n 458, 704; Seligman, above n 439**;** Lynn Stout, 'The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation' (1988) 87 *Michigan Law Review* 613, 700-01.

483 Lev, above n 472, 19.

484 Hakansson, above n 437, 413. See also Cox, above n 444, 13.

485 Garry Lawson, 'The Ethics of Insider Trading' (1988) 11 *Harvard Journal of Law and Public Policy* 727, 737, 753.

486 Kim Scheppele, 'It's Just Not Right': The Ethics of Insider Trading' (1993) 56 *Law & Contemporary Problems* 123, 151-54; David Gauthier, *Morals By Agreement* (1986).

487 Brudney, above n 67, 357, 360.

3 *Summary of Arguments Suggesting that Mandatory Disclosure Enhances Economic Efficiency and Market Fairness*

Some commentators acknowledge that the efficiency and fairness rationales are linked within contemporary markets. These parties argue that asymmetric access to information leads to a loss in investor confidence and reduced investor participation, with adverse effects on transactions costs, liquidity and costs of capital.[489] Empirical studies reflecting these views are outlined below.

C Mandatory Disclosure Empirical Research

Some scholars suggest the issues of whether, and the extent to which, mandatory disclosure is required, should be decided empirically. Market complexities are such that it is not possible to conclusively prove the need for mandatory disclosure. However, empirical research can provide valuable indicators. Much of the legal material in the US discusses studies from the 1930s when substantive securities regulation was introduced.[490] However, the world has changed significantly since this period.[491]

A broad range of global literature was searched for relevant evidence. Bodies of work from legal, accounting, finance and economic scholars use many different measures, samples and designs. Yet they present a surprisingly consistent story about the potential economic benefits for countries that promote investor confidence in the fairness and integrity of their markets through equality of access and transparent corporate disclosure in the public arena.

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[488] CASAC, above n 61, 15; Gregory Lyon and Jean Du Plessis, *The Law of Insider Trading in Australia* (2005) 9.

[489] See, eg, Lev, above n 472, 1; Richard Lambert, Christian Leuz and Robert Verrecchia, 'Accounting Information, Disclosure, and the Cost of Capital' (2007) 45 *Journal of Accounting Research* 385, 410-412.

[490] Coffee, above n 444, 719-720; George Stigler, 'Public Regulation of the Securities Markets' (1964) 37 *Journal of Business* 117; George Benston, ''Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934' (1973) 63 *American Economic Review* 132; Romano, above n 451, 2373; Fox, above n 444 (Issuer); Brian Bushee and Christian Leuz, 'Economic Consequences of SEC Disclosure Regulation: Evidence From the OTC Bulletin Board' (2005) 38 *Journal of Accounting and Economics* 233.

[491] Coffee, above n 444, 719-720.

Empirical evidence from finance scholars suggests trust is an important factor underlying stock market participation.[492] This is confirmed by finance studies across global securities markets.[493] La Porta et al have carried out a series of empirical studies over the last decade. In the earlier research, they found evidence suggesting that countries with better investor protection, measured by the character of the legal rules and the quality of law enforcement, have more valuable markets, larger numbers of listed securities per capita, and a higher rate of initial public offering activity than do countries with worse investor protection.[494] They suggest that companies in countries with greater minority shareholder protection are valued higher.[495] In a later study, they found evidence suggesting that laws in a country mandating disclosure and facilitating private enforcement through liability rules benefit the stock market.[496] They indicate that the answer to the question of whether securities laws matter is a definite yes. 'Financial markets do not prosper when left to market forces alone … Extensive disclosure requirements and standards of liability facilitating investor recovery of losses are associated with larger stock markets.'[497] They suggest these results 'point to the importance of regulating the agency conflict between controlling shareholders and outside investors to further the development of capital markets.'[498]

Other international studies have found similar links or associations. Young and Guenther suggest that countries with greater disclosure of value-relevant accounting

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[492] Luigi Guiso, Paola Sapienza and Luigi Zingales, 'Trusting the Stock Market' (2008) 63 *Journal of Finance* 2557.

[493] All empirical studies have limitations. For example, the directional and endogeneity issues are difficult to control in the global studies.

[494] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Legal Determinants of External Finance' (1997) 52 *Journal of Finance* 1131 (Legal), 1131. See also Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'The Quality of Government' (1999) 15 *Journal of Law, Economics and Organization* 222 (Government), 222; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113 (Law), 1152.

[495] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Investor Protection and Corporate Valuation' (2002) 62 *Journal of Finance* 1147, 1166-1169.

[496] Rafael La Porta, Florencio Lopez-de-Silanos and Andrei Shleifer, 'What Works in Securities Laws?' (2006) 61 *Journal of Finance* 1, 1, 27-28.

[497] La Porta et al, above n 496, 27.

[498] La Porta et al, above n 496, 28. See also Stephen Choi, 'Law, Finance, and Path Dependence: Developing Strong Securities Markets' (2002) 80 *Texas Law Review* 1657, 1726; Brian Cheffins, 'Law As Bedrock: The Foundations of an Economy Dominated By Widely Held Public Companies' (2003) 23 *Oxford Journal of Legal Studies* 1. Choi suggests that merely pointing to elements of a strong securities market does not address the more difficult question of how to get countries to embrace such elements. Cheffin suggests that the manner in which corporate governance evolved n the US and the UK does not foreclose the possibility that the law could play a significant role in countries that currently have an insider control-oriented system of ownership and control. Instead, law reform could perhaps provide a

information are more likely to have higher international capital mobility.[499] Bhattacharya et al suggest that an increase in the opacity of reported earnings in a country is linked to a significant increase in the cost of equity and a significant decrease in trading in the relevant stock market.[500] Similarly, Frost et al found evidence that the strength of a country's disclosure system is positively associated with market development, investor participation, and economic growth.[501] Hail and Leuz suggest that companies from countries with more extensive disclosure requirements, stronger securities regulation, and stricter enforcement mechanisms have a significantly lower cost of capital and higher valuations.[502] A more recent study by Francis et al concludes that a country's corporate transparency environment contributes to efficient resource allocation.[503] The study authors argue that transparency improves firms' access to lower cost external financing, contributes to more informative stock prices, and plays an important governance role by allowing greater monitoring by outside investors. They suggest that 'an improved information environment may enhance intersectoral asset allocation, irrespective of other underlying country characteristics and institutions.'[504]

Another body of global studies statistically correlates the returns of a company's securities against the synchronicity with, or the returns of, the market and the relevant sector, as a measure of share price accuracy. Using this approach, Wurgler suggests capital for promising investment opportunities is more likely to be allocated to countries with lower synchronized stock returns.[505] Durnev et al also suggest that

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"jump start" in an Anglo-American direction by offering outside investors sufficient protection to feel confident about owning tiny percentages of equity in publicly traded companies.

[499] Danqing Young and David Guenther, 'Financial Reporting Environments and International Capital Mobility' (2003) 41 *Journal of Accounting Research* 553. See also William Reese and Michael Weisback, 'Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings' (2002) 66 *Journal of Financial Economics* 65, 65.

[500] Utpal Bhattacharya, Hazem Daouk and Michael Welker, 'The World Price of Earnings Opacity' (2003) 78 *Accounting Review* 641.

[501] Carol Frost, Elizabeth Gordon and Andrew Hayes, 'Stock Exchange Disclosure and Market Development: An Analysis of 50 International Exchanges' (2006) 44 *Journal of Accounting Research* 437, 479.

[502] Luzi Hail and Christian Leuz, 'International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?' (2006) 44 *Journal of Accounting Research* 485, 485, 524. See also Ross Levine, 'Law, Finance, and Economic Growth' (1999) 8 *Journal of Financial Intermediation* 8, 32-33.

[503] Jennifer Francis, Shawn Huang, Inder Khurana and Raynolde Pereira, 'Does Corporate Transparency Contribute to Efficient Resource Allocation?' (2009) 47 *Journal of Accounting Research* 943.

[504] Francis et al, above n 503, 982.

[505] Jeffrey Wurgler, 'Financial Markets And The Allocation Of Capital' (2000) 58 *Journal of Financial Economics* 187.

capital allocation is more closely aligned with shareholder value maximization where share prices are more asynchronous.[506] Similarly, Morck et al suggest that in developed economies, stock markets providing public shareholders with stronger legal protection against corporate insiders are associated with greater firm-specific returns variation.[507]

There is also a significant and growing body of research that associates or links reductions in information asymmetry with lower costs of capital.[508] Information asymmetry reduction provides a rationale for efficient disclosure choice based on links between greater disclosure, reduced information asymmetry, and lower costs of capital.[509] One stream of empirical research links reductions in information asymmetry and lower equity capital costs with a reduction in investor estimation risks. Another stream links reductions in information asymmetry and lower equity capital costs with reduced transaction costs or increased liquidity.[510] Botosan concludes that while individual studies on cost of capital are not perfect, 'the bulk of the literature suggests that greater disclosure reduces the cost of equity capital.'[511] This analysis is affirmed by studies which suggest that companies can lower their cost of capital by disclosing publicly rather than privately.[512]

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[506] Art Durnev, Randall Morck and Bernard Yeung, 'Value Enhancing Capital Budgeting and Firm-Specific Stock Return Variation' (2004) 59 *Journal of Finance* 65.

[507] Randall Morck, Bernard Yeung and Wayne Yu, 'The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?' (2000) 58 *Journal of Financial Economics* 215, 258.

[508] Douglas Diamond and Robert Verrechia, 'Disclosure, Liquidity, and the Cost of Capital' (1991) 46 *Journal of Finance* 1325; Christian Leuz and Robert Verrecchia, 'The Economic Consequences of Increased Disclosure' (2000) 38 *Journal of Accounting Research* 91, 121; David Easley and Maureen O'Hara, 'Information and the Cost of Capital' (2004) 59 *Journal of Finance* 1553, 1553, 1555-1556, 1578; Christine Botosan, 'Disclosure and the Cost of Capital: What Do We Know?' (2006) *Accounting and Business Research* International Accounting Policy Forum 31, 39; Stephen Cooper, 'Discussion of 'Disclosure and the Cost of Capital: What Do We Know?' (2006) *Accounting and Business Research* International Accounting Policy Forum 41; Hail et al, above n 502, 485, 524; Lambert et al, above n 489, 487; Richard Lambert, Christian Leuz and Robert Verrechia, 'Information Asymmetry, Information Precision, and the Cost of Capital' (Working Paper, March 2008).

[509] Verrecchia, above n 449, 166, 173, 174. See also Arthur Levitt, 'The Importance of High Quality Accounting Standards' (1998) 12 *Accounting Horizons* 79, 81; Stephen Brown and Stephen Hillegeist, 'How Disclosure Quality Affects the Level of Information Asymmetry' (2007) 12 *Review of Accounting Studies* 443.

[510] Botosan, above n 508.

[511] Botosan, above n 508, 31. Various proxies have been used to date to measure cost of capital and improved levels or quality of disclosure. However, all of these proxies have flaws that are difficult to fully resolve.

[512] David Easley, Soeren Hvidkjaer and Maureen O'Hara, 'Is Information Risk a Determinant of Asset Returns?' (2002) 62 *Journal of Finance* 2185, 2219. See also Easley et al, above n 508, 1553, 1555-1556, 1578.

However, despite the documented benefits of public disclosure of high quality company information, empirical studies also suggest that some companies only disclose information in the public arena when required to do so, particularly when the news is negative. As outlined in Chapter Two, Holland found that listed companies in the UK didn't willingly release information about downside risks or negative news within public disclosures unless it 'involved a well-publicised problem, a profits warning, or they were faced by a clear regulatory requirement.'[513] 'The companies 'displayed a bias towards optimism in their disclosure behaviour and content and for avoiding discussion of downside risks.'[514] Similarly in the US, Pastena and Ronen found company managers disclosed information as if they attempted 'to delay the dissemination of negative information relative to positive information', disclosed primarily soft positive information rather than soft negative information, and disclosed negative information only after such information became hard.[515] Miller also found disclosure patterns consistent with managers strategically choosing to disclose positive news while avoiding discussion of impending downturns in performance.[516] A more recent study by Kothari et al confirmed that company management delayed the release of bad news to investors.[517] Lewellen et al found evidence that companies chose stock return benchmarks to report against that showed the results in a favourable light. The degree of downward bias was stronger for companies with relatively weaker earnings and share price performance.[518] Interestingly, Rogers and Stocken found company manager's willingness to misrepresent forward-looking information was a function of the market's ability to detect the misrepresentation.[519] That is, managers were more likely to issue forecasts that were biased when it was more difficult for investors to detect the bias.[520]

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[513] John Holland, *A Model of Corporate Financial Communications* (2006) 132.
[514] Holland, above n 513, 157.
[515] Victor Pastena and Joshua Ronen, 'Some Hypotheses on the Pattern of Management's Informal Disclosures' (1979) 17 *Journal of Accounting Research* 550, 563-564.
[516] Gregory Miller, 'Earnings Performance and Discretionary Disclosure' (2002) 40 *Journal of Accounting Research* 173, 173, 201.
[517] SP Kothari, Susan Shu and Peter Wysocki, 'Do Managers Withhold Bad News?' (2009) 47 *Journal of Accounting Research* 241.
[518] Wilbur Lewellen, Taewoo Park and Byung Ro, 'Self-Serving Behaviour in Managers' Discretionary Information Disclosure' (1996) 21 *Journal of Accounting and Economics* 227, 251. See also Donald Langevoort, 'Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)' (1997) 146 *University of Pennsylvania Law Review* 101, 106
[519] Jonathan Rogers and Phillip Stocken, 'Credibility of Management Forecasts' (2005) 80 *Accounting Review* 1233, 1233-1234.
[520] Rogers et al, above n 519, 1235.

A study by Graham et al comprising a combination of field interviews and a survey of more than 400 CFOs confirmed these trends. Although profitable companies were inclined to release bad news quickly, unprofitable companies were more likely to delay bad news.[521] Some CFOs admitted they allow "fuzziness" in bad news disclosures and several indicated that they delay the release of bad news 'in hopes that the firm's status will improve'.[522] Arlen and Carney reported that 91.3 percent of the fraud on the market cases in the US during the period 1970 to 1990 involved either the concealment of a decline in earnings or the concealment of bad news. These concealment cases had serious impacts, with overall stock prices falling between 42-48 percent when the truth was revealed.[523] Tillman and Indergaard highlighted that the most expensive corporate frauds to date have involved alleged CEO and CFO involvement or collusion.[524]

The global empirical study findings of reluctance to disclose negative information and attempts to disguise bad news within public releases were observed in the thesis study of Australian company disclosure practices outlined in Chapter Five.[525]

D Mandatory Company Disclosure Critique and Conclusion

The primary arguments made by other scholars against mandatory disclosure are: that companies have sufficient voluntary incentives to disclose information; market forces work to reduce information production costs; mandatory disclosure fails to enhance the monitoring of management; retail investors don't need protection; and mandatory disclosures are not very useful anyway. The implicit assumption that appears to underpin these arguments are that capital markets operate most efficiently by allowing companies discretion on the content, timing and recipients of their disclosures. Efficiency and fairness concepts are discussed in more detail in Part IV of this Chapter.

Most scholars that support disclosure regulation seek to justify it on either efficiency or fairness grounds. Those who support mandatory disclosure on efficiency grounds argue

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[521] John Graham, Campbell Harvey and Shiva Rajgopal, 'The Economic Implications of Corporate Financial Reporting' (2005) 40 *Journal of Accounting and Economics* 3, 63.
[522] Graham et al, above n 521, 65.
[523] Arlen et al, above n 458, 724-725. 8.7% of the cases involved attempts to understate the value of securities when there were conflicts of interest or the managers were attempting to buy out the shareholders at an unfairly low price.
[524] Robert Tillman and Michael Irgaard, *Control Overrides in Financial Statement Fraud: A Report to the Institute for Fraud Protection* (16 January 2007).

that voluntary incentives are insufficient to ensure disclosure of all material company information. It is suggested that disclosure regulation enhances allocative efficiency, by enabling more accurate information production at lower cost, reducing agency costs and social waste, and enhancing the monitoring of company management. Those who adopt market fairness theories argue that mandatory disclosure is needed to deter fraud, and to promote investor protection, equal access to information, and investor confidence in the integrity of the market.

The main areas of dispute within the mandatory disclosure debate require further analysis in light of the empirical research. I present my critique and conclusions under the following headings:

1. Are voluntary incentives sufficient for companies to disclose material information to all stakeholders?
2. Does corporate disclosure in the public arena enhance the monitoring of company managers?
3. Are uninformed investors protected by market efficiency?
4. What are the long-term economic efficiency benefits of transparent company disclosure in the public arena?

1 *Are Voluntary Incentives Sufficient for Companies to Disclose Material Information to All Stakeholders?*

All parties concur that information is essential to the efficiency of markets and that companies have some incentives to disclose information voluntarily. However, there is no consensus on the extent to which companies would disclose information voluntarily in the absence of mandatory disclosure regulation. Incentives in contemporary financial markets for informational advantages are considerable because such advantages are generally synonymous with making money. However, unlike general commodities, information is both a private and public good.[526] Within the public sphere, information is viewed as an infinite resource to be shared and spread as widely and equally as

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[525] See Chapter Five for a detailed outline.

[526] James Boyle, 'A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading' (1992) 80 *California Law Review* 1413, 1433-1437.

possible and the emphasis is on fairness and equality.[527] Once produced, information can be disseminated at virtually zero marginal cost creating social benefits.[528] However, since the providers of information as a public good are unable to receive full value for their efforts, they will tend to under-produce unless the government intervenes.[529] In contrast, within the private sphere, information is a finite good that is subject to the same economic laws as other goods.[530] Information is a resource that cannot be given away infinitely without diminishing its value.[531] Free markets are assumed to promote the most efficient outcome and equality is not relevant.[532] Accordingly, a producer of information requires a profit or an incentive to continue to produce, and rights in information may be required to avoid underproduction and inefficient allocation.[533]

The complexities arising from the dual nature of information flow through to the market information debates. Academics cannot agree whether in the absence of mandatory disclosure securities information would be under-or-over produced. In an unregulated market, company information may be underproduced and some investors may benefit from the information without bearing any of the production costs.[534] On the other hand, resources may be wasted when too many investors produce similar information in an attempt to gain a trading advantage.[535]

The theories and arguments on the property rights of company information take many forms, depending largely on a party's perspective on the private versus public nature of information and market participant incentives. Information may be treated as a public resource, the property right may remain with the information issuer, a non-exclusive property right may be granted to possessors of information that are not related to the issuer such as analysts, or a structure involving a mixture of these approaches can be

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[527] Kimberly Krawiec, 'Fairness, Efficiency and Insider Trading: Deconstructing the Coin of the Realm in the Information Age' (2001) 95 *North Western University Law Review* 443, 453; Boyle, above n 526, 1438.
[528] Boyle, above n 526, 1438.
[529] Bolye, above n 526, 1439, 1445.
[530] Boyle, above n 526, 1439.
[531] Boyle, above n 526, 1439.
[532] Krawiec, above n 527, 460.
[533] Krawiec, above n 527, 502.
[534] Blair, above n 440, 193.
[535] Jack Hirshleifer, 'The Private and Social Value of Information and Reward To Inventive Activity' (1971) 61 *American Economic Review* 561, 565-566; Easterbrook et al, above n 445, 682.

adopted. As might be expected, there is no academic consensus on which of these options is most appropriate.[536]

The property right theories most pertinent to the thesis propositions are those that argue that analysts require rights to selectively disclosed company information as incentive to produce research. These theories, which are presented in several forms, are discussed in detail in Part III of this Chapter on selective disclosure. I conclude that these arguments are not compelling in the Australian context. It is not possible to empirically model or to fully comprehend the net impacts of informational incentives across an entire market.[537] However, available evidence suggests the relationships or links between access to company information, selective disclosure, the production of analyst research, and economic efficiency, are tenuous. In any event, private access to company information in Australia does not depend on the production and provision of analyst research to third party investors.

The incentives that motivate companies to produce information about themselves differ from those that encourage the production of market information by persons outside of the company, such as analysts. Companies are not required to disclose proprietary or genuinely confidential information to the market under mandatory disclosure regimes.[538] Nevertheless, companies need to produce and provide information to some investors in order to compete successfully in the capital markets, and as part of operating a business.[539] Demands for equal access to company information are generally restricted to the information that companies choose to disclose to some investors. Thus, the real debate is not whether mandatory disclosure regulation is required to ensure disclosure of "new" information to the market, but how much of the information already disclosed by companies privately to some investors should be readily accessible in the public arena through the mandatory reporting processes.

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[536] James Cox, 'Insider Trading and Contracting: A Critical Response to the "Chicago School"' (1986) 4 *Duke Law Journal* 628; Michael Whincorp, 'Towards A Property Rights and Market Microstructural Theory of Insider Trading Regulation - The Case of Primary Securities Markets Transactions' (1996) 7 *Journal of Business and Finance Law* 212; Jonathan Macey, 'Securities Trading: A Contractual Perspective' (1999) 50 *Case Western Reserve Law Review* 269; Choi, above n 448; Kitch, above n 448.

[537] Frank Easterbrook, 'Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information' (1981) *Supreme Court Review* 309, 364; Boyle, above n 526, 1452; Maureen O'Hara, *Market Microstructure Theory* (1995).

[538] Ronald Dye, 'Disclosure of Nonproprietary Information' (1985) 23 *Journal of Accounting Research* 123; Krawiec, above n 527, 495.

[539] Krawiec, above n 527, 489.

Company disclosure on a private or selective basis, and delays in the provision of company information, can have significant detrimental consequences on uninformed investors and stakeholders. Empirical research consistently suggests that when company disclosure is voluntary or discretionary, some company managers only disclose negative information publicly when they have to. As outlined in Chapter Two, Holland suggested that companies in the UK only released bad news in the public arena when 'it involved a well-publicised problem, a profits warning, or they were faced by a clear regulatory requirement.'[540] In the US, Pastena and Ronen suggested that company managers attempted to delay the dissemination of negative information relative to positive information and disclosed negative information only after such information became hard.[541] Similarly, Kothari et al suggested that company management delayed the release of bad news.[542] Notably, the Graham et al study found that unprofitable companies were more likely to delay their disclosures than other companies.

The research also suggests that when corporate managers are required to release bad news, they often attempt to disguise it or present it in as positive a light as possible. Rogers and Stocken found that managers were more likely to issue forecasts that were biased when it was more difficult for investors to detect the bias.[543] Pastena and Ronen found that company managers attempted to disclose primarily soft positive commentary rather than negative commentary.[544] Similarly, Miller found disclosure patterns consistent with managers strategically avoiding discussion of impending downturns in performance.[545] The thesis empirical study outlined in Chapter Five found similar disclosure patterns to those identified in the global studies.

At the end of the day, we 'are what we repeatedly do. Not what we say we are. Not what we'd like to be. But what we do.'[546] The empirical studies suggest that voluntary incentives are not sufficient to ensure that companies publicly disclose all material information on a timely basis. Private disclosure of information is often preferred when it allows greater control over the dissemination processes, there are conflicts of interest

[540] Holland, above n 242, 134.
[541] Pastena et al, above n 515, 563-564.
[542] Kothari et al, above n 517.
[543] Rogers et al, above n 519, 1254.
[544] Pastena et al, above n 515, 563-564.
[545] Miller, above n 516, 173, 201.

involved, or management accountability for poor performance or bad news can be reduced.[547] In addition, when information is disclosed publicly, company managers sometimes try to disguise or spin the disclosure of bad news.

Critics may well argue that these studies, which were primarily done within mandatory disclosure regimes, evidence the ineffectiveness of these schemes. However, I suggest they highlight the need for mandatory disclosure regulation to be carefully crafted and effectively enforced to achieve the policy goals of transparent and timely corporate disclosure in the public arena.

2 *Does Transparent Corporate Disclosure in the Public Arena Enhance the Monitoring of Company Managers?*

Public scrutiny is a critical element of corporate governance and accountability processes. Persons or institutions outside of a company that are typically encompassed within a listed company's governance structure include auditors, independent advisors, ratings agencies, regulators, analysts and institutional investors. Corporate history indicates that these individual controls (commonly referred to as gatekeepers) are fallible.[548] Many of the largest global corporate collapses or losses have involved failures in professional gatekeeper controls and poor disclosure practices.[549] Moreover, empirical research confirms that institutional investors are not the only, or necessarily the most effective, corporate monitors on an ongoing basis.[550]

Sadly, it is often easier for parties, including regulators, to take action or place blame after a corporate collapse than while a company is still trading as a going concern. Those who become aware of financial or other corporate issues early on are often

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[546] Roberts, above n 35, 4.
[547] See, eg, Holland, above n 242, 134.
[548] William Bratton, 'Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value' (2002) 76 *Tulane Law Review* 1275, 1340.
[549] Beaver, above n 123, 159; Donald Langevoort, 'Investment Analysts and the Law of Insider Trading' (1990) 76 *Virginia Law Review* 1023, 1142; Commonwealth, above n 33; John Coffee Jr., *Gatekeepers: The Professions and Corporate Governance* (2006).
[550] Allen Craswell, Stephen Taylor and Richard Saywell, 'Ownership Structure and Corporate Performance: Australian Evidence' (1997) 5 *Pacific-Basin Finance Journal* 301, 301, 320; Bipin Ajinkya, Sanjeev Bhojraj and Partha Sengupta, 'The Association Between Outside Directors, Institutional Investors and the Properties of Management Earnings Forecasts' (2005) 43 *Journal of Accounting Research* 343; Jana Fidrmuc, Marc Goergen and Luc Renneboog, 'Insider Trading, News Releases, and Ownership Concentration' (2006) 61 *Journal of Finance* 2931.

discouraged from raising the alarm to a broader audience because of a heavy price for doing so. It is particularly difficult for individuals outside of a company or concerned insiders to warn or to take action against establishment companies.[551] For instance, there were senior management, analysts, media or auditors who raised the alarm in relation to HIH, One Tel, Enron, ABC Learning, Mazoff and Lehman Brothers, but these individuals were ignored, sacked or blacklisted.[552] Quiet withdrawal by informed parties is generally the preferred option. Parties warned either expressly or otherwise of arising corporate problems tend to exit in advance of other stakeholders and this is reflected in the steady collapse of the company's share prices.[553] Too often the wider public is not made aware of the true picture until the final stage of the collapse.

Recent global events have bought the importance of corporate accountability, market transparency and public scrutiny back into focus. Prior to the crisis, many financial companies transacted with each other, particularly in unregulated areas of the market, without publicly disclosing the nature and scope of their activity. Poorly aligned corporate and institutional incentives, greed, and conflicts of interest were all factors in the crisis.[554] However, the 'excesses built up most where the financing structures [and mortgage practices] were most opaque …[and] outright fraud had gotten to be … a problem'.[555] A lack of corporate transparency prevented or reduced the impact of professional gatekeeper and broader public control processes and responses. The potential losses continued to build, with the broader public largely unaware of the pending issues and consequences.

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[551] Andrew McRobert, *Corporate Collapse: An Early Warning System for Lenders, Investors and Suppliers* (1997) 80; Bratton, above n 548, 1279, 1332, 1352, 1358; Commonwealth, above n 33, Vol 1 68.

[552] Michael Westfield, *HIH The Inside story of Australia's Biggest Corporate Collapse* (2003) 135; Commonwealth, above n 33, Vol 1 xviii, 72-73; Roman Tomasic, 'Corporate Collapse, Crime and Governance - Enron, Anderson and Beyond' (2002) 14 *Australian Journal of Corporate Law* 183, 195; Vanda Carson, 'Exec Warned on One Tel', *The Australian* (Melbourne) 13 July 2005, 23; Christine Selb and Alexandra Frean, 'Lehman Vice-President Lost Job After Raising Repo 105 Ethical Concerns', *The Australian* (Sydney), 17 March 2010; Robert Rhee, 'The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers' (2009) 35 *Journal of Corporation Law* 363, 365.

[553] Commonwealth, above n 33, Vol 1 62; McRobert, above n 551, 69-70; Bratton, above n 548, 1283-1285.

[554] Financial Services Authority (FSA), 'The Turner Review: A Regulatory Response To The Global Banking Crisis' (March 2009) 8, 76-81, Luci Ellis, Head of Financial Stability Department, Reserve Bank of Australia, 'The Global Financial Crisis: Causes, Consequences and Countermeasures' (Speech delivered at the Conference On The Implications Of The Global Financial Crisis For Australia And Its Region, Victoria University, Melbourne, 15 April 2009); Ana Carvajal, Randall Dodd, Michael Moore, Erland Nier, Ian Tower and Luisa Zanforlin, International Monetary Fund (IMF), IMF Staff Position Note, 'The Perimeter of Financial Regulation' (26 March 2009).

[555] Ellis, above n 554.

Mandatory disclosure regulation does not, and cannot, prevent corporate losses and failures. Corporate losses and failures are an inherent part of open and competitive markets. However, regulation that promotes transparent corporate disclosure in the public arena can mitigate the extent to which corporate losses are borne by investors, stakeholders and the broader economy by drawing early attention to poor business practices, emerging issues, and excesses. A regulatory framework that requires public disclosure will in most cases, lead to earlier detection of corporate failures or associated losses than would otherwise be the case.[556] As some of the staff at the International Monetary Fund suggested, regulation needs to include 'as much public reporting (within a consistent framework) as possible – to enhance market discipline as well as to enable effective monitoring.'[557]

Markets undoubtedly work best when they operate in the sunlight. Justice Owen indicated in the HIH Royal Commission Report, that good corporate governance is about the 'fundamental notions of openness, integrity and accountability'.[558] 'Whatever the [corporate] model [adopted], the public must know about it and about how it is operating in practice …'.[559] Similarly, Lowenstein suggested in the US that 'people who are forced to undress in public will presumably pay attention … [to their actions or will] resist the order to disrobe …. [industry is likely to be more efficient and competitive when corporate executives know] their stewardship of other people's money is open to scrutiny.'[560]

A disclosure framework that requires companies to report in the public arena strengthens market and company governance and accountability processes.[561] The mechanisms of capital markets are messy. The all-consuming drive within markets to make money is a double-edged sword. While profit incentives and greed are essential

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[556] Julian Blanchard, 'Corporate Accountability and Information – Lessons From Democracy' (1997) 7 *Australian Journal of Corporate Law* 31, 326.
[557] Carvajal et al, above n 554.
[558] Commonwealth, above n 33. Vol 1, Pt 3, s 6.6.
[559] Commonwealth, above n 33, Vol 1, Pt 3, s 6.6.
[560] Louis Lowenstein, 'Financial Transparency and Corporate Governance: You Manage What You Measure' (1996) 96 *Columbia Law Review* 1335, 1339, 1344. See also Robert Bushman, Joseph Piotroski and Abbie Smith, 'What Determines Corporate Transparency?' (2004) 42 *Journal of Accounting Research* 207; Brudney, above n 67, 335; Commonwealth, above n 33; CASAC, above n 61, 6.
[561] Lowenstein, above n 560, 1361-1362; Blanchard, above n 556, 326.

capital market drivers, conflicts of interest, misaligned incentives, and excesses must be checked or controlled to keep markets optimally efficient.[562] The market disciplines which flow from public scrutiny are needed to promote genuinely open and competitive markets, discourage institutional and individual excesses that history and recent experience tell us inevitably arise, and ensure that losses are not unfairly placed on the most vulnerable participants.

3 *Are Uninformed Investors Protected by Market Efficiency?*

The arguments, which suggest that investors can free ride on the back of professional investors and are protected by the efficiency of the market, are not credible. As outlined more fully in Part IV of this Chapter, Fama developed the ECMH model in the 1960s to empirically test whether security prices fully reflect particular information subsets. He argued that an efficient market is one 'in which prices always "fully reflect" available information'.[563] In a strong form or perfectly efficient market, security prices fully reflect all currently known information, including public and private information. The semi strong information subset is limited to publicly available information and the weak form is restricted to historical price sequences.[564] No scholarly material has been found suggesting that markets are strong form informationally efficient. There is general consensus that markets are either semi-strong or weak form efficient (as defined under the ECMH).[565] Uninformed investors are not protected by price efficiency when trading against counterparties with private information in markets that are semi strong or weak form efficient. As discussed more fully in Part III of this Chapter, private or selective company disclosures can have significant detrimental consequences on uninformed investors and stakeholders.

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[562] Eric Posner, 'The Jurisprudence of Greed' (2003) 151 *University of Pennsylvania Law Review* 1097; Saul Levmore, 'Simply Efficient Markets and the Role of Regulation: Lesson from the Iowa Electronic Markets and the Hollywood Stock Exchange' (2003) 28 *Journal of Corporation Law* 589, 605, 645; Charlotte Villiers, *Corporate Reporting & Company Law* (2006) 36.

[563] Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383, 383.

[564] Fama, above n 563, 414.

[565] William Bratton and Michael Wachter, 'The Case Against Shareholder Empowerment' (2010) 158 *University of Pennsylvania Law Review* 653, 690.

4 *What are the Long-Term Economic Efficiency Benefits of Transparent Corporate Disclosure in the Public Arena?*

The empirical studies outlined in section D present a consistent story about the potential economic efficiency benefits for countries that promote investor confidence in the fairness and integrity of their markets through equality of access and transparent corporate disclosure in the public arena. They suggest that the economic efficiency of a country is linked to or associated with high company disclosure and transparency standards, reduced information asymmetry, the quality of law enforcement, widespread investor participation, investor confidence, effective minority shareholder protection and public trust.[566] Transparent corporate disclosure in the public arena enables widespread monitoring of corporate and market conduct, assists with the minimisation of fraud and corporate losses, and promotes robust competition necessary to enhance economic efficiency. In contemporary markets, it is cheaper and more efficient to disseminate company information publicly rather than privately or selectively.

While there are limits to what company disclosure regulation can achieve, carefully crafted and effectively enforced rules can promote and enhance the transparency and timeliness of corporate disclosures. To the extent that mandatory disclosure achieves these aims, the regulation is well justified. However, the rationales are weakened, or possibly even negated, if company information continues to be provided on a tiered, private or delayed basis.[567]

Issues around private versus public disclosure of company information are discussed in more detail in the following parts on insider trading and selective disclosure regulation. The debates on insider trading and selective disclosure regulation concern whether trading on private information should be permitted or prohibited by persons related to, or outside of, the company. Scholars in the US generally classify these traders as "insiders" and "outsiders" respectively. As outlined in Chapter Two, both types of

[566] These study findings are supported by the empirical research on selective disclosure and insider trading outlined later in the Chapter.

[567] Under a voluntary disclosure framework, listed companies would still be required to provide detailed information to some investors in order to raise capital and to maintain an informed share price. It is likely that larger shareholders would negotiate with companies for this information on an individual or group basis.

trading may be prohibited in Australia under insider trading regulation, and selective disclosure may constitute a breach of continuous disclosure regulation.

II INSIDER TRADING REGULATION: THEORETICAL BASIS

' …we do not let Paul rob Peter merely because he may be able to put the stolen property to a better economic use.'[568]

The most substantive insider trading regulation in the US is contained within Rule 10b-5. A brief summary of Rule 10b-5 is provided because most of the substantive global theoretical debate on insider trading has occurred in the US.[569] Rule 10b-5, which was promulgated by the SEC under s 10(b) of the Securities Exchange Act 1934, is a broad provision directed at fraudulent practices.[570]

The theoretical principles underlying Rule 10b-5 have progressed through a number of stages based on judicial interpretations in a series of cases. From the 1960s until 1980, the judiciary indicated that Rule 10b-5 was based on a "disclose or abstain rule" or an equality of access approach.[571] However, in *Chiarella*,[572] the Supreme Court rejected

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[568] Richard Jennings, 'Book Review of *Insider Trading and the Stock Market* by Henry G Manne'' (1967) 55 *California Law Review* 1229, 1234.

[569] There are other provisions in the United States apart from Rule 10b-5 relating to insider trading:

- Section 17 of the *Securities Act of 1933* 15 USC (1933) prohibits insider trading in relation to the "offer or sale" of a security.
- Rule 14e-3 prohibits insider trading in relation to a tender offer. Liability under this rule is not premised on breach of a fiduciary duty. Rule 14e-3 was promulgated under s 14 of the *Securities Exchange Act 1934.*
- Section 20 of the *Insider Trading and Securities Enforcement Act 1988* provides a private right of action for individuals against those who have breached Rule 10b-5.
- Section 16(b) of the *Securities Exchange Act of 1934* 15 USC (1934) provides a right of profit recovery by companies from officers, directors or large shareholders who have traded in the company's stock in specified circumstances.

[570] Rule 10b-5, Employment of Manipulative and Deceptive Devices, Exchange Release No 3230, 7 Fed Reg 3804 (1942) (codified at 17 CFR s 240.10b-5 (1991)). Rule 10b-5 forbids any person, in connection with the purchase or sale of any security: (a) 'To employ any device, scheme or artifice to defraud, (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person.'

[571] *In re Cady, Roberts & Co* 40 SEC 907 (1961); *SEC v Texas Gulf Sulphur* 401 F.2d 833 (2nd Cir 1968), cert denied 394 US 976 (1969*). In re Cady, Roberts & Co*, the SEC held that the duties of corporate insiders may extend to outsiders as temporary or constructive insiders in certain circumstances. A broker who traded while in possession of nonpublic information received from a company director was held to have violated Rule 10b-5. In *SEC v Texas Gulf Sulphur*, the Court indicated at 851-852 that the 'core of Rule 10b-5 is the implementation of the congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that

both the equality of access and informational parity theories in favour of a fiduciary-based framework.[573] The fiduciary-based approach was confirmed in *Dirks v SEC*,[574] and extended in 1997 when the Supreme Court adopted and applied the misappropriation theory in *United States v O'Hagan*.[575] In 2000, the SEC codified both

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all members of the investing public should be subject to identical market risks … inequities based upon unequal access to knowledge should not be shrugged off as inevitable'.

[572] *Chiarella v United States* 445 US 222 (1980). The Supreme Court reversed the criminal conviction of a printer who obtained non-public information of a proposed merger from tender documents that he was contracted to print, and based on this information purchased stock in the target company. It was held that the printer owed no duty to the target company shareholders and therefore did not defraud them. The SEC responded to this result by promulgating Rule 14e-3 under s 14(e) of the *Exchange Act*. Rule 14e-3 makes it illegal for anyone to trade on the basis of material non-public information in relation to tender offers when they know that the information source is an insider.

[573] *Chiarella v United States* 445 US 222 (1980). The majority rejected a parity of information approach due to a lack of legislative intent and because such a broad duty was too far divorced from the established doctrine that a duty to disclose only arises from a specific relationship between parties. The majority suggested at 232-233 that the decision by the Court of Appeal 'rested solely upon its belief that the federal securities laws created a system providing equal access to information necessary for reasoned and intelligent investment decisions.' However, 'neither the Congress nor the Commission … has adopted a parity-of-information rule.' Among the three dissenters, Justice Blackmun indicated at 251 that 'persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities.' Similarly, Justice Burger highlighted at 241 that 'the antifraud provisions were designed in large measure to assure that dealing in securities is fair and without undue preferences or advantages among investors.'

[574] 463 US 646 (1983). Justice Powell outlined the concept of "constructive insiders" who receive confidential information in the course of providing services to the corporation and who acquire the fiduciary duties of the true insider when the insider is bound to keep the information confidential. Tippees are liable if they knew or had reason to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and the tipper received a benefit from the disclosure. However, Dirk, the tippee, escaped liability because the original tipper disclosed the information to expose a fraud and not for personal gain. Justice Powell stated at 667 that 'there must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain … Moreover, to constitute a violation of Rule 10b-5, there must be fraud … Dirks … had no duty to abstain from use of the inside information that he obtained'. The liability of analysts to insider trading was left ambiguous. Justice Powell speaking for the majority indicated at 658 that '[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.' However, Justice Blackmun, suggested at 677 that the majority's improper purpose requirement 'seems little different from the theory that insider trading should be permitted because it brings relevant information to the market… [and the] extreme theory, which postulates that insider trading causes no harm at all to those who purchase from the insider … Th[is] theory rejects the existence of any enforceable principle of fairness between market participants.'

[575] *United States v O'Hagan* 521 US 642 (1997). O'Hagan was a partner in a law firm representing a company making a tender offer for Pillsbury Company. O'Hagan acquired options in Pillsbury and sold following the tender offer, making a profit of $4m. The Court held O'Hagan liable for fraud under Rule 10b-5 based on the misappropriation theory. Justice Ginsberg, delivering the opinion of the Court, indicated at 652-653 that the 'classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of non-public information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is designed to protect the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect the corporations' security price when revealed, but who owe no fiduciary or other duty to that corporations' shareholders.'

The Second Circuit developed the misappropriation theory in *United States v Newman. United States v Newman* 664 F.2d 12 (2nd Cir 1981), *cert denied*, 464 US 863 (1983). In this case, Newman, a securities trader, was liable under Rule 10b-5 for trading in the securities of a company while in possession of the fiduciary duty and the misappropriation theories in Rule 10b5-1. Rule 10b5-1 states that the insider trading prohibition under Rule 10b-5 is breached whenever someone trades on the basis of material non-public information.[576] The release accompanying this rule indicates that 'this language incorporates all theories of insider trading liability under the case law – classical insider trading, temporary insider theory, tippee liability, and trading by someone who misappropriated the inside information.'

A Insider Trading Regulation: Theoretical Basis

It is suggested that the 'history of the regulation of insider trading is largely the story of the legal system's quest to find an internally consistent justification for banning such trading.'[577] After many decades of vigorous debate, some scholars suggest the jury is still out on the following issues:

1. Whether insider trading enhances or impedes efficiency?
2. Whether insider trading harms anyone?
3. Whether gains from insider trading are appropriate compensation for entrepreneurs?[578]

1 *Does Insider Trading Enhance or Impede Market Efficiency?*

Manne argues that insider trading is desirable because it enhances efficiency by providing price signals to the market.[579] Some parties agree with Manne that insider

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information obtained from two investment bankers. The investment bankers had misappropriated the information from their employers.

[576] Rule 10b5-1(a) states: '*General*. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act … and [rule] 10b-5 … include among other things, the purchase or sale of a security of any issuer, on the basis of material non-public information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuers, or to any other person who is the source of the material non-public information.' The release accompanying this rule states that 'This language incorporates all theories of insider trading liability under the case law – classical insider trading, temporary insider theory, tippee liability, and trading by someone who misappropriated the inside information.'

[577] Jonathan Macey, 'From Fairness to Contract: The New Direction of the Rules Against Insider Trading' (1984) 13 *Hofstra Law Review* 9, 9-10.

[578] See, eg, Carol Swanson, 'Insider Trading Madness: Rule 10b5-1 and the Death of Scienter' (2003) 52 *Kansas Law Review* 147, 162.

[579] Henry Manne, 'In Defence of Insider Trading' (1966) 44 *Harvard Business Review* 113 (Defence). See also Henry Manne, *Insider Trading and the Stock Marke*t (1966) 77-158; Henry Manne, 'Insider Trading: Hayek, Virtual Markets And The Dog That Did Not Bark' (2005) 31 *Journal of Corporation Law* 167 (Dog), 185.

trading promotes informational efficiency.[580] Krawiec suggests that while regulation requiring issuers to disclose all material information would optimise 'informational efficiency and informational equality',[581] such an approach is not practicable for commercial or competitive reasons. Consequently, informational efficiency may be enhanced by the transmission of information to the market without full disclosure.[582]

Others argue that the dissemination of information through insider trading can be a relatively slow and noisy process[583] and a short-term delay in the release of information is unlikely to disrupt the allocation of economic resources.[584] Kahan suggests that

> [d]erivative disclosure of insider information through insider trading activities is … an imprecise means of communicating information: insiders may hide their trading activity; other market participants may not be able to distinguish between trades motivated by insider information … ; and even if detected, insider trades would be only a "noisy" indicator of the significance of the insider information for company value.[585]

Critics of insider trading argue that insider trading creates perverse incentives,[586] promotes poor investment decisions,[587] and encourages delays in the public release of valuable information.[588] They conclude that regulation is required to promote efficiency, to protect investors, and to sustain investor confidence in the integrity of the markets.[589]

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[580] Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 254-255, 261-262. See also Dennis Carlton and Daniel Fischel, 'The Regulation of Insider Trading' (1983) 35 *Stanford Law Review* 857, 861-872; Kitch, above n 448, 708, 719; Krawiec, above n 527, 495.

[581] Krawiec, above n 527, 494.

[582] Krawiec, above n 527, 495.

[583] Saul Levmore, 'In Defense of the Regulation of Insider Trading' (1988) 11 *Harvard Journal of Law & Public Policy* 101, 103; Cox, above n 536, 648, Krawiec, above n 527, 498; John Barry, 'The Economics of Outside Information and Rule 10b-5' (1981) 129 *University of Pennsylvania Law Review* 1307, 1329; Ashley Black, 'The Reform of Insider Trading Law in Australia' (1992) 15 *University of New South Wales Law Journal* 214, 219.

[584] Mark Klock, 'Mainstream Economics and the Case for Prohibiting Inside Trading' (1994) 10 *Georgia State University Law Review* 297, 304.

[585] Kahan, above n 566, 1004.

[586] Levmore, above n 583, 104; Morris Mendelson, 'The Economics of Insider Trading Reconsidered' (1969) 117 *University of Pennsylvania Law Review* 470, 489**;** Roy Schotland, 'Unsafe At Any Price: A Reply to Manne, Insider Trading and the Stock Market' (1967) 53 *Virginia Law Review* 1425, 1440-1442**;** Saul Levmore, 'Securities and Secrets: Insider Trading and the Law of Contracts' (1982) 68 *Virginia Law Review* 117, 149; Krawiec, above n 527, 496.

[587] Robert Haft, 'The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation' (1982) 80 *Michigan Law Review* 1051, 1053-1064; Easterbrook, above n 537, 332.

[588] Mendelson, above n 586, 489; Schotland, above n 586, 1448-1449; Krawiec, above n 527, 496; Barry, above n 583, 1329; Ayres et al, above n 473, 15, 23; Brudney, above n 67, 334. See also Cox, above n 536, 643.

2 *Does Insider Trading Harm Anybody?*

'[Insider trading] is a most serious offense, a fraud on the trading public by which individual investors are invariably victimized … '[590]

Manne argues that insider trading does not harm long-term investors because these investors do not trade on short-term noise.[591] He assumes that the transactions of long-term investors are not influenced by the security price.[592] In addition, Manne 'measures the damage to outsiders by how much the selling stockholders would have had if the information were not made public at all.'[593] Other scholars argue that insider trading does not disadvantage outsiders because the price paid by the outsiders reflects the existence and risk of insider trading.[594]

Critics of insider trading point out that price is nearly always a major consideration in share transactions, and informed investors are likely to sell to the insider when the price goes beyond the fundamental value of the securities based on publicly available news.[595] They suggest that a more 'appropriate measure [of harm] is how much more the sellers would have [made] if the information had been made public from the beginning.'[596] Many parties argue that uninformed investors suffer harm when insider trading is permitted.[597] The insider trader's gain equates to a loss by other investors,

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[589] Haft, above n 587, 1053-1067; Mendelson, above n 586, 477-478; Joel Seligman, 'The Reformulation of Federal Securities Law Concerning Non-Public Information' (1995) 73 *Georgetown Law Journal* 1083, 1115; Anisman, above n 54, 8-9.
[590] Alan Liman, *Lawyer: Life of Counsel and Controversy* (1998) 270.
[591] Manne, above n 579 (Defence), 114.
[592] Schotland, above n 586, 1447.
[593] Mendelson, above n 586, 482.
[594] Carlton et al, above n 580, 881 citing Kenneth Scott, 'Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy' (1980) 9 *Journal of Legal Studies* 801, 807-809.
[595] Mendelson, above n 586, 483.
[596] Mendelson, above n 586, 482. See also Barry, above n 583, 1329; Seligman, above n 589, 1098.
[597] See, eg, H Nejat Seyhun, 'Insider's Profits, Costs of Trading and Market Efficiency' (1986) 16 *Journal of Financial Economics* 189, 190; Robert Masson and Ananth Madhavan, 'Insider Trading and the Value Of the Firm' (1991) 39 *Journal of Industrial Economics* 333; Nicholas Georgakopoulos, 'Insider Trading as a Transaction Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation', 26 *Connecticut Law Review* 1, 17; Scheppele, above n 486, 160; Richard Painter, 'Insider Trading And The Stock Market Thirty Years Later' (1999) 50 *Case Western Reserve Law Review* 305, 308; Goshen et al, above n 473, 714, 733; David Easley, Soeren Hvidkjaer and Maureen O'Hara, 'Is Information Risk a Determinant of Asset Returns?' (2002) 62 *Journal of Finance* 2185, 2218; Ayres et al, above n 473, 15; Brudney, above n 67, 357, 360; Ernst Maug, 'Insider Trading Legislation and Corporate Governance' (2002) 46 *European Economic Review* 1569, 1588.

and to the extent that some outside investors gain from an inside trade, those harmed by the trade lose more than the insider trader's gain.[598]

3 *Are Gains from Insider Trading Appropriate Compensation for Entrepreneurs?*

Manne describes an insider-trading scheme as 'highly arbitrary', but probably 'the best scheme we can devise for compensating the entrepreneurial function in large corporations'.[599] Others argue that permitting managers to trade as insiders results in lower wages, thereby benefiting all shareholders.[600]

However, Boyle suggests that Manne's theory fails because: 'it cannot separate bad originality from good originality; … it can neither justify nor limit the class of people entitled to cash in on insider information; … [and there is only the] most tenuous argument to connect insiders and entrepreneurs in the first place.'[601] Other parties highlight that Manne fails to explain 'how the spoils of insider trading [can] be restricted to entrepreneurs in amounts commensurate with the value of their contributions.'[602] It is suggested that compensation schemes need to be carefully designed to incentivise superior performance in the interest of all shareholders.[603] Insider trading by management creates potential conflicts of interest between executives and shareholders.[604] These agency costs can be compounded by management stock options that allow managers' unlimited upside with no capital at risk.[605] Posner points out that insider trading 'does not reward efficient management … [Instead,] it rewards the possession of confidential information, whether favourable or

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598 William Wang, 'Trading on Material Non-Public Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom under SEC Rule 10b-5?' (1981) 54 *Southern California Law Review* 1217 (Material), 1235; William Wang, 'Stock Market Insider Trading: Victims, Violators And Remedies – Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect' (2001) 33 *Securities Law Journal* 381 (Victims), 417; William Wang and Marc Steinberg, *Insider Trading* (2nd ed, October 2006) Volume 1.

599 Manne, above n 579 (Defence), 116, 122. Manne defines an entrepreneur as an innovator or 'as a man who finds a new product or a new way to make or sell an old one.' See also Manne, above n 579 (Dog), 171-174.

600 David Haddock and Jonathan Macey, 'A Coasian Model of Insider Trading' (1986) 80 *North Western University Law Review* 1449, 1468.

601 James Boyle, *Shamans, Software, and Spleens: Law and the Construction of the Information Society* (1996) 96. See also Barry, above n 583, 1329; Mendelson, above n 586, 481, 489-490; Burton Malkiel, 'Review of *Insider Trading and the Stock Market* by Henry Manne' (1968) 41 *Journal of Business* 263, 264; Richard Posner, *Economic Analysis of Law* (6th ed, 2003) 433.

602 Barry, above n 583, 1329.

603 Klock, above n 584, 317.

604 Malkiel, above n 601, 264; Levmore, above n 583, 104-105.

605 Klock, above n 584, 314.

unfavourable to the corporation's prospects.'[606] Brudney argues that company employees or managers are not entitled to the information that has been acquired 'at the expense of the company, and for the purpose of conducting the business.'[607]

4 *Other Arguments*

Langevoort suggests that 'while there may be a number of rational, efficiency-based reasons to prohibit insider trading, they are too conceptual, and admit of too many countervailing arguments, to capture the strong political sentiment that exists against insider trading.'[608] He indicates that most of the academic community dismiss fairness-based arguments supporting insider-trading regulation, including the argument that investor confidence is undermined 'by a sense of systematic discriminatory treatment between those "in the know" and the average investor.'[609] However, these concerns are not so easily dismissed at a political level if a significant proportion of the public finds insider trading abhorrent. This is so, regardless of the source and accuracy of such views.[610]

B Scholarly Commentary on the Australian Rationales

As outlined in Chapter Two, Australian policy documents indicate that market efficiency and market fairness are the primary rationales supporting Australian company disclosure and insider-trading regulation. There is only limited scholarly commentary on these rationales. Most parties argue that the dual rationales are in conflict, and that equal access needs to be limited to some extent in order to ensure efficiency.

For instance, Mannolini argues that the market fairness rationale has 'indiscriminate application to insiders, "outsiders" and diligent market analysts alike … thus inhibiting

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[606] Posner, above n 601, 433.
[607] Brudney, above n 67, 344. See also Levmore, above n 583, 104-105; Jennifer Moore, 'What is Really Unethical about Insider Trading?' (1990) 9 *Journal of Business Ethics* 171, 175. Brudney indicates that 'the insiders have acquired the information at the expense of the enterprise, and for the purpose of conducting the business for the collective good of all the stockholders, entirely apart from personal benefits from trading in its securities. There is no reason for them to be entitled to trade for their own benefit on the basis of such information.'
[608] Langevoort, above 549, 1046-1047.
[609] Langevoort, above n 549, 1048.
[610] Langevoort, above n 549, 1048. See also Rider, above n 217, 25; Schotland, above n 586, 1440-1441.

the allocative efficiency of the market.' [611] He suggests that a more sophisticated approach to insider trading would involve concepts of fraud on the market with civil remedies available to disgruntled parties. Semaan et al also argue that Australian insider trading regulation is too focused on notions of fairness at the expense of efficiency and this has resulted in regulation that is too encompassing.[612] They suggest that while there is no case law in Australia that defines securities market efficiency, there has been growing acceptance of the efficiency arguments in the US.[613] They note that the issue of the position of broker-analysts creates a tension between the aims of the continuous disclosure and insider trading regulations. They admit that broker-analysts have the ability to ask questions that can reveal price-sensitive information but suggest that trading on this information can assist with price efficiency.[614]

Similarly, Golding and Kalfus suggest that the premise of the ASIC Grapevine paper[615] and ASX Guidance Note 8 are investor confidence and equal access to information without any consideration given to market efficiency. This is described as problematic because 'equal access to information for all investors is not necessarily consistent with the cost effective dissemination of information to advance market efficiency.'[616]

Jacobs suggests that

> the market fairness theory operates in an indiscriminate, majority-focused fashion that cannot look to the justice of the individual case … because underpinning the theory is a benevolent concern for investor protection. The theory requires identification of an unfair advantage vis-à-vis an insider and the majority outsiders … [617]

He argues that the market efficiency theory espoused by Justice Mason in *R v Firns*[618] is prescient and more reflective of global markets.[619] He also suggests that the majority

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[611] Justin Mannolini, 'Insider Trading – The Need for Conceptual Clarity' (1996) 14 *Company and Securities Law Journal* 151, 156.
[612] Lori Semaan, Mark Freeman and Michael Adams, 'Is Insider Trading a Necessary Evil For Efficient Markets?: An International Comparative Analysis' (1999) 17 *Company and Securites Law Journal* 220, 220. The article does not explain the nature or relevance of the efficiency arguments in the US.
[613] Semaan et al, above n 612, 223, 225, 226. See also Kose John and Larry Lang, 'Insider Trading Around Dividend Announcements: Theory and Evidence' (1991) 46 *Journal of Finance* 1361.
[614] Semaan et al, above n 612, 239.
[615] ASIC, above n 177. See Chapter Two for an outline of this paper.
[616] Greg Golding and Natalie Kalfus, 'The Continuous Evolution of Australia's Continuous Disclosure Laws' (2004) 22 *Company and Securities Law Journal* 385, 389 footnote 36.
[617] Adam Jacobs, 'Time is Money: Insider Trading From a Globalisation Perspective' (2005) 23 *Company and Securities Law Journal* 231, 234.
[618] (2001) 38 ACSR 223. Jacobs does not explain what the market efficiency theory espoused by Justice Mason is. The *R v Firns* case is outlined and discussed in detail in Chapter Four.
[619] Jacobs, above n 617, 241. Jacobs does not explore these broad efficiency arguments further.

proposal in the CAMAC 2003 Report on Insider Trading acknowledges the shift towards a market efficiency rationale driven by globalisation imperatives.[620]

Lyons and Plessis indicate that the Griffiths Report[621] shifted the insider trading policy objectives to market fairness (or equal access) and market efficiency.[622] They suggest that insider trading is unfair when 'other investors cannot obtain the same information by competitive means' and the trading becomes a 'riskless (or reduced risk) undertaking.'[623] However, in practice 'the equal access theory does not guarantee actual information symmetry for all investors [because] market fairness and equal access are modified by the … objective of … market efficiency'.[624] In some instances, principles of fairness must be traded off to achieve efficiency.[625] The "generally available" and readily observable matter tests in s 1042A of the Act are cited as examples of this trade-off.

Rubenstein also argues for a balancing of the market efficiency and fairness approaches. The market fairness rationale is described as a requirement for 'equal opportunity to access and evaluate information relating to trading decisions.'[626] Rubenstein concludes that the broad scope of the equal access theory must be reconciled with the need to encourage market analysis and research, with exclusion from penalty for those who exercise 'skill, acumen and diligence in their trading.'[627]

Similarly, Locke argues that 'while the insider trading provisions go a long way toward creating a level playing field, the parity of information norm necessarily has its

[620] Jacobs, above n 617, 246-247. The 2003 CAMAC report on insider trading policy is outlined in detail in Chapter Four.
[621] The findings of the Griffiths Report were outlined in Chapter 2.
[622] Lyon et al, above n 488, 8-9 citing Griffiths Report, above n 56, 17. See also *R v Firms* (2001) 51 NSWLR 548, 45; TE Bostock, 'Australia's New Insider Trading Law' (1992) 10 *Company and Securities Law Journal* 165, 170; Mannolini, above n 611, 152-156; Michael Gething, 'Insider Trading Enforcement: Where are We Now and Where Do We Go From Here?' (1998) *Company and Securities Law Journal* 607, 608; Rhys Bollen, 'Research Analysts and the Australian Insider Trading and Misleading or Deceptive Conduct Regimes' (2003) 21 *Company and Securities Law Journal* 430, 436-437.
[623] Lyon et al, above n 488, 9 citing Brudney, above n 67, 347.
[624] Lyon et al, above n 488, 9 citing *Explanatory Memorandum, Corporations Legislation Amendment Bill 1991* (Cth) 339.
[625] Lyon et al, above n 488, 9.
[626] Simon Rubenstein, 'The Regulation and Prosecution of Insider Trading in Australia: Toward Civil Penalty Sanctions for Insider Trading' (2002) 20 *Company and Securities Law Journal* 89, 93.
[627] Rubenstein, above n 626, 95.

limits'.[628] 'A strict adherence to the parity of information norm risks clogging up the channels of information flow and … the smooth operation of the mechanisms of market efficiency.'[629] Locke hopes that 'a pragmatic regard for economically beneficial practices tamper [sic] the otherwise broad sweep of the widely framed proscriptions.'[630]

Finally, Ford et al suggest that Australian insider trading regulation is 'a product of pragmatism rather than theory, and is more commonly justified by reference to the difficulty in defining effective "fiduciary" limitations for the offence.'[631]

C Insider Trading Empirical Research

1 *Empirical Research*

Some scholars and market practitioners suggest the debate on whether insider-trading regulation is justifiable ought to be determined empirically.[632] Insider-trading studies are restricted in scope due to the inherent secrecy involved in such trading. It is not possible to conclusively prove the extent of insider trading or the economic efficiency effects of insider trading or insider trading regulation. Nevertheless, the available research suggests a valid economic basis for insider trading regulation.[633]

Empirical research on excess returns examines whether private information held by corporate insiders enables abnormal returns over a period compared to benchmark market returns. All of the reviewed studies found that insiders were able to make abnormal gains or reduced losses. Seyhun found that corporate insiders were able to

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[628] Alexander Loke, 'From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the UK, Australia and Singapore' (2006) 54 *American Journal Comparative Law* 123, 158.
[629] Loke, above n 628, 158.
[630] Loke, above n 628, 172.
[631] Ford et al, above n 481, *LexisNexis* [9.620].
[632] Cox, above n 536, 644-645; Laura Beny, 'Insider Trading Law and Stock Markets Around the World: An Empirical Contribution to Theoretical Law and Economics Debate' (2007) 32 *Journal of Corporation Law* 237, 239; Wang, above n 598 (Material), 1229; Easterbrook, above n 537, 338; Easterbrook et al, above n 445; Christopher Saari, 'The Efficient Capital Markets Hypothesis, Economic Theory and the Regulation of the Securities Industry' (1977) 29 *Stanford Law Review* 1031, 1056.

make excess returns, particularly chairman or officer directors.[634] Similarly, Elliott, Morse and Richardson found that the direction of insider trading was consistent with insider's using private information in a profitable manner.[635] Eyssell, and Seyhun and Bradley found that insiders, particularly top executives and officers, were involved in significant sale trades prior to bankruptcy filings thereby avoiding significant capital losses based on non-public information.[636] Fidrmuc et al found that share ownership by directors and outside shareholders had an impact on the abnormal returns achieved by insiders. The abnormal returns made by directors as insiders were significantly lower when the company was controlled by other companies, individuals or families unrelated to the directors, than when the dominant shareholders were institutional investors.[637] In Australia, Brown et al found evidence consistent with share sales by Australian directors resulting in avoidance of future abnormal losses, while director purchases yielded mixed results.[638] Chang et al suggested that gains made by Australian directors from purchase transactions increased with the level of director ownership and the size of the trade.[639] Watson and Young also found some evidence of insider trading by Australian directors prior to takeover announcements.[640]

The next group of studies suggest that the long run impacts of allowing insider trading are a reduction in market liquidity and an increase in bid / ask spreads, two recognised measures of market efficiency. Cornell and Sirri found that short-term liquidity improved when insiders were active in the market prior to the announcement of a

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[633] See, eg, Lawrence Ausubel, 'Insider Trading In a Rational Expectations Economy' (1990) 80 *American Economic Review* 1022, 1022, 1038; Hayne Leland, 'Insider Trading: Should It Be Prohibited?' (1992) 100 *Journal of Political Economy* 859, 884.

[634] Seyhun, above n 597, 210; H Nejat Seyhun, 'The Effectiveness of the Insider Trading Sanctions' (1992) 35 *Journal of Law and Economics* 149, 176. See also Michael Rozeff and Mir Zaman, 'Market Efficiency and Insider Trading: New Evidence' (1988) 61 *Journal of Business* 25, 45; Stephen Penman, 'Insider Trading and the Dissemination of Firm's Forecast Information' (1982) 55 *Journal of Business* 479.

[635] John Elliott, Dale Morse and Gordon Richardson, 'The Association Between Insider Trading and Information Announcements' (1984) 15 *RAND Journal of Economics* 521, 535.

[636] Thomas Eyssell, 'Corporate Insiders and the Death of the Firm: Evidence on the Incidence of Insider Trading in Corporate Dissolutions' (1991) 26 *Financial Review* 517, 517, 531; H Nejat Seyhun and Michael Bradley, 'Corporate Bankruptcy and Insider Trading' (1997) 70 *Journal of Business* 189, 214.

[637] Fidrmuc et al, above n 550, 2933.

[638] Philip Brown, Mark Foo and Iain Watson, 'Trading by Insiders in Australia: Evidence on the Profitability of Directors' Trades' (2003) 21 *Company and Securities Law Journal* 248, 260.

[639] Millicent Chang, Richard Hillman and Iain Watson, 'Are Corporate Governance Mechanisms Effective in Reducing Insider Trading Profits?' (2005) 23 *Company and Securities Law Journal* 165, 178.

[640] Iain Watson and Annie Young, 'A Preliminary Examination of Insider Trading Around Takeover Announcements in Australia' (Working Paper, University of Western Australia). See also Mark Freeman

takeover bid due to higher trading volumes.[641] However, the market makers and insiders were able to exploit the uninformed in such cases, and Cornell and Sirri suggested that the likely long run impact of such incidents is an increase in spreads.[642] A model by Fishe and Robe found that insider trading had a negative impact on market liquidity because market makers adjusted the depth and spread to compensate for the risk from informed traders.[643] Moreover, Masson and Madhavan suggested that insider trading lowers a firm's value.[644]

Another body of work examines selected variables across global securities markets. These studies have limitations because directional and endogeneity issues are difficult to control. Nevertheless, this research suggests that countries with insider trading laws have more liquid markets, more accurate pricing and a lower cost of capital. A study by Bhattacharya and Daouk found that countries that enforce their insider trading law have a significantly lower cost of capital.[645] Du and Wei suggested that countries with more prevalent insider trading have more volatile markets after controlling for the liquidity, maturity and fundamentals of the relevant markets, and the 'effect of insider trading is quantitatively significant when compared with the effect of economic fundamentals.'[646] Similarly, Beny suggested that countries with insider trading laws generated positive market externalities; that is, such laws are associated with more liquid stock markets and more informative stock prices. This enhanced liquidity and price accuracy results in a reduced overall cost of equity and improves the efficiency of capital allocation.[647]

The evidence from these bodies of work is consistent with outperformance by corporate insiders relative to market benchmarks. The research also suggests that

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and Michael Adams, 'Australian Insiders Views on Insider Trading' (1999) 10 *Australian Journal of Corporate Law* 148.

[641] Bradford Cornell and Erik Sirri, 'The Reaction of Investors and Stock Prices to Insider Trading' (1992) 47 *Journal of Finance* 1031.

[642] Cornell et al, above n 641,1055.

[643] Raymond Fishe and Michael Robe, 'The Impact of Illegal Insider Trading in Dealer and Specialist Markets: Evidence From a Natural Experiment' (2004) 71 *Journal of Financial Economics* 461, 461-462, 481.

[644] Masson et al, above n 597, 333.

[645] Utpal Bhattacharya and Hazem Daouk, 'The World Price of Insider Trading' (2002) 62 *Journal of Finance* 75.

[646] Julian Du and Shang-jin Wei, 'Does Insider Trading Raise Market Volatility?' (2004) 114 *Economic Journal* 916, 916, 940. Du and Wei point out that a certain degree of market volatility is unavoidable; however excessive volatility not related to economic fundamentals diminishes the signalling function and impedes resource allocation.

[647] Laura Beny, 'Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence' (2005) 7 *American Law and Economics Review* 144; Beny, above n 632, 280-281.

countries or markets that establish and effectively enforce insider-trading regulation achieve superior economic efficiency outcomes in the form of lower costs of capital and more efficient capital allocations. This appears to arise, at least in part, from a reduction in information asymmetry. Notably, no scholarly research could be found that suggests or infers that permitting insider trading enhances long-term market or economic efficiency.

D Insider Trading Regulation Critique and Conclusion

Scholarly literature suggests the jury is still out on whether insider trading harms anybody, appropriately compensates entrepreneurs, and enhances economic efficiency. I argue that insider trading:

1. Results in losses to uninformed traders;
2. Provides a highly arbitrary scheme to compensate entrepreneurs; and
3. The economic efficiency and market fairness rationales supporting insider-trading regulation are sound.

1 *Insider Trading Results in Losses to Uninformed Traders*

The arguments that insider trading does not harm anybody are made on alternate bases:

- long term investors are not harmed because they don't trade;
- uninformed investors can compensate for insider trading by discounting their bids;
- uninformed investors would have traded anyway; or
- the investors that may have been harmed cannot be identified.

Rational investors trade when security prices go beyond their fundamental value based on available information. The information available to those who do not have access to inside information is generally the information released in the public arena. In practice, uninformed investors have no means to determine when, or the extent to which, insider trading is occurring. Even if they did, there are no easy mechanisms for investors to calculate the necessary amount of compensation and to adjust their trading processes.[648] While it may be difficult to identify who has been harmed from insider trading, individual trades are zero-sum. Consequently, all other things being equal, when a person benefits from trading on inside information, other parties suffer harm to the equivalent extent.

2 *Insider Trading Provides a Highly Arbitrary Scheme to Compensate Entrepreneurs*

Few of the modern day potential corporate insiders within listed companies are entrepreneurs in the true sense. In any event, Manne's scheme does not differentiate between bad entrepreneurial ideas from good, it does not link the potential trading profits to the value of any ideas or restrict trading to those who generate ideas, and it creates significant potential conflicts of interests between corporate management and stakeholders. In *Dirks v SEC*,[649] the US Supreme Court confirmed that 'a significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.'[650]

Management compensation schemes need to be carefully designed to align management interests with investors and other stakeholders without undue externalities arising. Insider trading profit incentives have the potential to distort company decision-making making at every level.[651] The potential moral hazards arising from insider trading by company management for personal profits are significant. Trading by executives on confidential information may hinder strategic and day-to-day management of the company, potential issues may arise under director duties to act

[648] Some scholars suggest or imply that the price signals of insiders can be incorporated within a share price without the relevant news being disseminated. Such a view assumes the rest of the market will effectively adopt and verify insider trading on trust without knowing or understanding the relevant information. However, fundamental valuations would not be possible on this basis. It is also suggested that investors can respond to insider trading by widening their bid-ask spreads. Presumably this means that one values a security and then adjusts the valuation by a certain margin. However, such a process is likely to be counterproductive, particularly if a significant proportion of the market participants are "insiders" that don't make the equivalent margin adjustments.

[649] 463 US (1983) 653.

[650] In *Dirks v SEC* 463 US (1983) 653, the US Supreme Court confirmed that 'a significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.'

[651] Easterbrook, above n 537, 332, 338; Haft, above n 587, 1053-1064; Cox, above n 536, 648-662; Boyd Dyer, 'Economic Analysis, Insider Trading, and Game Markets' (1992) 1 *Utah Law Review* 1, 21-25; Wang et al, *Insider Trading*, above n 598,Volume 1; Cf Carlton et al, above n 580, 872-875.

bona fide in the interest of the company and to avoid conflicts of interest,[652] and inopportune disclosure of confidential information may cause serious harm to a company and its stakeholders.

3 *Conclusion – The Economic Efficiency and Fairness Rationales Supporting Insider Trading Regulation are Sound.*

The argument that insider trading enhances economic efficiency assumes that: insider trading provides effective price signalling to the market; this price signalling is the most efficient mechanism for incorporating the relevant information within the share price; and there is an established link between the market efficiency gains and the real economy. However, when insider trading is permitted, all noisy and uncertain signals are likely to result in increased speculative trading activity, leading to a reduction in share price accuracy and increased price volatility. Public disclosure of the information results in more rapid and complete absorption of the information. In any event, information that is revealed through insider trading generally becomes public information soon after the insider trading occurs.[653] When this occurs, any potential efficiency gains are restricted to short term price efficiency, with little, if any, impact on capital allocations.

While it is difficult to theoretically or empirically ascertain the net economic efficiency of insider trading rules within securities markets,[654] the outlined research suggests a sound economic basis for insider-trading regulation.[655] The studies suggest that any possible short-term efficiencies arising from insider trading are likely to be significantly outweighed by the negative long-term effects on investor confidence,

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[652] See, eg, *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286; *Aberdeen Railway Co v Blaikie Bros* (1954) 1 Macq 461; *Phipps v Boardman* [1967] 2 AC 46; *Whitehouse v Carlton Hotel Ltd* [1987] 5 ACLC 421; *Re Spargos Mining NL* (1990) 8 ACLC 1218.

[653] Parties that argue that not all inside information is publicly released or that it is only released after long delays need to explain what type of information falls into these categories in modern markets and how important (on a weighted basis) this information is within the total company information pool. As outlined in Chapter Five, market practitioners are most concerned about trading on private knowledge about pending takeover bids, capital raisings and earnings news. My experience suggests that this type of information constitutes a large proportion of the total insider trading activity and this kind of information is generally released soon after insider trading occurs.

[654] Wang, above n 598 (Material), 1237.

[655] Masson et al, above n 597, 333; Bhattacharya et al, above n 645; Du et al, above n 646, 916, 940; Beny, above n 647; Beny, above n 632, 280-281; See also Ausubel, above n 633, 1022, 1038; Michael Fishman and Kathleen Hagerty, 'Insider Trading and the Efficiency of Stock Prices' (1992) 23 *RAND Journal of Economics* 106, 118**;** Leland, above n 633, 884.

volatility, liquidity, price accuracy, capital costs, and economic returns.[656] Beny suggests that adequately enforced insider trading laws are linked with enhanced liquidity, more informative stock prices, lower costs of capital, and improved allocative efficiency.[657] Bhattacharya and Daouk suggest that countries that enforce their insider trading law have a significantly lower cost of capital. They conclude that

> though the debate about the pros and cons of allowing insider trading in stock markets has been quite contentious in the law, economics and finance literature, … [in] practice, the debate seems to have been settled.[658]

By the end of 1998, 'all of the 22 developed countries and four out of five of the 81 emerging markets had insider trading laws in their books.'[659]

Some scholars argue that public opposition to insider trading is irrational and emotive.[660] However, the empirical research suggests the detrimental effects of insider trading on companies, investors, markets, economies and the broader public are significant, while the potential benefits are minimal. Investment in a market that permits trading by insiders with easy access to valuable private information that is available only to company managers or employees of a favoured institution is inherently high risk. Insiders are generally well positioned to control the release of information and to manipulate their trades to enhance, or even to guarantee, potential trading profits. In such circumstances, an uninformed investor's skill or diligence simply doesn't come into play. The rational response of such investors is to withdraw from the market.[661]

The next section builds on the insider trading debate by reviewing the arguments on trading on selectively disclosed information or outsider trading.

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[656] See, eg, Griffiths Report, above n 56.

[657] Beny, above n 647; Beny, above n 632, 280-281. See also Du et al, above n 646, 916, 940.

[658] Bhattacharya et al, above n 645, 104.

[659] Bhattacharya et al, above n 645, 104. Bhattacharya and Daouk indicate at page 75 that prior to 1990, only 34 countries had insider-trading laws and only 9 of these had any record of enforcement. However, by 2000, 87 of the 103 countries with stock markets had laws prohibiting insider trading and 38 had taken enforcement action.

[660] See, eg, Frank Easterbrook and Daniel Fischel, 'Corporate Control Transactions' (1982) 91 *Yale Law Journal* 698, 703; Scott, above n 594, 805.

[661] Stephen Choi, 'Selective Disclosure in the Public Capital Markets' (2002) 35 *UC Davis Law Review* 533, 535; Georgakopoulos, above n 597, 17; Langevoort, above n 549, 1049-1050; Merritt Fox, 'Regulation FD and Foreign Issuers: Globalisation's Strains and Opportunities' (2001) 41 *Virginia Journal of International Law* 653, 676; Ronald Kidd, 'Insider Trading: The Misappropriation Theory Versus an "Access To Information" Perspective' (1993) 18 *Delaware Journal of Corporate Law* 101, 121-122; Brudney, above n 67, 356.

III SELECTIVE DISCLOSURE REGULATION: THEORETICAL BASIS

'[S]elective disclosure is inimical to a belief that a level playing field exists, as well as to its existence in fact.'[662]

As outlined in Chapter Two, selective disclosure is the release of information by companies to selected investors such as analysts without disclosure to the wider public. In Australia, selective disclosure of company information to analysts or other investors is only prohibited to the extent that it breaches continuous disclosure or insider trading regulation.

There is minimal Australian commentary on the theoretical basis for selective disclosure regulation. Cox suggests that communication between company management and analysts should not be subject to disclosure regulation because this may discourage market research, thereby reducing the efficiency of the market.[663] As previously outlined, Rubenstein concludes that the broad scope of the equal access theory must be reconciled with the need to encourage market analysis and research, with exclusion from penalty for those who exercise 'skill, acumen and diligence in their trading'.[664] Semaan, Freeman and Adams suggest the issue of the position of broker-analysts creates a tension between the aims of continuous disclosure and insider trading regulation. They admit that broker-analysts have the ability to ask questions that can reveal price-sensitive information, but suggest that trading on this information can assist with price efficiency.[665] However, these comments on the role of analysts, research incentives, and efficiency are not explored further.

In contrast, the debates and empirical studies in the US on selective disclosure regulation provide a rich spectrum of views on the role of analysts and selective disclosure issues. There has been vigorous debate on these topics for many decades, culminating with the introduction of Reg FD in 2000. The US material and experiences are outlined on the basis that they can usefully inform the Australian disclosure debates.

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662 *ASIC v Southcorp Limited (No 2)* (2003) 130 FCR 406.
663 James Cox, 'An Outsider's Perspective of Insider Trading Regulation in Australia' (1990) 12 *Sydney Law Review* 455, 467, 481. See also Black, above n 583.
664 Rubenstein, above n 626, 93.
665 Semaan et al, above n 612, 239.

A Selective Disclosure Theories

Some of the theories and arguments on selective disclosure, including the investor harm arguments and market efficiency theories based on price signalling and agency costs, are similar to those made in relation to insider trading. In addition, there are theories specific to selective disclosure regulation based on analyst or research incentives.

1 *Are Investors Harmed by Selective Disclosure?*

Several scholars argue that uninformed or unsophisticated investors do not require protection from selective disclosure because they are protected by, or can free ride on, the efficiency of the market.[666] However, as discussed within the insider trading discussion, unless markets are strong form efficient (explained more fully in Part IV of this Chapter) uninformed investors are not protected when trading against counterparties with private information. Others suggest trading profits from selective disclosure provide compensation for professional research efforts and are not at the expense of uninformed or unsophisticated investors.[667]

However, Brudney points out that the US Congress introduced securities legislation to protect public investors from the exploitation of institutional informational advantages that cannot be lawfully overcome or offset.[668] Other commentators suggest that market participants 'with an information advantage benefit systematically at the expense of participants without such an advantage.'[669]

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[666] Saari, above n 632, 1076; Easterbrook et al, above n 445, 693-694; Romano, above n 451, 2378; Donald, above n 445, 112-115.

[667] See, eg, Daniel Fischel, 'Symposium on Insider Trading: Insider Trading and Investment Analysts: An Economic Analysis of *Dirks v Securities and Exchange Commission*' (1984) 13 *Hofstra Law Review* 127, 146; Kripke, above n 465, 14-16, 284-286.

[668] Brudney, above n 67, 357, 360.

[669] Seyhun, above n 597, 190. See also Masson et al, above n 597, 335; Choi, above n 661; Ayres et al, above n 473, 15.

2 *Selective Disclosure and Market Efficiency*

Some parties argue that trading on selectively disclosed information provides price signals to the market, thereby increasing share price accuracy and market efficiency.[670] This price efficiency theory is similar to that expounded by Manne in defence of insider trading, except that the parties trading on the private information are persons outside of the company.

The counter arguments are also similar to those made in relation to insider trading. The price signals may be missed and the signals are noisy and slow. Market and economic efficiency may be more effectively achieved by immediate disclosure of the information to all investors.[671]

3 *Selective Disclosure as Incentive for Analysis and Research*

Most traditional scholarly literature suggests that analysts require the right to obtain and use private company information in return for enhancing market efficiency by the provision of genuinely independent analysis and research.[672] It is often assumed that analysts do all the discovery of security related information because they have the required education, experience, resources, and economies of scale to gather, analyse and produce information efficiently.[673] As such, analysts are portrayed as 'crucial players in the mechanisms of market place efficiency that lead to optimal allocation of capital resources'.[674] Some parties argue that individual investors have access to the private information by buying the information from an intermediary or investing with a fund manager.[675] Alternatively, they can accept the market price and free ride on the presumption of marketplace efficiency.[676] The broader public are seen to benefit from

[670] Choi, above n 661, 535, 541; Ayres et al, above n 473, 15, 20-22; Barry, above n 583, 1330; Fox, above n 444 (Disclosure), 115-116. See also Paul Brountas Jr, 'Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts' (1992) 92 *Columbia Law Review* 1517, 1533; Donald, above n 445, 112-115.
[671] Brudney, above n 67, 341; Seligman, above n 589, 1119.
[672] Jill Fisch and Hillary Sale, 'The Securities Analysts as Agent: Rethinking the Regulation of Analysts' (2003) *88 Iowa Law Review* 1035.
[673] See, eg, Goshen et al, above n 473, 722-725; Dennis Corgill, 'Insider Trading, Price Signals and Noisy Information' (1996) 71 *Indiana Law Journal* 355, 397.
[674] Langevoort, above n 549, 1024.
[675] Langevoort, above n 549, 1025; Fischel, above n 667, 146; Saari, above n 632.
[676] Fischel, above n 667, 146.

the existence of analysts because the information discovered by analysts leads to more accurate or efficient security prices.[677]

Some commentators claim that selective disclosure is needed as incentive for financial analysts to enter or remain in the market.[678] Barry indicates that stock trading based on selective disclosures prior to the publishing of research 'provides a just return for legitimate industry and encourages economically efficient behaviour.'[679] Fischel suggests that 'the explanation for hiring analysts is simple - to obtain superior information and earn abnormal positive returns.'[680] 'Nobody will pay an analyst for information that he must publicly disclose before selling it to his clients.'[681] Choi and Barry argue that giving possessors of outside information a right to trade without disclosure preserves the necessary incentives for private analysis.[682] Brountas advocates the use of analysts as a filter to provide credibility to the information so it enters the public arena in a format that is more easily understandable by other investors.[683]

Some companies similarly argue that they need to disseminate information privately as incentive for analysts to produce research.[684] Fischel argues that the fact that companies 'voluntarily transmit information to analysts suggests the use of analysts is an efficient method of communicating information.'[685] Forcing companies to disclose publicly may increase information production costs, making it more difficult to reduce the information disparity.[686] However, Lee suggests 'the argument for the necessity of speculative profits rests on untested, debateable assumptions about the absence of other incentives for investment in information.'[687] He argues that while 'the early dissemination of information about firms and market conditions has social value, the

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[677] Russell, above n 15, 550. See also *SEC v Bausch & Lomb, Inc*, 420 F. supp. 1226, 1230 (SDNY, 1976).
[678] Barry, above n 583, 1353, 1387-1388; Corgill, above n 673, 397-398; Stephen Choi and Eric Talley, 'Playing Favorites With Shareholders' (2002) 75 *Southern California Law Review* 271, 310; Choi, above n 661, 545; Brountas Jr, above n 670, 1540; Bruce Kobayashi and Larry Ribstein, 'Outsider Trading as an Incentive Device' (2006) 40 *UC Davis Law Review* 21, 31.
[679] Barry, above n 583, 1388. See also Corgill, above n 673, 397-398, 416-1417.
[680] Fischel, above n 667, 144.
[681] Fischel, above n 667, 145.
[682] Choi, above n 661, 544-545; Barry, above n 583, 1353.
[683] Brountas Jr, above n 670, 1540.
[684] Langevoort, above n 549, 1029-1031; Brountas, above n 670, 1540.
[685] Fischel, above n 667, 144.
[686] Fischel, above n 667, 145.
[687] Ian Lee, 'Fairness and Insider Trading' (2002) 1 *Columbia Business Law Review* 119, 175.

private rewards from being the first to know are independent of, and their magnitude is not limited to, the social value of the information once it is disseminated.'[688] Indeed, there may be no 'relationship between the social value of information and the private value of prior knowledge of that information … private trading advantages are, at best, a haphazard means of incentivising the production of socially valuable information.'[689]

To the extent that company information is produced for multiple purposes, there is a range of incentives driving the production of company information.[690] It is argued that investors operate in a competitive market and incentives to discover valuable information are powerful. In any event, the mandatory disclosure system ensures an information rich environment. Consequently, it is 'unclear how much additional positive externality-related benefits additional research beyond this level may have for the securities market as a whole.'[691] 'Having multiple analysts engaging in duplicative information research … may not add much to the common pool of available information.'[692]

4 *Agency Cost Reduction*

Some parties argue that analysts require the guaranteed higher returns resulting from selective disclosures in return for continuous monitoring of a company. It is suggested that analysts act as unbiased market gatekeepers, resulting in lower agency costs and enhanced market efficiency.[693]

However, many legal and accounting scholars question these agency and analyst efficiency claims. Selective disclosure between companies and analysts can result in biased research and reduced share price accuracy and market efficiency.[694] Companies may choose to provide private information only to those most likely to respond with

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[688] Lee, above n 687, 178-9.
[689] Lee, above n 687, 175.
[690] Krawiec, above n 527, 488. See also Harold Demsetz, 'The Private Production of Public Goods' (1970) 13 *Journal of Law and Economics* 293, 295**;** Jonathan Oever, 'Insider Trading and the Dual Role of Information' (1997) 106 *Yale Law Journal* 1325; Krawiec, above n 527, 488.
[691] Ayres et al, above n 473, 56-57.
[692] Ayres et al, above n 473, 55.
[693] Stephen Thurber, 'The Insider Trading Compensation Contract as an Inducement to Monitoring by the Institutional Investor' (1994) 1 *George Mason University Law Review* 119, 134; Cf John Coffee Jnr, 'What Caused Enron? A Capsule Of Social and Economic History of the 1990s' (2003) 89 *Cornell Law Review* 269 (Enron), 286-289. See also John Coffee Jnr, 'Understanding Enron: 'It's About The Gatekeepers, Stupid' (2002) 57 *Business Lawyer* 1403 (Gatekeeper), 1413, 1420.

favourable company recommendations,[695] or to those in a position to provide the company with new capital. If the relationship between a company and analysts or other favoured investors becomes too close, company management may feel pressured to manipulate or massage the company results, or even to adjust the corporate strategy, in order to satisfy analyst expectations or forecasts.[696] Analysts who issue a negative recommendation on the company, or criticise the company, may be blacklisted or frozen out from future access to management and company information.[697] Moreover, when management receive a large proportion of their remuneration as bonuses or stock options, selective disclosure may be used to artificially maintain or increase the share prices when this maximises personal returns.[698]

Maug suggests that when trading based on selective disclosure is not regulated, 'managers and large shareholders … form a "cozy cartel" at the expense of small shareholders'.[699] In practice, analysts and other investors who are privy to selective private information can choose to profitably trade on the information themselves rather than, or prior to, disseminating it to the public.[700] Institutions often prefer to exit when companies are in trouble rather than demanding governance changes from the management.[701] Favoured analysts or institutional recipients that are selectively forewarned of bad news can sell down in advance of other investors.[702] Even when the private information is disseminated, it may be done on a preferential client basis.[703] Finally, when sell-side analyst commissions are tied to brokerage levels or investment banking revenue, this can result in pressure on analysts to produce particular recommendations in order to increase brokerage volumes or obtain new investment

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694 Fox, above n 661, 657, 677; Choi, above n 661, 548.
695 See, eg, Bin Ke and Yong Yu, 'The Effect Of Issuing Biased Earnings Forecasts On Analysts' Access To Management And Survival' (2006) 44 *Journal of Accounting Research* 965; Langevoort, above n 549, 1041; Fisch et al, n 672, 1054.
696 Fisch et al, above n 672, 1056. See also Coffee, above n 693 (Enron), 257.
697 Langevoort, above n 549, 1042; Fisch et al, n 672, 1054. See also Coffee, above n 693 (Enron), 258. John Olsen the Merrill Lynch energy market securities analyst was fired when he downgraded Enron's stock. Similarly, analysts who criticised HIH Insurance were blacklisted.
698 Fisch et al, above n 672, 1090; Brudney, above n 67, 335.
699 Maug, above n 597, 1588.
700 Langevoort, above n 549, 1042; Fisch et al, above n 672, 1044.
701 John Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 *Columbia Law Review* 1277, 1288; Fisch et al, above n 672, 1088; Choi, above n 661, 549, 555; Ayres et al, above n 473, 24.
702 Fisch et al, above n 672, 1090; Choi, above n 661, 549.
703 Brountas Jr, above n 670, 1546.

banking business.[704] All of these outlined conflicts of interest and biases have the potential to increase agency costs and to interfere with an efficient allocation of capital.[705]

Empirical instances of such conflicts of interests and biases are well documented.[706] Coffee suggests that analysts in the US during the 1990s 'were not so much professionals as legally immune purveyors of inside information' from companies to institutions.[707] Gilson and Kraakman suggest that when they first published on the mechanisms of market efficiency, they should have been more sceptical of market institutions, their incentives, and about how well they perform their roles.[708] They indicate that they 'failed to appreciate the magnitude of the incentive problems in the core market institutions that produce, verify, and process information about corporate issuers'.[709] They admit that they were naïve about the role of security analysts, particularly those on the sell-side of the market.[710]

As Langevoort suggests, the process of informal contacts between companies and analysts 'creates its own moral hazard problem'.[711]

> [T]here are conflicts of interest inherent in the disclosure process that will on occasion interfere with the quality of investment advice produced[712] … [U]nder many circumstances, the benefits of selective disclosure will be captured largely or exclusively by the recipients, not the market as a whole. In these instances, … the resemblance between such activity … [and] a corporate insider is striking. [713]

Langevoort concludes that the public policy of actively encouraging informal analyst contacts seems premature when so much of the profit is captured privately.[714]

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[704] See, eg, Fisch et al, above n 672, 1045-1046; Hsiou-Wei Lin and Maureen McNichols, 'Underwriting Relationships, Analysts Earning Forecasts And Investment Recommendations' (1998) 25 *Journal of Accounting & Economics* 101, 124-125; Harrison Hong and Jeremy Kubik 'Analysing The Analysts: Career Concerns and Biased Earnings Forecasts' (2003) 58 *Journal of Finance* 313.

[705] Langevoort, above n 549, 1025; Fisch et al, above n 672, 1079, 1097-8. A conflict of interest exists when a party to a transaction can gain by taking actions that are detrimental to its counterparty.

[706] Fisch et al, above n 672, 1053-1056; John L Orcutt, 'Investor Skepticism v Investor Confidence: Why the New Research Analyst Reforms will Harm Investors' (2003) 81 *Denver University Law Review* 1, 26-8; Westfield, above n 552, 135; Commonwealth, above n 33, Vol 1 xviii, 72-73.

[707] Coffee, above n 693 (Enron), 263.

[708] Ronald Gilson and Reinier Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' (2003) 28 *Journal of Corporation Law* 715, 736-737.

[709] Gilson et al, above n 708, 736.

[710] Gilson et al, above n 708, 737.

[711] Langevoort, above n 549, 1044.

[712] Langevoort, above n 549, 1044.

[713] Langevoort, above n 549, 1046.

[714] Langevoort, above n 549, 1045, 1048-1049.

Ultimately this is the key issue underlying selective disclosure regulation, as reflected in the debate leading up to the introduction of Reg FD in the US.

B Regulation Fair Disclosure

'No matter what the market does, analysts just seem to keep saying buy… the average investor should take their bottom line recommendation with at least a grain of salt, if not a whole bucket'[715]

The courts in the US previously adopted the traditional assumptions on the role of analysts. Justice Ward indicated in *Securities and Exchange Commission v Bausch & Lomb Inc* that

> [a]nalysts provide a needed service in culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports. These analyses can then be used by both the ordinary investor and by the professional investment advisor as a basis for the decision to buy or sell a given stock. The data available to the analyst – his raw material – comes in part from published sources but must also come from communication with management.

Similarly, Justice Powell indicated in *Dirks v Securities and Exchange Commission*,[716] that the nature of non-public information received by analysts from corporate officers and insiders at briefings is such that this

> information cannot be made simultaneously available to all of the corporation's stock holders or the public generally … Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses; neither corporate insiders nor analysts can be sure when the line is crossed.[717]

The Securities and Exchange Commission (SEC) has also highlighted the important role played by analysts. It stated *In the Matter of Raymond L Dirks*[718] that

> [t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and

[715] *The Wall Street Journal* (New York) February 28, 2002, 3 citing Senator Lieberman
[716] 463 US 646 (1983).
[717] *Dirks v Securities and Exchange* 463 US 646, 659 (1983). The judgment by Justice Powell represented the majority view.
[718] SEC Lexis 2213 (1981).

> analyze information, and thus the analysts' work redounds to the benefit of all investors.[719]

Moreover, during the Reg FD consultation period, the SEC confirmed that analysts serve a screening function for technical financial information and that 'benefits may flow to the markets from the legitimate efforts of securities analysts … based on their superior diligence and acumen'.[720]

Nevertheless, the SEC indicated that selective disclosure from companies to favoured analysts: impacts on the principles of integrity and transparency, and undermines the fundamental principle of fairness;[721] can lead to potential conflicts of interest further impacting the confidence of investors; and can undermine the independence of analyst reporting leading to incentives to delay public disclosure and to manipulate earnings and expectations.[722] It argued that advances in technology had reduced the importance of analysts as information intermediaries and made it easier and less costly for issuers to disseminate information directly to the public.[723]

The SEC proposed Reg FD in 2000 to ensure equal access to information for all investors and to deter selective disclosure of company information. It was hoped that the regulation would level the playing field and remove the advantages that analysts and others with privileged access to companies enjoyed relative to other investors.[724] The SEC posited that Reg FD would result in:

- more open disclosure practices and increased investor confidence in the integrity of the market, with a consequential lowering in capital costs;
- an improvement in the information provided to the marketplace, because of enhanced direct company disclosure to the market or improved analyst performance;

[719] SEC Lexis 2213 (1981). This paragraph is cited by Justice Powell in *Dirks v Securities and Exchange Commission*, 463 US 646, 659 (1983).
[720] United States Securities and Exchange Commission, *Proposed Rule: Selective Disclosure and Insider Trading* (2000).
[721] Arthur Levitt, 'Audit Committee Oversight, Selective Disclosure and Insider Trading' (Statement delivered at the Open Commission Meeting, United States Securities and Exchange Commission, 15 December 1999) <http://www.sec.gov/news/extra/alsdisc.htm> at 26 April 2009; United States Securities and Exchange Commission (SEC), 'Final Rule', *Selective Disclosure and Insider Trading* (2000).
[722] SEC, above n 721.
[723] SEC, above n 721.
[724] SEC, above n 721.

- genuine competition among analysts, with performance measured on ability and effort rather than favoured access to company management; and
- independent analyst reporting without company access consequences.[725]

It suggested that while the New York Stock Exchange and National Association of Securities Dealers required listed companies to promptly disclose material information, companies' still retained some control over the release, timing, audience, and forum of many important disclosures.

Levitt, the Chairman of the SEC, indicated that 'quality information is the lifeblood of strong, vibrant markets … and is at the very core of investor confidence.'[726] He suggested that the 'all-too-common' and 'insidious practice of selective disclosure' impacts on the principles of integrity and transparency and 'undermines the fundamental principle of fairness'[727] because the recipients of the selective disclosure and their clients are able to profit at the expense of the general public. Selective or favoured disclosure by companies to analysts can also lead to potential conflicts of interest, further impacting the confidence of investors. When the independence of analyst reporting is undermined, this can lead to incentives to delay public disclosure and manipulate earnings and expectations.[728]

The SEC received six thousand public submissions or responses to the Reg FD proposal, most of which were from individual or retail investors.

1 *Arguments Supporting Regulation Fair Disclosure*

Retail investors responded enthusiastically to the Reg FD proposal. Many expressed a strong desire to fairly compete directly with institutional investors and an unwillingness to invest through intermediaries.[729] A submission from Beyers stated that

> I've never picked a stock on the basis of an analyst recommendation or report … I take serious offence with the notion that I can't make an intelligent investment choice without

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[725] Levitt, above n 721.
[726] Levitt, above n 721.
[727] Levitt, above n 721. See also SEC, above n 721.
[728] SEC, above n 721.
[729] SEC, *Comments of 50 Individuals Received* (2000) <http://www.sec.gov/rules/proposed/s73199/0420b01w.html> at 26 April 2009.

> first contacting a professional … Let analysts make their money as "analysts" - interpreters of data - rather than as gatekeepers of it as they mostly do today.[730]

Connolly indicated that

> [a]nalysts usually issue upgrades (downgrades) after good news (bad news) has been announced and is reflected in the companies' stock prices. I have been the chief accountant at a mid-sized publicly held company where I have seen certain analysts being " schmoozed" by top management.[731]

Dieckelman suggested that

> the vast majority of … analysts probably have no more or less business education that [sic] many of the general public who would use this information … In the long run, if the analysts are more efficient, we will all come back![732]

Corbin argued that '[t]oday's investing marketplace is quite different from what we previously had … The practice of companies disclosing information to select analysts in closed meetings is an anathema to the open flow of information.'[733]

2 *Arguments Opposing Regulation Fair Disclosure*

In contrast, industry response to the proposed regulation was very negative. A number of commentators suggested the only evidence provided by the SEC was anecdotal.[734] Many critics argued the regulation would lead to a reduction in information flow from companies and increased price volatility.[735] Brokers submitted that a decrease in information flow would result in more dramatic stock price movements upon the public release of earnings or earnings related news, known as the chill effect, and a shorter-term focus by investors.[736] Some parties suggested that efficient markets would be replaced by herd behaviour in which irrational individual investors would either speculate madly or free ride informed investors.[737] Lawyers pointed out that companies

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[730] SEC, above n 729, submission from Beyers.
[731] SEC, above n 729, submission from Connolly.
[732] SEC, above n 729, submission from Dieckelman.
[733] SEC, above n 729, submission from Corbin.
[734] Russell, above n 15, 536; Brian Barry, 'The Securities and Exchange Commission's Regulation Fair Disclosure: Parity of Information or Parody of Information?' (2002) 56 *University of Miami Law Review* 645, 650, 661. The SEC cited a 1998 study by the NIRI which disclosed that 26% of responding companies confirmed that they engage in some type of selective disclosure practices.
[735] Russell, above n 15, 536; Yi, above n 15, 263-268; Barry, above n 734, 662.
[736] Russell, above n 15, 542; Yi, above n 15, 257-258.
[737] Russell, above n 15, 551.

would have to make difficult decisions on what information is material on a real-time basis.[738]

Other critics suggested that private meetings are required for nuanced communication and for the airing of difficult or confidential topics and questions.[739] It was argued that companies would hold public meetings or conference calls with watered down or scripted disclosures.[740] In addition, companies would not be able to monitor and control market expectations through private discussions with analysts, and as a result, analyst forecasts would be less accurate and more dispersed.[741] The Securities Industry Association suggested that 'analysts should be able to ferret out information on behalf of investors.'[742] It was also suggested that individual analysts would no longer be able to distinguish themselves.[743]

3 *Regulation Fair Disclosure Outcome*

The SEC board voted three to one in favour of Reg FD, and the new law took effect on 23 October 2000. When a company chooses to disclose material information, the information must be disclosed broadly to the investing public, and not selectively to a favoured few.[744] Companies, or those acting on the company's behalf, are prohibited from selectively disclosing material non-public information to securities industry professionals, institutional investors, and specified other persons. Reg FD applies to closed-door meetings, conference calls with analysts,[745] and any situations where material information is communicated, verbally or in writing.[746]

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[738] Russell, above n 15, 539.
[739] Russell, above n 15, 542.
[740] Yi, above n 15, 268-270.
[741] Barry, above n 734, 662.
[742] See, eg, T Andrew Eckstein, 'The SEC's New Regulation FD: A Return to the Parity Theory' (2001) 69 *University of Cincinnati Law Review* 1289, 1300-1301.
[743] Eckstein, above n 742, 1301.
[744] SEC, above n 721.
[745] The courts in the United States have ruled that conference calls with analysts that have been recorded and transcribed are admissible as evidence: *Wenger v Lumisys, Inc*, 2 F Supp.2d 1231 (ND Cal, 1998).
[746] Liability under Regulation Fair Disclosure (Reg FD) only arises when an issuer's personnel either knows, or is reckless in not knowing that the information he or she is communicating is both material and non-public.

The final rule adopted was substantially modified in response to the many submissions received.[747] Reg FD only applies to communications to securities market professionals and any holder of the issuer's securities under circumstances in which it is reasonably foreseeable that the security holder will trade on the basis of the information. The issuer personnel subject to Reg FD are senior officials and those persons who regularly communicate with securities market professionals or security holders.[748]

Commissioner Unger voted against Reg FD because it interfered with 'the longstanding relationship between issuers and their analysts – a liaison that has never been particularly easy.'[749] She highlighted the benefits of having analysts 'ferret out and analyse'[750] information and the provision of reports to investors that explain the information after digesting it and putting it into context.[751] She suggested that 'investors will now be forced to perform the role previously played by analysts.'[752]

Unger agreed that trading by analysts or institutional investors on information selectively disclosed during closed analyst calls, or at corporate meetings, is offensive or even illegal. However, she thought that Reg FD went too far in requiring all material information disclosed to analysts to be made public.[753] She was concerned that investors would not be able to process the information disclosed during webcasts or conference calls and that companies would reduce both their level and quality of disclosure.[754]

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747 Reg FD does not establish a duty under Rule 10b-5's insider trading laws. A violation of Reg FD does not result in an issuer's loss of eligibility to use short-form registration for a securities offering. Communications made in connection with most securities offerings registered under the Securities Exchange Act are exempt from the scope of Reg FD. Foreign governments and foreign private issuers are also outside of the scope of Reg FD.

748 Failures by issuers to comply with Regulation Fair Disclosure may be subject to an SEC enforcement action under the regulation and sections 13(a) or 15(d) of the *Securities Exchange Act*. The SEC may bring an administrative action seeking a cause-and-desist action, or a civil action seeking an injunction and/or civil penalties. The SEC may also bring an enforcement action against an individual or the issuer responsible for the violation, either as a 'cause of' the violation on a cease and desist proceeding or as an aider and abetter of the violation in an injunction action.

749 Laura Unger, Commissioner SEC, 'Fallout from Regulation FD: Has the SEC Finally Cut the Tightrope?' (Speech delivered at the Glassier LegalWorks Conference, 27 October 2000), citing *Dirks v SEC* 463 US 646 (1983). Unger referred to the court's description of the relationship between companies and analysts as a 'fencing match conducted on a tightrope' in *SEC v Bausch & Lomb Inc,* 565 F 2d 8 (2nd Cir, 1977).

750 Unger, above n 749.

751 Unger, above n 749 citing *Aircraft Carrier Release* (1998).

752 Unger, above n 749.

753 Unger, above n 749.

754 Unger, above n 749.

Empirical studies on the impact of Reg FD and open access conference calls are outlined in Section D.

C Selective Disclosure in Australia

The Royal Commission Report in Australia into the failure of HIH Insurance Limited highlighted a variety of conflicts of interests that were ignored by company management and third parties.[755] For instance, the handful of analysts who publicly criticised the HIH or placed a sell recommendation on the stock were frozen out from any further contact with the company.[756] Guidance Note 8 to ASX Listing Rule 3.1 states that blacklisting of qualified analysts or the provision of favoured treatment to some analysts is inappropriate.[757] The Commission recommended that the prohibition on blacklisting should be upgraded to a full listing rule. However, this recommendation has not been implemented. There are no remedies available to analysts or other persons that are blacklisted.

Research independence issues and potential or actual conflicts of interest between companies and analysts are regulated through ASIC policy papers and disclosure requirements.[758] In addition, section 912A(1)(aa) of the Act requires financial services licensees to 'have in place adequate arrangements for the management of conflicts of interest that may arise…' Empirical research on conflict of interest issues is outlined in the next section.

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755 Commonwealth, above n 33.

756 Commonwealth, above n 33, Vol 1 72-73, Recommendation 46; Westfield, above n 552, 135.

757 ASX, above n 177, No 62. Guidance Note 8 indicates that it is inappropriate for entities to 'blacklist' or exclude analyst with the purpose of minimising or eliminating reasonable opportunities for qualified analysts to ask relevant questions of the entity in relation to publicly available information. Similarly, it is inappropriate for entities to extend more favourable treatment and access to a select group of analysts. No guidance is provided on what constitutes a "qualified" analyst.

758 ASIC, *Consultation Paper 46 – Licensing, Managing Conflicts of Interest* (2003); ASIC, *Regulatory Guide 79- Managing Conflicts of Interest: A Guide for Research Report Providers* (2004). Page 49 of the 2003 document and page 19 of the 2004 document indicate that research report providers should disclose the extent to which they have or are likely in the future to have an interest in financial products that are the subject of the report, or the extent to which they are likely to receive any benefits from the report. See also ASIC, *Consultation Paper 73- Managing Conflicts of Interest in the Financial Services Industry* (2006) The consultation paper uses hypothetical case studies illustrating real or perceived conflicts of interest to explain ASIC's views on how these conflicts should be managed. Section A concerns research report providers.

D Selective Disclosure Empirical Research

Empirical research on selective disclosure is inherently limited because of the private nature of the events involved. It is very difficult, if not impossible, to precisely measure the extent of selective disclosure in a market or the net efficiency of selective disclosure regulation. Nevertheless, the empirical studies on a combined basis provide valuable pointers.

One body of work encompasses surveys and interviews that gather and analyse views on the level and extent of selective disclosure occurring. There are also studies that measure specified variables in the periods before and after the introduction of Reg FD. Other research examines the efficacy of institutional investors as corporate monitors. Finally, there are studies that review the extent and effects of potential and actual conflicts of interest.

1 *International Research*

(a) Regulation Fair Disclosure

In April 2001, a roundtable review of Regulation Fair Disclosure was held. Analysts indicated that the quality of corporate information had reduced dramatically and some argued that pricing had become more volatile. However, independent empirical studies suggest these views may have been overstated.

NIRI and Price Waterhouse Coopers carried out company surveys in 2002 on the impact of Reg FD on information disclosure.[759] In both of these surveys, about half of the respondents indicated that Reg FD had not impacted their disclosure practices or share price volatility, with the remaining respondents split almost evenly between increases and decreases in disclosure.[760]

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[759] NIRI, 'National Investor Relation Institute Releases Survey Result on the Impact of SEC Regulation Fair Disclosure' (Press Release, 2 July 2001); Jennifer Francis, Dhananjay Nanda and Xin Wang, 'Re-Examining the Effects of Regulation Fair Disclosure Using Foreign Listed Forms to Control for Concurrent Shocks' (2006) 41 *Journal of Accounting and Economics* 271, 275 footnote 6.

[760] NIRI, above n 759; Francis et al, above n 759.

There are many scholarly accounting and finance studies based on Reg FD. It is difficult to summarise this body of work as the studies examine a wide range of market variables and incorporate a variety of assumptions. However, Gomes et al suggest there is consensus in the academic literature that the quantity of voluntary company disclosures increased after Reg FD.[761]

(b) Other International Studies

(i) Selective Disclosure

In a study on US quarterly earnings announcements during the period 1987-1990, El-Gazzar found that the higher the institutional holdings, the lower the market reaction to earnings releases because private information acquired by the institutions had already been impounded in the pre-announcement prices.[762] Similarly, in a study covering the period 1983-2004, Bushee and Goodman found evidence suggesting that changes in ownership by institutions with large positions in a company were consistent with informed trading on private information. This informed trading was most evident in small companies and when investment advisors and large institutions took large positions.[763]

Studies in the US have specifically examined conference calls as a disclosure medium. A NIRI survey in July 2001 indicated that 99 percent of the respondent listed US companies had opened up their conference calls to all investors.[764] Kimbrough found initiation of result related conference calls was associated with a reduction in post-earnings announcement drift and more timely market response to earnings announcements.[765] Lee et al found the quantity of information post Reg FD measured by the number of conference calls and the number of companies hosting conference

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[761] Armando Gomes, Gary Gorton and Leonardo Madureira, 'SEC Regulation Fair Disclosure, Information and the Cost Of Capital' (Working Paper, 19 October 2006) 3. There are many empirical studies on Reg FD. See, eg, Frank Heflin, Kenneth Subramanyam and Yuan Zhang, 'Regulation FD and the Financial Information Environment: Early Evidence' (2003) 78 *Accounting Review* 1; Warren Bailey, Haitao Li, Connie Mao and Rui Zhong, 'Regulation Fair Disclosure and Earnings Information: Market, Analyst, and Corporate Responses' (2003) 58 *Journal of Finance* 2487.

[762] Samir El-Gazzar, 'Predisclosure Information and Institutional Ownership: A Cross-sectional Examination of Market Revaluations During Earnings Announcement Periods' (1998) 73 *Accounting Review* 119, 119, 128.

[763] Brian Bushee and Theodore Goodman, 'Which Institutional Investors Trade Based on Private Information About Earnings and Returns?' (2007) 45 *Journal of Accounting Research* 289, 317-18.

[764] NIRI, 'Most Corporate Conference Calls Are Now Open to Individual Investors and the Media' (Press Release, 29 Feb 2000).

[765] Michael Kimbrough, 'The Effect Of Conference Calls On Analyst And Market Underreaction To Earnings Announcements' (2005) 80 *Accounting Review* 189.

calls dramatically increased, with no significant increase in volatility.[766] Matsumoto et al suggested that conference call presentations are not "boiler plate" disclosure. Rather they allow analysts to uncover information on the performance and quality of the earnings signal, resulting in a richer information environment than would otherwise exist.[767] Bowen et al inferred that conference calls increase the total information available about a company and suggested that conference calls may present a selective disclosure problem if the public is not privy to these calls.[768] Brown et al argued that companies that regularly hold conference calls experience sustained reductions in information asymmetry. They suggested these companies have lower costs of capital based on prior studies that link reductions in information asymmetry to lower costs of capital.[769]

As outlined in Chapter Two, a study by Holland of listed companies in the UK concluded that selective or private voluntary disclosure dominates public voluntary disclosure.[770] Holland argued that public disclosure is only made to the point where it is thought 'sufficient to legitimize additional private disclosure around the same public information disclosure, to satisfy external communication benchmarks and legal requirements and where it also satisfies the executive's need for liquidity and costs of capital benefits.'[771] He suggested that companies were 'aware that fund managers and analysts sought a unique information advantage and that there was no point to the private meeting[s] unless this occurred.'[772]

[766] Chun Lee, Leonard Rosenthal and Kimberly Gleason, 'Effect of Regulation FD on Asymmetric Information' (2004) 60 *Financial Analysts Journal* 79, 87.
[767] Dawn Matsumoto, Maarten Pronk and Erik Roelofsen, 'Managerial Disclosure vs Analyst Inquiry: An Empirical Investigation of the Presentation and Discussion Portions of Earnings-Related Conference Calls' (Working Paper, 1 November 2006) 32. See also Richard Frankel, Marilyn Johnson and Douglas Skinner, 'An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium' (1999) 37 *Journal of Accounting Research* 133**.**
[768] Robert Bowen, Angela Davis and Dawn Matsumoto, 'Do Conference Calls Affect Analysts' Forecasts?' (2002) 77 *Accounting Review* 285, 313. See also William Mayew, 'Evidence of Management Discrimination Among Analysts During Earnings Conference Calls' (2008) 46 *Journal of Accounting Research* 627.
[769] Stephen Brown, Stephen Hillegeist and Kin Lo, 'Conference Calls And Information Asymmetry' (2004) 37 *Journal of Accounting and Economics* 343, 345-346. Brown et al define information asymmetry as 'investors … differentially informed about a firm's value … [allowing] investors with superior information to trade profitably at the expense of other investors.'
[770] Holland, above n 242, 63.
[771] Holland, above n 242, 63-64.
[772] Holland, above n 523, 20.

(ii) Conflicts of Interest

Reuters conducted a survey in the US on the consequences of making "sell" recommendations. Eighty eight percent of the sell-side analysts indicated exclusion from stock offerings and merger deals and 54 percent indicated exclusion from company briefings.[773]

Frankel et al suggested that 'analyst incentives to misinform, combined with mounting evidence of market inefficiency with respect to analyst reports … implies analyst research cannot be unambiguously interpreted as serving to enhance informational efficiency of the capital markets.'[774] As previously highlighted, empirical evidence suggests that institutional investors may not be the only, or indeed the most effective, corporate monitors.[775]

Official investigations during 2001-2003 found that individual investors in the US were being systematically harmed by tainted investment advice.[776] De Franco et al estimated that the losses resulting from misleading analyst behaviour were primarily borne by retail or individual investors.[777] Such evidence prompted the introduction of new regulation[778] requiring clear separation of the research and investment banking

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[773] Scott Findlay and Prem Mathew, 'An Examination of the Differential Impact of Regulation FD on Analyst's Forecast Accuracy' (2006) 41 *Financial Review* 9, 10 footnote 2.

[774] Richard Frankel, SP Kothari and Joseph Weber, 'Determinants Of The Informativeness Of Analyst Research' (2006) 41 *Journal of Accounting and Economics* 29, 33.

[775] See, eg, Ajinkya et al, above n 550, Fidrmuc et al, above n 550.

[776] Laura Unger, 'Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts' (Written testimony to the Committee on Financial Services, United States House of Representatives, Washington DC, 31 July 2001). See also Paul Mahoney, 'Manager-Investor Conflicts In Mutual Funds' (2004) 18 *Journal of Economic Perspectives* 161; Orcutt, above n 706, 26-28. Unger indicated that:

- The line between research and investment banking was badly blurred;
- Analysts' relationships with the companies followed was cozy;
- "Booster shot" research reports were used close to the expiration of lock-up periods; and
- Sell side analysts and other employees of the brokerage firms with stock ownership in companies covered sold their personal stock while maintaining a "buy" rating.

[777] Gus De Franco, Hai Lu and Florin Vasvari, 'Wealth Transfer Effects of Analysts Misleading Behavior' (2007) 45 *Journal of Accounting Research* 71, 104. De Franco et al estimated that actively trading individual investors lost $2.2 billion, about two and half times the amount lost by institutions.

[778] The four major regulatory actions included:

1. Section 501 in the *Sarbanes-Oxley Act* 2002 governing analysts conflict of interest;
2. New analyst independence rules by the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE);
3. Enactment of Regulation Analyst Certification (Reg AC); and
4. A global settlement with leading investment banks.

Section 501 of the *Sarbanes-Oxley Act*, codified as s 15D of the *Securities Exchange Act* of 1934, required the SEC to adopt rules, directly or indirectly, to address analyst conflicts of interest. The NYSE and the NASD are self-regulated organizations that are subject to oversight by the SEC. As such, they were required to adopt new analyst independence rules.

divisions at firms;[779] restricted personal trading by analysts in the companies covered; analyst certification;[780] and mechanisms for providing free independent research and transparency of analyst rating information.[781]

2 Australian Research

(a) Selective Disclosure

Empirical research in Australia on selective disclosure includes studies examining the continuous disclosure and insider trading regimes. The Australian studies on insider trading were discussed in Part II of this Chapter. Empirical research on the continuous disclosure regime is outlined in Chapter Five. Most of the scholarly studies, including the thesis research, find evidence consistent with non-compliance with the continuous disclosure obligations. These study authors suggest or infer the likelihood of selective disclosure.

(b) Conflicts of Interest

Analysts from Goldman Sachs JB Were in Australia admitted that they 'seek to curry favour with management in order to preserve their information networks.'[782] They also confirmed that analysts manage their reputational risks by engaging in herding behaviour.[783] As previously outlined, Ries, the Research Director of E.L&C Ballieu, stated on the ABC program Inside Business that

> [m]ost [Australian] companies are very smart these days in massaging analysts' expectations. You know they give you a nod and a wink and stamp their feet on the

[779] The NASD and NYSE adopted rules that require analyst compensation to be determined on criteria without any consideration given to service or contribution to an investment banking division. Investment banking staff may not: influence or control analyst compensation; review or discuss pending research reports; tie analyst compensation to investment banking business; or influence analyst coverage decisions: NASD Rules 2711(b)(1)(2), 2711(d)(1)(2); NYSE Rules 472(b)(1)(2) (1)(2), 472(h)(1)(2). In addition, analysts may not solicit investment-banking business, participate in road shows and offer favourable research in return for business. Measures also included a ban on initial public offering spinning and preferential access to stock allocations; the appointment of independent monitors; and investor education programmes. Companies may not retaliate against analysts who issue unfavourable research or ratings: NASD Rules 2711(c)(4), 2711(e)(j); NYSE Rule 472(b)(5), 472(g)(1)(2).

[780] Reg AC requires certification by an analyst of a research report of the views expressed. That is, analysts must certify that they agree with their own recommendations: Securities Act Release 33-8193 (27 Feb 2003).

[781] Under the global settlement, certain research reports by investment banks have to be made public within 90 days after the end of a quarter, allowing public analysis of such research. In addition, ten investment banks paid a collective $1.3875 billion dollars under a global settlement.

[782] Alan Kohler, *Secrets and Lies* (2 December 2008) Business Spectator <http://www.businessspectator.com.au/bs.nsf/Article/Secrets-and-lies-LWRDP?OpenDocument&src=srch> at 3 December 2008.

floor three times so most of the numbers will be pretty close to what the companies report.[784]

Empirical studies on Australian sell-side broker research suggest that dissemination of broker reports is done on a client-rank basis, with retail investors typically at the bottom of the hierarchy. Aitken et al found that abnormal trade volumes and returns began many days prior to the official release of broker buy and sell recommendations. This finding could be explained as brokers being reactive in making their recommendations or the release of the recommendations to privileged clients first.[785] The study authors suggested that the only investors who benefited economically from the broker recommendations were those whose transactions costs were minimal and who had access to the recommendations prior to their official release, or those who were able to act within hours of the release of the recommendation.[786] Fong et al also suggested that brokers pass their best and most timely information to their largest clients first in order to generate higher returns for fund managers who are active enough to rank as a broker's "best client". The information was only disseminated to smaller clients later.[787] Similarly, Chan et al found evidence consistent with leakage of the Australian broker recommendations prior to their "official" release.[788]

In the Aitken et al study, trading activity was abnormally high during the broker recommendation periods, suggesting that the recommendations generated business for the brokers. Buy and hold recommendations resulted in higher average market share for the recommending broker, while sell recommendations resulted in lower market

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[783] Kohler, above n 782.

[784] Australian Broadcasting Corporation Television, *Ivor Ries with a Reporting Season Forecast* (19 July 2009) Inside Business <http:/www.abc.net.au/insidebusiness/content/2009/s2629947.htm> at 2 August 2009.

[785] Michael Aitken, Jayaram Muthuswamy and Kathryn Wong, 'The impact of Broker's Recommendations: Australian Evidence' (Working Paper, University of Sydney, May 2000) 1, 21.

[786] Aitken et al, above n 785, 17.

[787] Kingsley Fong, David Gallagher, Peter Gardner and Peter Swan, 'A Closer Examination Of Investment Manager Herding Behaviour' (Working Paper, University of New South Wales, 25 February 2004). See also Maureen McNichols and Brett Trueman, 'Public Disclosure, Private Information Collection, And Short-Term Trading' (1994) 17 *Journal of Accounting and Economics* 69, 89. McNichols and Trueman found that analysts typically publicly disclosed their forecasts only after privately revealing them to the company's favoured clients.

[788] Howard Chan, Rob Brown and Yew Kee Ho, 'Initiation Of Analyst Coverage: Does It Add Value?' (Working Paper, Monash University, University of Melbourne, 20 May 2003) 14.

share.[789] This finding may explain the natural bias towards optimistic broker reports. A study by the *Australian Financial Review* and IBES found that 44 percent of the analyst recommendations from Australia's largest brokers were "buy", 44 percent were "hold" and only 6.3 percent were "sell".[790]

E Selective Disclosure Regulation Critique and Conclusion

Some traditional academic material categorises stock market investors as institutional or individual. Some commentators assume that *all* institutional investors are sophisticated, professional, informed and rational and *all* individual investors are poorly informed and irrational "widow and orphans" or "mum and dads". It is often further assumed that investment analysts do all of the discovery of security related information on the basis that individual investors do not have the required education, experience, resources, and economies of scale to gather, analyse and produce information efficiently.[791] These parties generally argue that individual investors require professional analysts to interpret company information and present it to them in a way that can be understood.[792] It is suggested that individual investors can obtain the benefits of any private information by purchasing the analyst reports, investing with fund managers or trading at the market price and free riding on the presumption of market efficiency.

Based on these assumptions, many academics and the courts view analysts as 'crucial players in the mechanisms of market place efficiency that lead to optimal allocation of capital resources'.[793] The public are seen as benefiting from the existence of analysts because the information discovered by analysts leads to more accurate or efficient security prices.[794]

However, some of these assumptions about the roles of particular investor participants groups are unduly simplistic or no longer valid within contemporary markets.

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[789] Aitken et al, above n 785, 1, 16, 19, 21. Buy recommendations generate more brokerage and apply to more investors than sell recommendations. Sell recommendations may also damage the relationship with the relevant company.
[790] Uren, above n 121, 60.
[791] See, eg, Goshen et al, above n 473, 723-725; Corgill, above n 673, 397.
[792] Russell, above n 15, 551; Yi, above n 15, 261.
[793] Langevoort, above n 549.
[794] *In the Matter of Raymond L Dirks*, SEC Lexis 2213 (1981).

1 *Retail or Individual Investors Are Protected by Market Efficiency*

The arguments that expressly or impliedly suggest that individual, retail or other excluded investors can free ride on the back of professional investors and are protected from insider trading or selective disclosure because of market efficiency, require further explanation to be credible. As outlined in the insider trading discussion, when only a few market participants have valuable private information, the resulting price signal is noisier and the factoring of news into share prices is slower than when the information is widely disseminated. It takes a period of time for share prices to incorporate new information, and during this period, uninformed investors are not generally able to distinguish between trading volume and price movement based on credible private information and trading on an uninformed basis.

Moreover, Australian market participants are not generally able to accurately predict the effects of their own actions or the decisions of others on share prices.[795] Share prices in Australia reflect the aggregated trading position of investors. There is no mechanism for investors to know how other parties arrive at their decision or indeed whether another party is better informed. Consequently, when investors trade on valuable private information that has been selectively disclosed, uninformed investors are typically not protected by the market price.

The price efficiency argument is even less credible when parties simultaneously argue that retail investors are protected by market efficiency and professional investors require selective disclosure as incentive to produce research. The mathematics of the assertion that trades resulting from information that has been selectively disclosed produce a gain for the party with the private information but other investors do not make a corresponding loss, simply does not add up.[796]

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[795] Razeen Sappideen, 'Securities Market Efficiency Reconsidered' (1988) 9 *University of Tasmania Law Review* 132, 146.

[796] Wang, above n 598 (Material), 1235; Wang, above n 598 (Victim), 417. See also Wang et al, above n 598.

2 *Selective Disclosure as Analysis and Research Incentive*

The argument that selective disclosure to favoured investors is necessary as incentive for analysts to produce research, which in turn is necessary to enhance efficiency, is also tenuous. The relationships or links between access to company information, selective disclosure, the production of research, and economic efficiency are not clear.[797] The impacts of specific research strategies on market and economic efficiency are poorly understood.[798] In any event, many of the arguments on selective disclosure, analyst incentives and company access fail to differentiate between institutional investors who provide research to the broader market and those who don't. Access to company managers and private information in Australia are not dependent on the provision of third party research.

No compelling evidence has been found suggesting the security prices of companies that are not covered by analysts are inefficient, primarily because of a lack of analyst coverage.[799] The potential commissions or investment banking business from some listed companies, particularly smaller companies, may be insufficient for institutions to justify initiation or the maintenance of sell-side analyst coverage. However, companies may compensate for analyst research production by enhanced voluntary disclosure to the broader market. Company management who believe their securities are not trading at appropriate levels now have many cheap and easy options to convey their "story" directly to existing and potential investors. Many institutional and retail investors are willing to invest in companies with genuine investment potential regardless of a company's size. In modern developed markets, the search for misvalued stocks and an informational advantage is fiercely competitive. This includes many specialist professional funds that invest solely in companies with smaller market capitalisations and retail investors who are knowledgeable on particular securities.

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[797] Lee, above n 687, 175; Kenneth Boudreaux, 'Competitive Rates, Market Efficiency, and the Economics of Security Analysis' (Mar/April 1975) *Financial Analysts Journal* 18, 22. See Part IV of this Chapter for more detailed discussion on efficiency.
[798] Jeffrey Gordon and Lewis Kornhauser, 'Efficient Markets, Costly Information and Securities Research' (1985) 60 *New York University Law Review* 761, 792.
[799] There are empirical studies that measure the incremental impact of analyst initiation. However, the causal effects are not clear within these studies.

3 *Excluded Investors Can Obtain Selectively Disclosed Information in the Form of Research.*

The submissions from retail investors in relation to the Reg FD proposal, and the outlined studies on broker research and conflicts of interest in the US and Australia, suggest it is difficult for retail investors to benefit economically from sell-side analyst research. Fund managers confirm that they do their own security valuations and make independent investment decisions.[800] They indicate that the primary value of sell-side research and analysts is to provide ideas and insights, assist with thinking through of issues, and facilitate superior access to company management, rather than to provide investment recommendations and valuations.[801] However, few retail investors have sufficient client power to maintain such relationships with their brokers.

4 C*onclusion - The Economic Efficiency and Fairness Rationales Supporting Selective Disclosure Regulation are Sound.*

The arguments made by critics of Reg FD are that: retail investors would be overwhelmed by the information provided; trading activities and volatility would be significantly altered; companies would have practical difficulties in determining what information to release; companies would no longer be able to present a nuanced presentation of information; companies would reduce the amount and quality of information provided; and the traditional role and function of analysts would be threatened. These arguments seem to have been largely unfounded.

Some of the Reg FD studies suggest that companies adjusted their disclosure processes following enactment of Reg FD by increasing the amount of publicly disclosed information, and institutional investors responded to the increased public disclosure by trading after, rather than prior to, earnings releases.[802] The empirical studies examining conference call effects indicate that the number of companies in the US providing open access to conference calls increased leading up to and post Reg FD.[803] None of the call

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[800] Michael Evans, 'Top of their League: the Brokers Who Can Move Markets', *Sydney Morning Herald* (Sydney), 17 July 2010; Boris Groysberg, Paul Healy and David Maber, 'What Drives Financial Analyst Compensation at High-Status Banks?' (Working Paper, Harvard Business School, 21 May 2008) 33.
[801] Groysberg et al, above n 800, 33. See also Kohler, above n 782.
[802] Heflin et al, above n 761, 34; Bailey et al, above n 761, 2487, 2512.
[803] NIRI, above n 764**;** Bushee et al, above n 763, 625; Lee et al, above n 766, 87.

studies found evidence consistent with a "chilling" in the amount of information provided by companies during calls post Reg FD.[804] Indeed, those that examined the impact of open access suggested or implied an improvement in the information provided to the wider market because of the richness of the information provided during the calls.[805] These changes in behaviour suggest that Reg FD resulted in more equitable access to company information, and overall efficiency may have been enhanced through a reduction in information asymmetry.

In a market without any disclosure regulation, institutional investors are likely to systematically lose to better informed company insiders, but systematically gain at the expense of less informed retail investors as a result of selective private disclosures.[806] When insider trading is banned, it is generally the recipients of selective disclosure, and not the market as a whole that capture most of the trading gains from selective disclosure, making many of the alleged efficiency gains doubtful. Market professionals are likely to disproportionately capture these gains.[807] If so, enactment of insider trading regulation without supporting regulation prohibiting selective disclosure merely shifts the potential gains from trading on private information from company insiders to the recipients of selective disclosure.

Investor confidence in the integrity of a market is just as threatened by outsider trading as insider trading, and the potential negative efficiency impacts from the withdrawal of non-favoured or excluded investors from the market are the same. Consequently, the suggested market fairness and economic efficiency gains from the introduction and enforcement of insider trading regulation are likely to be diluted when not supported by regulation prohibiting selective disclosure.

The nature of these market fairness and economic efficiency gains are discussed in more detail in the next Part.

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[804] Bushee et al, above n 763, 625; Lee at al, above n 766, 87.

[805] Brown at al, above n 769, 345-346; Matsumoto et al, above n 767, 32; Frankel et al, above n 767, 149; Brian Bushee, Dawn Matsumoto and Gregory Miller, 'Open versus Closed Conference Calls: The Determinants and Effects of Broadening Access to Disclosure' (2003) 34 *Journal of Accounting and Economics* 149, 178.

[806] Langevoort, above n 549, 1046.

[807] Jonathan Macey, 'Ethics, Economics and Insider Trading: Ayn Rand Meets the Theory of the Firm' (1988) 11 *Harvard Journal of Law & Public Policy* 785, 803.

IV EFFICIENCY, FAIRNESS AND RATIONALITY CONCEPTS WITHIN MARKETS

'[Our decision] to do something positive … can only be taken as a result of animal spirits … and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities'[808]

Differences in the company disclosure and insider trading policy efficiency and fairness goals can have significant consequences for investors and other corporate stakeholders. This makes it important to review the spectrum of efficiency and fairness concepts encompassed within the theoretical and empirical debates, the proxies commonly adopted to determine or measure efficiency and fairness within markets, and the market and legal frameworks to enhance or optimise fairness and efficiency.

Many of the arguments outlined throughout the thesis tend to endorse or promote a market philosophy based on efficiency, fairness or participant rationality. Put simply, the efficiency advocate argues in favour of free markets or minimum regulatory interference, with corporate disclosure left to competitive forces on the basis that securities prices generally reflect available information. The behavioural advocate argues that the economic rationalist model does not work because the behaviour of market participants is often, or predictably, irrational, and in any event, the market is a beauty contest in which one wins by 'anticipating what average opinion expects the average opinion to be'.[809] The fairness advocate argues that markets only work when people are confident they are informed and trading in a market with equal or near equal access to company information.

These narrow philosophical approaches present major difficulties for policy makers and the judiciary who respectively design and interpret corporate disclosure and insider trading regulation based on dual efficiency and fairness goals, for securities markets that inherently incorporate both rational and irrational decision-making.

As previously outlined, I argue that the primary fairness rationale is equal access, the appropriate efficiency rationale for company disclosure policy is long-term economic

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[808] John Keynes, *The General Theory of Employment, Interest and Money* (1936) 131.
[809] Keynes, above n 808, 156.

efficiency,[810] and the equal access and economic efficiency rationales are complementary.

A Efficiency and Rationality Concepts within Markets

1 *Economic Efficiency*

The term "efficiency" generally encompasses notions of productivity, effectiveness and competency. Within the economic sphere, efficiency generally refers to the use of allocated resources or inputs in a way that optimises the specified or desired outcome. Market efficiency is generally a precondition of, but does not guarantee, economic efficiency.

Economic or allocative efficiency can be defined and measured in many different ways. Models adopted by economists include Pareto efficiency,[811] Kaldor Hicks efficiency,[812] and social welfare optimisation. Arguably, the predominant economic or efficiency approaches cited or adopted by legal academics in relation to securities regulation are utilitarian or wealth-maximisation based.[813] Some academics suggest

[810] The thesis definitions of price, market and economic efficiency were provided in Chapter One.

[811] The Pareto optimum was introduced by Vilfredo Pareto in 1896. The Pareto efficiency approach asks whether a transaction or change will make somebody better off while making no one worse off. Pareto efficiency is a form of utilitarianism, and the inherent theoretical and practical difficulties that arise from utilitarian models apply. There are no criteria for weighing up preferences and excluding those that may not deserve recognition and issues of unequal distribution may be skewed. In addition, the assumptions of voluntariness, complete information and a lack of "externalities" may not be valid. In practice, 'few policies have no losers'. A pareto optimal allocation may be theoretically possible despite taxes and transaction costs. However, the allocation of resources may be privately optimal but publicly suboptimal when externalities cause a divergence between private and social costs and benefits.

[812] The difficulties in measuring and applying the Pareto efficiency criteria led to the development of the Kaldor-Hicks approach, which asks whether a transaction or change will result in a net benefit to all affected individuals. Under the Kaldor test, redistributions are possible in order to achieve an allocation that is superior to the other state according to the Pareto criterion. The Hicks test is met when it is not possible to further redistribute to make everyone better off within a Pareto superior state. The Pareto and Kaldor-Hicks measurements of economic efficiency exclude distributive considerations in an attempt to be value-free. Kaldor argue that an economist cannot be concerned with distributional questions because it is impossible to decide on economic grounds what pattern of income-distribution maximises social welfare. Similarly, Hicks notes that if measures making for efficiency are to have a fair chance, they should be freed from distributive complications.

[813] The relationship between a country's legal system and its economy has been acknowledged and discussed by great thinkers for a long time. See, eg, Adam Smith, *A Theory of the Moral Sentiments* (1759); Adam Smith, *The Wealth of Nations* (1776); Jeremy Bentham, *Fragment on Government* (1776); John Mill, *Utilitarianism* (1861); Karl Marx, *A Critique of the Gotha Programme* (1875).

The *Journal of Law and Economics* published by the University of Chicago School of Law began publication in 1958. The law and economics movement has developed and matured and now encompasses a broad range of views. Posner indicates at page 34 of *Frontiers of Legal Theory* (2001) that the economic analysis of law 'tries to explain and predict the behaviour of participants in the legal that market or economic efficiency approaches should be applied without any value judgments and without consideration of wealth distribution. Others argue that the Pareto and Kaldor-Hicks approaches simply protect existing resource allocations regardless of merit or equity, and they reject a welfare prescription that excludes value judgments.[814] Some of these scholars adopt economic models that incorporate income distribution considerations and notions of fairness and equality.[815]

Most lawyers now accept that economic analysis or models are useful tools within policy and judicial decision-making. However, the extent to which economic or efficiency measures should ultimately determine policy and judicial decision-making remains controversial.[816] There is a broad range of views among scholars on the use of economic models and analysis within public policy decision-making.[817]

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system and even the doctrinal, procedural, and institutional structure of the system.' Malloy suggests that "law and economics" is simply 'an inquiry or study concerning the relationship between law and economics': Robin Malloy, 'Debate: Is law and Economics Moral?' (1990) 24 *Valparaiso University Law Review* 147.

[814] Malloy, above n 813; Michael Trebilcock, 'An Introduction to Law And Economics' (1997) 23 *Monash University Law Review* 123; Eric Posner, *Law and Social Norms* (2000); Richard Zerbe Jr, *Economic Efficiency In Law And Economics* (2001) 2; Walter Schultz, *The Moral Conditions of Economic Efficiency* (2001). Zerbe argues that 'modern economists have abandoned the search for a perfectly scientific welfare criterion, and have recognised that the justification for any criterion must encompass both moral and technical considerations.'

[815] See, eg, Louis Kaplow and Shavell Shavell, *Fairness versus Welfare* (2002) 18; Louis Kaplow and Shavall Shavall, 'Fairness versus Welfare' (2001) 114 *Harvard Law Review* 961. Kaplow and Shavall interpret individual preferences broadly in their social welfare model. Individual tastes for a notion of equality and for legal rules that 'comport with some personally held notions of fairness' are included in their assessment of individuals' well-being and thus in determining social welfare. No weight is given to notions of fairness that are independent from individual well-being. However, they suggest that 'redistributing income from the rich to the poor will tend to raise social welfare, assuming that the marginal utility of income is greater for the poor than for the rich.'

[816] Laurence Tribe, 'Constitutional Calculus: Equal Justice or Economic Efficiency?' (1985) 98 *Harvard Law Review* 592, 596; Klock, above n 584, 326-327; Lynne Dallas, 'Two Models of Corporate Governance: Beyond Berle and Means' (1988) 22 *University of Michigan Journal of Law Reform* 19, 45; Alex Johnson Jr, 'An Appeal for the Liberal Use of Law and Economics: The Liberals Fight Back' (1989) 67 *Texas Law Review* 659, 667; Herbert Hovenkamp, 'The First Great Law & Economics Movement' (1990) 42 *Stanford Law Review* 993, 1045; Lawrence Mitchell, 'Book review –The Cult of Efficiency' (1992) 71 *Texas Law Review* 217, 218, 226-228, 241-242. Tribe argues that the appeal of utilitarian policy analysis, as well as its power, lies in its ability to reduce the various dimensions of a problem to a common denominator. The law-and-economics school of thought typically argues that rights should be awarded on grounds of efficiency to reflect the discontinuous preferences of those who would refuse any inducement to cede those "rights". Further, one of the most persistent myths of policy analysis based on a utilitarian approach is that the analytical techniques *in themselves* lack significant substantive bias or controversial content. The disregard of those for distributive concerns cannot be corrected merely by punching in one or more dummy variable labelled "values". The cost-benefit comparisons and marginal analyses are already engineered, whether intentionally or not, to serve a specific agenda. Mitchell suggests that the economic models used have enormous public policy consequences, including exacerbating the potentially dangerous trend towards the concentration of corporate wealth in the hands of a relatively small group of institutional investors. Moreover they draw conclusions based on their model, expressed with characteristic certitude that are debatable even on their own terms. Mitchell objects to the view that small investors simply need to diversify to protect themselves or obtain the benefits of portfolio investment by placing their money with mutual funds,

2 *Market Efficiency Theory*

'[T]he ECMH [Efficient Capital Markets hypothesis] is the context in which serious discussion of the regulation of financial markets takes place'[818]

"Market efficiency" can also be defined and measured in a number of different ways. However, most scholarly material on market efficiency refers to, or derives from, the Fama efficient markets theory.

Fama argues that 'the primary role of the capital market is allocation of ownership of the economy's capital stock'.[819] He suggest**s** that an ideal market is one

> in which prices provide accurate signals for resource allocation: that is, a market in which firms can make production-investment decisions, and investors can choose among the securities that represent ownership of firm's activities under the assumption that security prices at any time 'fully reflect' all available information.[820]

Fama developed the efficient capital markets hypothesis (ECMH) in the 1960s to empirically test whether security prices "fully reflect" specified information subsets.[821]

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because this results in these investors giving their money to the very institutions whose informational superiority drove them out of the market in the first place. He describes the approach as ultra-utilitarian, openly discriminatory and lacking any conception of justice or distributional fairness. He notes that Adam Smith accommodated the goals of altruism and concern for others in his economic theories.

[817] John Chipman and James Moore, 'The New Welfare Economics 1939-1974' (1978) 19 *International Economic Review* 547, 548; Peter Hammond, *Welfare Economics* (1985); Robert Frank, 'If Homo Economicus Could Choose His Own Utility Function, Would He Want One with a Conscience?' (1987) 77 *American Economic Review* 593, 603; Harold Demstez, 'Professor Michelman's Unnecessary and Futile Search for the Philosopher's Touchstone' in J Roland Pennock and John William Chapman, eds, *NOMOS XXIV: Ethics, Economics and the Law* (1982) 41, 43; Amitai Etzioni, *The Moral Dimension: Toward a New Economics* (1988); Amartya Sen, *On Ethics and Economics* (1987) 22-28. Chipman and Moore argue that economics must be considered a failure judged in relation to its basic objective of enabling economists to make welfare prescriptions without having to make value judgments and, in particular, interpersonal comparisons of utility. They suggest that policy recommendations must be made on the basis of value judgments, and these value judgments should be made explicit. Sen suggests that public choice theory is made unduly narrow by the insistence that individuals invariably behave as *Homo Economicus* because such restrictions can significantly misrepresent the nature of social concerns and values. Hammond agrees that value-free measures are undesirable and impossible. Frank indicates that it is neither necessary nor productive for modern economists to exclude behavioral factors such as conscience and other moral sentiments from utility maximisation models.

[818] Ronald Gilson and Reinier Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549, 550.

[819] Fama, above n 563, 383. See also Irwin Friend, 'The Economic Consequences of the Stock Market' (1972) 62 *American Economic Review* 212; Merritt Fox, Randall Morck, Bernard Yeung and Artyom Durnev, 'Law, Share Price Accuracy, and Economic Performance: The New Evidence' (2003) 102 *Michigan Law Review* 331, 366.

[820] Fama, above n 563, 383.

[821] Paolo Cioppa, 'The Efficient Capital Market Hypothesis Revisited: Implications of the Economic Model for the United States Regulator' (2005) 5 *Global Jurist Advances;* Sappideen, above n 795, 134. The ECMH formally evolved in the 1960s from the PhD dissertation of Fama. However, its origins date

Markets which reflect these information subsets are categorised as strong, semi-strong or weak form efficient.[822] In a strong form or perfectly efficient market, security prices fully reflect all currently known information, including public and private information. Fama does not expect this extreme model to be an exact description of the world; instead it provides the benchmark against which deviations can be measured.[823] The information subset tested in the semi-strong form is limited to publicly available information. The weak form is limited to historical price sequences.[824]

When a market is strong form or perfectly efficient, no investor can benefit from new information, including persons that possess inside information or information not publicly available, because the prices will already reflect such information. In a market with a semi-strong form of efficiency, a person may earn superior returns from information that is not publicly available, but no investor can earn excess returns by fundamental research or the identification of mispriced securities on the basis of publicly available information.[825] Finally, in a market with weak-form efficiency, investors cannot earn superior returns by technical analysis, or the study of past security pricing or volume trends.[826] In such a market, price changes occur randomly, so that security prices or patterns of price change cannot be objectively valued and future movements cannot be predicted.

The assumptions underpinning the ECMH are that investor expectations are homogeneous, companies and investors act rationally, and information is costless and freely available to all market participants.[827] Fama acknowledged that investor expectations may differ to some degree, no company or investor acts entirely rationally, and information is not costless and may not be available to all participants.

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back to a dissertation by Bachelier, a student of the French mathematician, Henri Poincare. Bachelier analyzed the French commodities market in 1900 and found the market prices to be unbiased estimates of future prices, with changes in pricing the result of new information, the emergence of which was random.

[822] Fama, above n 563, 383, 388.

[823] Fama, above n 563, 414.

[824] Fama, above n 563.

[825] Fundamental analysis seeks to values companies and their securities based on the present value of the estimated future earnings and distributions. See, eg, Baruch Lev and S Ramu Thiagarajan, 'Fundamental Information Analysis' (1993) 31 *Journal of Accounting Research* 190.

[826] Technical analysis looks at patterns based on security prices and trading volumes and presumes that future patterns are predictable based on previous patterns of security prices and trading volumes.

[827] Fama, above n 563, 388.

He indicated that the goal of empirical work was to examine the extent to which the model assumptions applied in real world markets.[828]

In practice, markets are not totally inefficient or strong form efficient. Meaningful discussion on the efficiency of capital markets concerns the relative efficiency of one market to another or how to enhance or optimise the efficiency of a particular market.[829] One measure of the level of market efficiency is the relative speed and accuracy of share prices in reaching new equilibrium levels when new information becomes available[830] – or 'the extent to which prices anticipate earnings information and the completeness with which prices react to earnings news.[831]

Fama admits that 'market efficiency per se is not testable. It must be tested jointly with some model of equilibrium, [such as] an asset-pricing model'.[832] The asset-pricing model generally used in conjunction with the ECMH is the Capital Asset Pricing Model (CAPM). The CAPM assumes that investors rationally adopt a fundamental valuation approach to individual security investments and they seek to minimise portfolio risk through diversification.[833]

Markets are described as fundamentally efficient 'if stock prices respond to available information not only quickly but *accurately*, so that market prices mirror the best possible estimates, in light of all available information, of the actual economic value of securities in terms of their expected risks and returns.'[834] A market may achieve fundamental efficiency 'when there are large numbers of rational, profit-maximisers

[828] See Fama, above n 563, 388.
[829] Gilson et al, above n 818, 560; Andrew Lo (ed), *Market Efficiency: Stock Marker Behaviour and Theory and Practice Volume I* (1997) xvii; Donald Langevoort, 'Revisiting Gilson and Kraakman's Efficiency Story' (2003) 28 *Journal of Corporation Law* 499, 500.
[830] Nichols et al, above n 20, 270.
[831] Nichols et al, above n 20, 281. See the empirical studies on market response to result announcements outlined in section 3(a) of Part II of Chapter Two.
[832] Eugene Fama, 'Efficient Capital Markets: II' (1991) 46 *Journal of Finance* 1575, 1575-1576. See also Gordon et al, above n 798, 772.
[833] As explained later in this section, the Capital Asset Pricing Model (CAPM) posits that shares will earn the risk-free rate of return plus a risk premium. The risk premium only applies to the element of risk in the portfolio that cannot be eliminated by diversification, or the specific risk of an individual investment. The specific risk represents the component of the return that is uncorrelated with general market moves. The non-diversifiable risk element is known as the market or systemic risk.
[834] Lynn Stout, 'The Mechanisms of Market Inefficiency: An Introduction to the New Finance' (2003) 28 *Journal of Corporation Law* 635, 640. See also William Sharpe, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 418, 418.

actively competing with each other to predict future market values of individual securities.'[835]

3 *Market Efficiency Paradox*

'There is an old joke, widely told among economists, about an economist strolling down the street with a companion when they come upon a $100 bill lying on the ground. As the companion reaches down to pick it up, the economist says Don't bother – if it were a real $100 bill, someone would have already picked it up.''[836]

'Markets do not become efficient automatically. It is the actions of investors, sensing bargains and putting into effect schemes to beat the market, that make the markets efficient'.[837] That is, a market only remains efficient if there are sufficient market participants who act as though it is not and who continue to engage in the necessary research to ensure the market's efficiency. Yet, paradoxically, an investor can only earn a return on the research cost if the market is sufficiently inefficient.[838] This means that 'there is a fundamental conflict between the efficiency with which markets spread information and the incentives to acquire information'.[839] Indeed, Grossman and Stiglitz suggest that a perfectly efficient market is an impossibility because there is no incentive for arbitrageurs or investors to acquire information. They therefore redefine the efficient market concept and provide a model in which there is an 'equilibrium degree of disequilibrium'.[840] Under this model, security prices only partially reflect available information, leaving sufficient price uncertainty for investors to earn a return to compensate them for resources spent to obtain information. The price uncertainty arises due to noise interference.[841]

Other parties argue that although prices reflect aggregate-or-consensus-forecasts that are more accurate over the long run than those of individual traders, this consensus

[835] Russell, above n 15, 550. Some academics use the term intrinsic value rather than fundamental value. For example, Dodd and Cottle viewed efficiency in terms of deviations from "intrinsic " value: Benjamin Graham, David Dodd and Sidney Cottle, *Security Analysis, Principles and Techniques* (4th ed, 1962). Intrinsic value can be defined in a number of ways but is generally close to, or synonymous with, fundamental value.
[836] Lo, above n 829, xi.
[837] Aswath Damodaran, *Investment Valuation: Tools And Techniques For Determining The Value Of Any Asset* (1996) 149.
[838] Kitch, above n 448, 708, 711; Gordon, et al, above n 798, 786; Barry, above n 583, 1333.
[839] Sanford Grossman and Joseph Stiglitz, 'On The Impossibility of Informationally Efficient Markets' (1980) 70 *American Economic Review* 393, 405.
[840] Grossman et al, above n 839, 393.
[841] Grossman et al, above n 839, 393.

may not exist in the short run, allowing some traders abnormal returns. Hard information or known historical facts are quickly assimilated into stock prices, but soft information or uncertain forecasts and estimates take longer.[842] Uncertainty prevails in securities markets for several reasons.[843] 'Market prices are buffeted by a continuous flow of information, or rumours and innuendos disguised as information.'[844] Individuals responding to information cannot know whether, and to what extent, the information is already reflected in the price. 'The market is in a continuous state of adjustment.'[845]

4 *Criticisms of the Market Efficiency Theory*

In 1978, Jensen boldly stated that 'there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis.'[846] However, since the 1980s, a growing number of parties have questioned its validity on both theoretical and empirical grounds. The Turner Review in the UK concluded that 'in the face of the worst financial crisis for a century … the assumptions of efficient market theory have been subject to increasingly effective criticism'.[847]

Some critics claim that the ECMH concept of market efficiency has been severely challenged by growing empirical evidence of short-term inefficiencies. Others question the assumptions underpinning the ECMH including the rational investor assumption, the link with the capital assets pricing model, and the extent of alignment between price, market and economic efficiency. These broader criticisms are reviewed initially.

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[842] Gilson et al, above n 818, 561, 579-580. See also Sappideen, above n 795, 132; Caryn Beck-Dudley and Alan Stephens, 'The Efficient Market Theory and Insider Trading: Are We Headed in the Right Direction?' (1989) 27 *American Business Law Journal* 441, 455-456.
[843] Sappideen, above n 795, 132.
[844] Charles Lee, 'Market Efficiency and Accounting Research: A Discussion of "Capital Market Research in Accounting" by SP Kothari' (2001) 31 *Journal of Accounting Finance* 233, 237. Lee describes market efficiency as a journey, not a destination.
[845] Lee, above n 844, 237.
[846] Michael Jensen, 'Some Anomalous Evidence Requiring Market Efficiency' (1978) 6 *Journal of Financial Economics* 95, 95.
[847] FSA, above n 554, 40.

(a) Rationality or Behavioural Anomalies

'Anyone taken as an individual, is tolerably sensible and reasonable – as a member of a crowd, he at once becomes a blockhead'[848]

A growing number of critics question the ECMH assumption that rational investors seek to optimise their economic position on a self-interested basis (referred to as economic rationalism).[849] Those who believe the market is significantly influenced by noise and investor psychology point to the market bubbles and crashes as examples of inefficiencies based on non-fundamental signals.[850] Keynes even described the stock market as a beauty contest in which one wins by 'anticipating what average opinion expects the average opinion to be.'[851]

Some behavioral economists argue that investors are often, if not always, irrational in a predictive way.[852] They argue that most people tend to overreact to unexpected and dramatic news events.[853] Trading on noise produces lower returns than trading on rational expectations.[854] Similarly, investor overconfidence can lead to reduced returns, excess volatility and stock mispricing.[855] Others argue that 'there is no fundamental psychological principle that people always tend to over-react or … underreact'.[856]

International empirical research confirms that investors may be overconfident,[857] prone to overreact,[858] loss averse,[859] subject to herding,[860] incapable of assessing

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[848] Charles MacKay (eds), *Extraordinary Popular Delusions and the Madness of Crowds (*1841) xiii,
[849] David Romer, 'Rational Asset-Price Movements without News' (1993) 83 *American Economic Review* 1112; Andrew Lo, 'Reconciling Efficient Markets with Behavioral Finance: The Adaptive Markets Hypothesis' (Working Paper, 8 March 2005).
[850] Joseph Stiglitz, 'Symposium on Bubble' (Spring 1990) *Journal of Economic Perspective* 13, 17; Andrei Shleifer and Lawrence Summers, 'The Noise Trader Approach in Finance' (Spring 1990) *Journal of Economic Perspective* 19, 19.
[851] Keynes, above n 808, 156.
[852] Lo, above n 849, 7.
[853] Werner De Bondt and Richard Thaler, 'Does the Stock Market Overreact?' (1985) 40 *Journal of Finance* 793; Werner De Bondt and Richard Thaler, 'Further Evidence On Investor Overreaction And Stock Market Seasonality' (1987) 42 *Journal of Finance* 557.
[854] Shleifer et al, above n 850.
[855] Daniel Kent, David Hirshleifer and Avanidhar Subrahmanyam, 'Investor Psychology and Security Market under and Overreactions' (1998) 53 *Journal of Finance* 1839, 1867.
[856] Robert Shiller, 'From Efficient Markets Theory to Behavioural Finance' (2003) 17 *Journal of Economic Perspectives* 83, 101-102.
[857] Barber et al, above n 350.
[858] De Bondt et al, above n 853; Kent et al, above n 855.
[859] Daniel Kahneman and Amos Tversky (1979) 'Prospect Theory: An Analysis of Decision under Risk' (1979) 47 *Econometrics* 263; Shlomo Benartzi and Richard Thaler, 'Myopic Loss Aversion and the Equity Premium Puzzle' (1995) 110 *Quarterly Journal of Economics* 73; Bainbridge, above n 444, 1047.

probabilities,[861] subject to regret,[862] biased towards past behaviour or the status quo,[863] or subject to fads.[864] In empirical studies, institutional *and* individual investors admit they are not always systematic in their stock decisions and are heavily influenced by other people's behaviour. The sort of behaviour underlying contagion models or herd behaviour is important among all investor groups, including professional "smart money".[865] For instance, it has been argued that the main failings of the Long Term Capital Markets model were the overconfidence of the Nobel winning laureates and highly respected traders and the fact that the model created by these mathematicians and economists did not take into account that human behaviour is often irrational.[866] The distinction between zealots and smart money is not always sharp. Instead, 'there are … gradations in between, especially since the objective evidence about the fundamental value of individual stocks is always somewhat ambiguous'.[867]

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860 Robert Shiller, 'Conversation, Information, and Herd Beaviour' (1995) 85 *Amercian Economic Review* 181; Gur Huberman and Tomer Regev, 'Contagious Speculation and a Cure for Cancer: A Non-Event that Made Stock Prices Soar' (2001) 56 *Journal of Finance* 387; Bainbridge, above n 444, 1038-1041; Kingsley Fong, David Gallagher, Peter Gardner and Peter Swan, 'A Closer Examination of Investment Manager Herding Behaviour' (Working Paper, University of New South Wales, 25 February 2004) 30, 31. Herding behaviour occurs when a decision-maker imitates the actions of others, while ignoring his or her own information and judgment with regard to the merits of the underlying decision. Fong et al found evidence of active manager herding behaviour in Australia, particularly on the sell-side and among small stocks. This herding was substantially more pronounced amongst managers that executed trades using the same broker.

861 David Laibson, 'Golden Eggs and Hyperbolic Discounting' (1997) 112 *Quarterly Journal of Economics* 443.

862 Roger Clarke, Scott Krase and Meir Statman, 'Tracking Errors, Regret and Tactical Asset Allocation' (1994) 20 *Journal of Portfolio Management* 16.

863 Bainbridge, above n 444, 1041-1044. Bainbridge indicates that the status quo bias posits a systematic decision-making bias such that actors favour maintaining the status quo rather than switching to some alternative state.

864 Robert Shiller, 'Market Volatility and Investor Behavior' (1990) 80 *American Economic Review* 58; Stephen Choi and AC Pritchard, 'Behavioral Economics and the SEC' (2003) 56 *Stanford Law Review* 1; 72; David Hirshleifer, 'Investor Psychology and Asset Pricing' (2001) 56 *Journal of Finance* 1533, 1576; Bainbridge, above n 444, 1040.

865 Bainbridge, above n 444, 1038-1039; John Coffee Jnr, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms' (2004) 84 *Boston University Law Review* 301, 329; Robert Shiller and John Pound, 'Survey Evidence on Diffusion of Interest and Information among Investors' (1989) August *Journal of Economic Behaviour and Organisation* 44; Marcel Kahan and Michael Klausner, 'Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases' (1996) 74 *Washington University Law Quarterly* 347, 355-356. Bainbridge indicates that there is lots of evidence that smart, seemingly rational decision-makers are prone to herd behaviour. He suggests that herding can arise because of a reputational pay-off even if the chosen course of action fails, it can be a response to bounded rationality and information asymmetries, or it can be a so-called conformity effect. Coffee suggests that the primary motive of professional managers is to perform no worse than their major institutional rivals and this provides a strong incentive to herd. Indeed, fund managers who are cautious or who prematurely respond to new information may under perform their rivals and may lose their jobs. During a market bubble, it is dangerous to be sane in an insane world.

866 Prentice, above n 413, 1461, 1509.

867 Shiller, above n 856, 98.

None of us respond to market events like highly programmed machines. As Hirshleifer highlights, 'man is neither infinite in faculties, nor in apprehension like a god. Nor is fallibility shed at the doorstep of the stock exchange'.[868] Moreover, irrational behaviour is not restricted to market practitioners. Kahneman, a Nobel prize-winning economist, argues that business decision makers are not always rational. He indicates that 'businesses do not invest in trying to figure out what they've done wrong. This is not an accident. They don't want to know'.[869] Similarly, Choi et al argues that regulators as well as investors suffer from cognitive failings and behavioural biases.[870]

Some parties argue that when market inefficiencies arise, 'irrational tendencies causing prices to move away from fundamental values [are] immediately … exploited and eliminated by arbitrageurs.'[871] However, such arbitrage is limited and incomplete because there is no way for the arbitrageurs to know the true state of affairs and because of the unpredictability of noisy trading.[872] The arbitrage activities of informed investors do not always fully counteract the actions of uninformed speculators.[873]

(b) Criticism of the Capital Asset Pricing Model

As previously highlighted, Fama admits that 'market efficiency per se is not testable.[874] When evidence of anomalous returns is found, 'the way it should be split between market inefficiency or a bad model of market equilibrium is ambiguous'.[875] This ambiguity results in interpretive difficulties.[876]

There are significant issues with the CAPM as an accurate model of how markets work in practice.[877] Some parties question the appropriateness of using beta to determine the

[868] Hirshleifer, above n 535, 1576.
[869] Michael Schrage, 'Daniel Kahneman: Thought Leader Interview' (Winter 2003) 33 *Strategy +Business* 125.
[870] Choi et al, above n 864, 72.
[871] Cioppa, above n 821.
[872] Donald Langevoort, 'Theories, Assumptions and Securities Regulation: Market Efficiency Revisited' (1992) 140 *University of Pennsylvania Law Review* 851, 863, 870.
[873] Fox et al, above n 819, 348-349. Fox et al argue that the arbitrage activities of smart money speculators do not always fully counteract the actions of naïve speculators.
[874] Fama, above n 832, 1575-1576; Gordon, et al, above n 798, 772.
[875] Fama, above n 832, 1576.
[876] Alon Brav and JB Heaton, 'Market Indeterminacy' (2003) 28 *Journal of Corporation Law* 517, 636-638.
[877] Gordon et al, above n 798, 785; G William Schwert, 'Size and Stock Returns, and other Empirical Irregularities' (1983) 12 *Journal of Financial Economics* 3, 9; James Patell, 'Discussion on the Usefulness of Earnings and Earning Research: Lesson and Directions from Two Decades of Empirical Research' (1989) 27 *Journal of Accounting Research* 193, 197.

risk of an investment or portfolio.[878] Beta is generally based on historical volatility, which is often a poor predictor of the future. Gilson and Kraakman suggest that the CAPM is tautological.[879] They argue that it is impossible for all market participants to acquire, understand and trade on all available relevant securities information because there are several price moving mechanisms and these are complex and inter-related.[880] An alternative definition put forward for an efficient market is one in which 'security prices act *as if* everyone knows the information'.[881] Others argue that it is not always possible for prices to act as if everyone knows the information.[882]

(c) Misalignment between Price, Market and Economic Efficiency

Capital markets impact on the real economy through first, the inclusion of savings or investments in the national income and secondly, the market processes that allocate the capital to companies for production or investment.[883] Optimal economic efficiency depends on optimal real capital or investment decisions.[884] However, there are sometimes significant discrepancies between price, market and economic efficiency measures.

Individual security and market pricing does not always accurately reflect returns based on the underlying economic value.[885] Markets experience periods of boom and bust

[878] Lowe, above n 73, 160; Seth Klarman, 'A Response to Lowenstein's Searching for Rational Investors in a Perfect Storm' (2005) *Journal of Corporation Law* 561, 561. See also, Donald, above n 445, 112-118; David Downes and Thomas Dyckman, 'The Efficient Market Reconsidered' (Fall 1977) 4 *Journal of Portfolio Management* 4. The risk premium used in the CAPM only applies to the element of risk in the portfolio that cannot be eliminated by diversification, or the specific risk of an individual investment. The specific risk represents the component of the return that is uncorrelated with general market moves. The non-diversifiable risk element is known as market or systematic risk.

[879] Gilson et al, above n 708, 718.

[880] Gilson et al, above n 818. Gilson & Kraakman suggest that there are four different types of market trading: universally informed trading; professionally informed trading; derivatively informed trading, and uninformed trading.

[881] William Beaver, 'Market Efficiency' (1981) 56 *Accounting Review* 23, 35. See also Robert Verrecchia, 'On the Theory of Market Information Efficiency' (1979) 1 *Journal of Accounting and Economics* 77, 77, 89.

[882] George Foster, 'Capital Market Efficiency: Definitions, Testing Issues and Anomalies' in MJR Gaffikin and RJ Chambers (eds), *Contemporary Accounting Thought, Essays in Honour of RJ Chambers* (1984) 175-176.

[883] Friend, above n 819, 212.

[884] Friend, above n 819, 213; Gordon, et al, above n 798, 767.

[885] See, eg, Stephan Schulmeister, 'Boom-Bust Cycles and Trading Practices in Asset Markets, the Real Economy and the Effects of a Financial Transaction Tax' (Working Paper 364, Austrian Institute of Economic Research, March 2010).

when security valuations move away from fundamental valuation trend lines.[886] Moreover, an increasing proportion of market activity is secondary trading of existing securities. There is an indirect connection between trading on secondary issues and new capital raisings because parties infer information for and about investment decisions from stock prices.[887] However, amounts traded on capital markets around the globe (particularly in the form of derivative instruments) have increased dramatically over the last twenty years.[888]

5 *Responses to Criticisms of the ECMH*

In 1998 Fama argued that many of the identified market efficiency anomalies are not inconsistent with the market efficiency model because overreactions to information are as common as under-reactions, suggesting the anomalies are chance occurrences.[889] He indicated that most of the long-term anomalies could be accounted for by reasonable changes in technique or the way the anomalies are measured. Critics responded that investors inevitably disagree about what may happen in the future so the average opinion does not necessarily represent the best possible estimate of a security's future value based on available information.[890]

Fama suggests that the ECMH can only be 'replaced by a better specific model of price formation, itself potentially rejectable by empirical tests.'[891] Alternative or adaptive models to the ECMH have been proposed. Some parties suggest that a new paradigm founded in modern finance and incorporating the many complex realities and nuances in capital markets is emerging.[892] Others argue that at this stage behavioural economics provides only valuable after-the-fact explanations for observed behaviour rather than

[886] Gordon, et al, above n 798, 769; Kassouf, above n 447, 424; Stephan Schulmeister, 'A General Financial Transactions Tax: A Short Cut of the Pros, the Cons and a Proposal' (Working Paper No 344, Austrian Institute of Economic Research, October 2009).
[887] James Dow and Gary Gorton, 'Stock Market Efficiency and Economic Efficiency: Is there a Connection?' (1997) 52 *Journal of Finance* 1087, 1115.
[888] FSA, above n 554; Lawrence Summers and Victoria Summers, 'When Financial Markets Work Too Well: A Cautious Case For a Securities Transaction Tax' (1989) 3 *Journal of Financial Services Research* 261, 263; Schulmeister, above n 885, 5. Schulmeister indicates that the ratio of the volume of financial transactions relative to nominal world GDP in 2007 was 75.3 compared to 15.3 in 1990.
[889] Eugene Fama, 'Market Efficiency, Long-Term Returns, and Behavioural Finance' (1998) 49 *Journal of Financial Economics* 283, 287.
[890] Stout, above n 834, 650.
[891] Fama, above n 889, 283-284.
[892] Stout, above n 834, 666-669.

generating testable predictions.[893] The ECMH remains deeply entrenched within academic and industry circles, partially because it underpins some of the most important models and theories used in business and finance, including the CAPM, the Arbitrage Pricing theory, and the Black-Scholes model for pricing options.[894]

6 *Efficiency Mechanisms and Assessments*

Potential measurements of market efficiency include the speed and accuracy of price adjustment to new information,[895] liquidity,[896] spreads,[897] volatility,[898] transaction costs,[899] and the inability to earn persistent abnormal returns.[900] These proxies are

[893] Stephen LeRoy, 'Efficient Capital Markets and Martingales' (1989) 27 *Journal of Economic Literature* 1585, 1616; Gilson et al, above n 708, 739-742; Brav et al, above n 876, 519. See also Harrison Hong and Jeremy Stein, 'A Unified Theory of Underreaction, Momentum Trading, and Overreaction in Asset Markets' (1999) 54 *Journal of Finance* 2143.

[894] See Posner, above n 601, 17; Guido Calabresi and A Douglas Melamed, 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089, 1128. Posner highlights that there is generally a trade-off between the theoretical strength of a measure and the extent of its applicability. Theoretical assumptions are often not fully reflective of real world complexities. Nevertheless, an important test of a theory is its ability to explain reality. Calabresi and Melamed indicate that framework or model building has two shortcomings. The first is that models can be mistaken for the total view of phenomena, like legal relationships, which are too complex to be painted in any one picture. The second is that models generate boxes into which one then feels compelled to force situation which do not truly fit. There are, however, compensating advantages. Legal scholars, precisely because they have tended to eschew model building, have often proceeded in an ad-hoc way, looking at cases and seeing what categories emerged. But this approach also affords only one view. It may neglect some relationships among the problems involved in the cases which model building can perceive, precisely because it does not generate boxes or categories.

[895] Gilson et al, above n 818, 560; Catherine Woodruff and AJ Senchack Jr, 'Intradaily Price-Volume Adjustments of NYSE Stocks to Unexpected Earnings' (1988) 43 *Journal of Finance* 467; Paul Mahoney, 'Market Microstructure and Market Efficiency' (2003) 28 *Journal of Corporation Law* 541, 549; Goshen et al, above n 473, 714.

[896] Gilson et al, above n 818, 569-570; Diamond et al, above n 508; Francis Longstaff, 'Optimal Portfolio Choice and the Valuation of Illiquid Securities' (2001) 14 *Review of Financial Studies* 407, 407-408**;** Goshen et al, above n 473, 714.

[897] Lawrence Glosten and Lawrence Harris, 'Estimating the Components of the Bid/Ask Spread' (1988) 21 *Journal of Financial Economics* 123.

[898] Kenneth French and Richard Roll, 'Stock Return Variances: The Arrival of Information and the Reaction of Traders' (1986) 17 *Journal of Financial Economics* 5; Charles Jones, Gautam Kaul and Marc Lipson, 'Transactions, Volume, and Volatility' (1994) 7 *Review of Financial Studies* 631; Brian Bushee and Christopher Noe, 'Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility' (2000) 38 *Journal of Accounting Research* 171, 200; John Campbell, Martin Lettau, Burton Malkiel and Yexiao Xu, 'Have Individual Stocks Become More Volatile? An Empirical Exploration of Idiosyncratic Risk' (2001) 61 *Journal of Finance* 1. Campbell et al found that over the period 1962-1997 there was a noticeable increase in firm-level volatility relative to market volatility in the United States. The R^2 of the stocks has also declined, while the number of stocks needed to obtain any given amount of portfolio diversification has increased. However, the percentage volatility of market index returns shows no systematic tendency to increase over time.

[899] Louis Chan and Josef Lakonishok, 'Institutional Trades and Intraday Stock Price Behaviour' (1993) *33 Journal of Financial Economics* 173.

[900] Yakov Amihud and Haim Mendelson, 'Asset Pricing and the Bid-Ask Spread' (1986) 17 *Journal of Financial Economics* 223; Semaan et al, above n 612, 223-224; Goshen et al, above n 473, 714; Goshen and Parchomovsky argue that the two main determinants of market efficiency are share price accuracy

discussed under the headings of share price accuracy, liquidity and performance, but these measures are interconnected or endogenous making assessment or measurement on a market or economy wide basis difficult.[901]

(a) Share Price Accuracy

The mechanisms to achieve share price accuracy include a number of steps, including information searching, accuracy verification, information analysis and trading.[902] Stock price accuracy 'depends on the ability of insiders or information traders to counter the actions of noise traders and to price newly disclosed information.'[903] The number of traders and their level of market participation determine the extent of efficiency. 'Given equal information and transaction costs for a number of securities, those securities for which there are more market participants … will show lower quasi-profits than those securities for which there are fewer market participants.'[904]

There are many reasons 'why stock prices deviate from their fundamental value: lack of information, misassessment of information, speculative trading, and liquidity crunches.'[905] Stock price inaccuracies may result from short termism, excess market volatility, random short-run inaccuracies, industry-wide inaccuracies or systematic discounts.[906] As explained more fully in the next section, it is important to distinguish between the various kinds of security mispricing, including short and longer-term inefficiencies and the differential impacts on resource allocative decisions and secondary market trading.[907]

There are many bodies of empirical research that identify short term price or market inefficiencies. For instance, there are studies suggesting that markets are sometimes slow to fully reflect company earnings announcements. This phenomenon is commonly

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and financial liquidity. Semaan et al indicate that the efficiency of a market can be empirically measured by assessment of its liquidity, volatility, transaction costs and cumulative abnormal returns.

901 Amihud et al, above n 900, 246-247.

902 Goshen et al, above n 473, 714, 721.

903 Goshen et al, above n 473, 714, 729-730. See also David Walsh, 'Price Reaction to Order Flow "News" in Australian Equities' (1997) 5 *Pacific-Basin Finance Journal* 1, 21.

904 Robert Verrecchia, 'On the Theory of Market Information Efficiency' (1979) 1 *Journal of Accounting and Economics* 77, 89. Market participation is proxied by trading volume, the number of shares outstanding, and the number of shareholders.

905 Kahan, above n 566, 988.

906 Kahan, above n 566, 994-997. See also Du et al, above n 646, 916, 940.

907 Kahan, above n 566, 981, 987 994-1043.

referred to as post-earnings announcement drift.[908] Other studies identify levels of security price volatility that suggest inefficiencies.[909]

(b) Liquidity

Markets are generally defined as liquid when traders can execute transactions speedily and at low cost.[910] Liquid markets benefit an economy by reducing 'the cost of transacting and the risk associated with investment'.[911] The main factors influencing liquidity are information, transaction costs, and market integrity.[912] The transaction costs of a security generally decline as trading activity increases.[913] Companies with deeper and more liquid markets tend to have lower spreads.[914] Market liquidity is achieved primarily through portfolio adjustments, consumption / investment adjustments, and divergence of opinions.[915]

The main indication of liquidity is the bid / ask spread. Factors that influence the bid / ask spread include company size, trading levels, trade size, the extent of asymmetric

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[908] Stewart Brown, 'Earnings Changes, Stock Prices, and Market Efficiency' (1978) *Journal of Finance* 17; Henry Latane and Charles Jones, 'Standardized Unexpected Earnings – A Progress Report' (1977) 32 *Journal of Finance* 1457; Ross Watts, 'Systematic "Abnormal Returns" After Quarterly Earnings Announcements' (1978) *Journal of Financial Economics* 127; Victor Bernard and Jacob Thomas, 'Post-Earnings-Announcement Drift: Delayed Price Response or Risk Premium?' (1989) 27 *Journal of Accounting Research* 1, 5.

[909] Guy Charest, 'Dividend Information, Stock Returns and Market Efficiency' (1978) 6 *Journal of Financial Economics* 297. See also Ray Ball, 'Anomalies in Relationships Between Securities Yields and Yield Surrogates' (1978) 6 *Journal of Financial Economics* 103; Robert Shiller, 'Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?' (1981) 71 *American Economic Revie*w 421.

[910] Amihud et al, above n 900, 223; Goshen et al, above n 473, 1244; Maurice Newman, 'The Perfect Storm: Managing Investor Relations in a Volatile Market' (Speech delivered to AIRA Conference, 23 November 2006) 4. See also Albert Kyle, 'Continuous Auctions and Insider Trading' (1985) 53 *Econometrics* 1315, 1316; Larry Harris, *Trading and Exchanges: Market Microstructure For Practitioners* (2003) 398. Kyle suggests that market liquidity encompasses "tightness", that is, the cost of turning around a position over a short period of time; "depth", or the size of an order flow innovation required to change prices a given amount; and "resiliency", or the speed with which [rices recover from a random, uninformative shock. Harris suggests that the three dimensions of liquidity are immediacy, or how quickly trades of a given size can be arranged at a given cost; width, or the cost of doing a trade of a given size; and depth, or the size of a trade that can be arranged at a given cost.

[911] Goshen et al, above n 473, 1244; Newman, above n 910, 4.

[912] Newman, above n 910, 2.

[913] Harold Demsetz, 'The Cost of Transacting' (1968) 82 *Quarterly Journal of Economics* 33, 50; Seha Tinic, 'The Economics of Liquidity Services' (1972) 86 *Quarterly Journal of Economics* 79, 93; George Benston and Robert Hagerman, 'Determinants of Bid-Ask Spreads in the Over-the-Counter Market' (1974) *Journal of Financial Economics* 353, 355, 363.

[914] Lawrence Glosten and Paul Milgrom, 'Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders' (1985) 14 *Journal of Financial Economics* 71; David Easley and Maureen O'Hara, 'Price, Trade Size and Information in Securities Markets' (1987) 19 *Journal of Financial Economics* 69; Carolyn Callahan, Charles Lee and Teri Yohn, 'Accounting Information and Bid-Ask Spreads' (1997) 11 *Accounting Horizons* 50, 51.

[915] Goshen et al, above n 473, 714, 740.

information among traders, differences in valuation among groups of investors, the proportion of investors with different valuations, and inventory levels.[916] Liquidity is reduced when traders facing asymmetric information increase the bid / ask spread to protect themselves.[917] Similarly, large spreads and transaction costs are generally associated with low trading volumes and trader numbers,[918] and information asymmetry.[919]

(c) Performance

Investors should not be able to persistently outperform the market under the efficient markets theory. Most empirical studies confirm this hypothesis. Studies in the US in the 1950s and 1960s concluded that fund managers and analysts were not able to earn excess returns to the market.[920] Later research found some evidence of persistence.[921] However, more recent studies argue that most of this outperformance can be explained by expense ratios and stock return momentum.[922]

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[916] Tinic, above n 913, 93; Richard Roll, 'A Simple Implicit Measure of the Effective Bid-Ask Spread in an Efficient Market' (1984) 39 *Journal of Finance* 1127, 1135; Amihud et al, above n 900, 224; Puneet Handa, Robert Schwartz and Ashish Tiwari, 'Quote Setting and Price Formation in an Order Driven Market' (2003) 6 *Journal of Financial Markets* 461, 461, 482; Goshen et al, above n 473, 714, 727-728.

[917] Tinic, above n 913, 93; Benston et al, above n 913, 363; Thomas Copeland and Dan Galai, 'Information Effects on the Bid-Ask Spread' (1983) 38 *Journal of Finance* 1457, 1468; Goshen et al, above n 473, 714, 728-729; Glosten et al, above n 914, 97; Lev, above n 472, 8.

[918] Demsetz, above n 913, 50; Tinic, above n 913, 93; Benston et al, above n 913, 362-363; Copeland et al, above n 917, 1468; Lev, above n 472, 8; Glosten et al, above n 914, 97**;** Jonathan Karpoff, 'A Theory of Trading Volume' (1986) 41 *Journal of Finance* 1069, 1069, 1084-1085; Amihud et al, above n 900, 214; Jennifer L Koski and Roni Michaely, 'Prices, Liquidity and the Information Content of Trades' (2000) 13 *Review of Financial Studies* 659, 659, 693. Koski and Michaely find that information asymmetry as manifested in trade size and the information environment of the trade has an impact on both prices and liquidity. The impact of an individual trade on spreads is most pronounced during periods when the amount of information asymmetry is highest.

[919] Glosten et al, above n 914, 97; Lev, above n 472, 8.

[920] Michael Jenson, 'The Performance of Mutual Funds in the Period 1945-1964' (1967) 23 *Journal of Finance* 389-416; Irwin Friend and Douglas Vickers, 'Portfolio Selection and Investment Performance' (1965) 20 *Journal of Finance* 391; JG Cragg and Burton Malkiel, 'The Consensus and Accuracy of Some Predictions of the Growth of Corporate Earnings' (1968) 23 *Journal of Finance* 67.

[921] James Bjerring, Josef Lakonishok and Theo Vermelen, 'Stock Prices and Financial Analysts' Recommendations' (1983) 38 *Journal of Finance* 187; Bruce Lehmann and David Modest, 'Mutual Fund Performance Evaluation: A Comparison of Benchmarks and a Benchmark of Comparisons' (1987) 42 *Journal of Finance* 233; Mark Grinblatt and Sheridan Titman, 'The Persistence of Mutual Fund Performance' (1992) 47 *Journal of Finance* 1977; Darryl Hendricks, Jayendu Patel and Richard Zeckhauser, 'Hot Hands in Mutual Funds: The Persistence of Performance 1974-1988' (1993) 48 *Journal of Finance* 93.

[922] Mark Carhart, 'On Persistence in Mutual Fund Performance' (1997) 52 *Journal of Finance* 57; Russ Wermers, 'Mutual Fund Performance: An Empirical Decomposition into Stock-Picking Talent, Style, Transactions Costs, and Expenses' (2000) 55 *Journal of Finance* 1655.

Nevertheless, there is international research indicating that some institutional and individual investors are able to achieve persistent outperformance.[923] One of the most intriguing examples of outperformance is Warren Buffett.[924] Similarly, Australian studies indicate that while most institutional funds are unable to earn superior risk-adjusted returns,[925] some individual managers achieve excess returns.[926]

Taking a different approach, there are international empirical studies that suggest outperformance is possible by trading in smaller sized companies.[927]

7. *Efficiency Summary*

Empirical studies require defined assumptions and proxies, and the credibility of individual studies depend on the accuracy and relevance of the selected model and assumptions. Efficiencies or inefficiencies as measured within a narrowly defined study may or may not effect efficiency across an entire market and may or may not effect economic efficiency. For instance, the studies outlined in Chapter Two that suggest that security prices quickly absorb information (including private and public information) don't fully explain whether markets are optimally efficient or real capital is allocated efficiently.[928]

Parties that argue for company disclosure or insider trading policy on efficiency or economic grounds need to explain what form of efficiency is sought and the timeframe

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923 Hemang Desai, Bing Liang and Ajai Singh, 'Do All-Stars Shine? Evaluation of Analyst Recommendations' (2000) 56 *Financial Analysts Journal* 20, 20; Joshua Coval, David Hirshleifer and Tyler Shumway, 'Can Individual Investors Beat the Market?' (Working Paper 04-025, Harvard University, September 2005).

924 See Lawrence Cunningham, 'The Essays of Warren Buffet: Lessons for Corporate America' (1997) 19 *Cardozo Law Review* 1, 12; Harris, above n 910, 463.

925 David Gallagher and Elvis Jarnecic, 'International Equity Funds Performance, and Investor Flows: Australian Evidence' (Working Paper, University of New South Wales, August 2002); Ron Bird, Helen Chin and Michael McCrae, 'The Performance of Australian Superannuation Funds' (1983) 8 *Australian Journal of Management* 49; Terence Hallahan and Robert Faff, 'An Examination of Australian Equity Trusts for Selectivity and Market Timing Performance' (1999) 9 *Journal of Multinational Financial Management* 387; Alan Kohler, 'Put Your Money on Alpha Bet', *The Sydney Morning Herald* (Sydney) 24 March 2007, 45.

926 David Gallagher, 'Investment Manager Characteristics, Strategy, Top Management Changes and Fund Performance' (2003) 43 *Accounting and Finance* 283; Ray da Silva Rosa, 'The Efficacy of Active and Passive Investment Strategies among Institutional and Retail Funds' (Working Paper, University of Sydney, 2007); Peter Gunning, 'Maximising Returns not Risk' *Money Management* 8 March 2007, 28.

927 Schwert, above n 877; Christopher Barry and Stephen Brown, 'Differential Information and the Small Firm Effect' (1984) 13 *Journal of Financial Economics* 283.

928 See, eg, Ball et al, above n 122, Brown, above n 125.

over which efficiency is measured. Empirical efficiency proxies are highly interdependent and short-term improvements may be negated over longer periods of time.[929] For instance, the insider trading research outlined in Chapter Three suggests that any efficiency gains arising from insider trading are likely to be significantly outweighed over the long run by increases in market volatility[930] and reductions in other efficiency measures such as bid ask spreads, liquidity, price accuracy and capital costs.[931] The global research also suggests that countries with insider trading laws have more liquid markets, more accurate pricing, a lower cost of capital and higher economic returns.[932]

Broad analyses of the empirical studies outlined in Chapters Two and Three suggest that well developed financial markets improve the allocation of real capital. However, market participants do not act entirely rationally within markets and during some periods, this irrational behaviour can be widespread. In addition, many studies point to short-term anomalies in various efficiency proxies. Empirical evidence on efficiency across entire markets is more complex. There is research that highlights periods when market valuations spike and move away from underlying economic values or fundamental valuation trend lines. There is also evidence of increased levels of market volatility and excessive levels of market trading relative to real world economic activity.[933] These studies can be variously interpreted. However, in practice long bull or bear cycles and excessive levels of volatility and trading not related to economic fundamentals diminish the signalling function and impede real capital or resource allocations.[934]

The ultimate goal of the Fama efficient market theory and the ECMH is economic efficiency. As argued more fully in Chapters Four and Six, this is also the appropriate efficiency goal to ensure that company disclosure and insider-trading policy is made in the "public interest of Australia".[935] A goal of long-term economic efficiency enables disclosure policy decisions to be assessed on a broad basis incorporating competing

[929] See, eg, Summers et al, above n 888, 262, 264.
[930] Du et al, above n 646, 940.
[931] Cornell et al, above n 641, 1055; Fishe et al, above n 643, 461-462, 481.
[932] Bhattacharya et al, above n 645; Beny, above n 647.
[933] Summers et al, above n 888, 267-268; Shiller, above n 864.
[934] Summers et al, above n 888; Du et al, above n 646, 916, 940.
[935] I equate "the public interest of Australia" with optimal economic efficiency on the basis that this requires, or is dependent upon, public confidence in the fairness of markets.

efficiency measures. A goal focused on economic efficiency also brings fairness concepts into sharp focus because the empirical research outlined earlier in this Chapter consistently links economic growth with public trust, high company disclosure standards, reductions in information asymmetry, market transparency, broad capital market participation and protection of minority shareholder rights.

Market fairness concepts are discussed further in the next section.

B Fairness Concepts within Markets

'[T]he general rules of morality are ultimately founded upon experience of what, in particular instances, our moral faculties, our natural sense of merit and propriety, approve or disapprove of. We do not originally approve or condemn particular actions, because, upon examination, they appear to be agreeable or inconsistent with a certain general rule. The general rule, on the contrary, is formed by finding from experience that all actions of a certain kind, or circumstances in a certain manner, are approved or disapproved of.'[936]

1 *What is Market Fairness? Is It a Valid Theoretical Basis for Securities Regulation?*

Philosophers, lawyers and economists have been debating notions of justice, morality, fairness, equality and efficiency for many centuries.[937] Within this vast philosophical and theoretical framework, "market fairness" is a difficult concept to define. Indeed, some academics argue that a market fairness rationale 'is devoid of principled content'[938] and too subjective to stand as a relevant theory for securities regulation. The lawyer's concept of fairness has been described as a 'suitcase full of bottled ethics from which one freely chooses to blend [one's] own type of justice'[939] and as 'one of those qualities that exist in the eye of the beholder and elicit little effort at explanation.'[940] However, other legal, economic and accounting scholars acknowledge that policymakers are concerned with issues of equity as well as economic efficiency.[941]

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[936] Adam Smith, *The Theory of Moral Sentiments* (1976) 264.

[937] See, eg, Homer, *Iliad* (ca 800 B.C.); Plato, *Republic* (ca 380 B.C.); Aristotle, *Nicomachean Ethics* (ca 322B.C.); Thomas Aquinas, *Summa Theologica* (1274); John Locke, *Treatise on Government* (1690); David Hume, *An Inquiry Concerning the Principles of Morals* (1751); Adam Smith, *A Theory of the Moral Sentiments* (1759); Immanuel Kant, *The Philosophy of Law* (1797); Georg Hegel, *The Philosophy of Right* (1821); John Stuart Mill, *Utilitarianism* (1861).

[938] Lee, above n 687, 121.

[939] Tribe, above n 816, 593 citing Easterbrook et al, above n 445, 703.

[940] Scott, above n 594, 805.

[941] William Baumol, 'Applied Fairness Theory and Rationing Policy' (1982) 72 *American Economic Review* 639, 639; Robert Frank, 'If Homo Economicus Could Choose His Own Utility Function, Would He Want One with a Conscience?' (1987) 77 *American Economic Review* 593, 603; Tribe, above n 816,

Some scholars adopt market fairness concepts using a philosophical approach such as Rawl's goal of like (or equal) treatment of like (or equal) cases, or Dworkin's principle of equality, particularly equal treatment and equal concern and respect.[942] Others incorporate fairness criteria within economic analysis.[943] These fairness criteria generally involve value judgments and individual preferences.[944]

Most policy and scholarly commentary on fairness within capital markets focuses more narrowly on concepts of equality of access, fraud minimisation, investor protection, and investor confidence in the integrity of the market. These concepts were introduced in the policy commentary in Chapter Two, and they were referred to in the mandatory

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593; Levmore, above n 586, 122; Steven Salbu, 'The Misappropriation Theory of Insider Trading: A Legal and Economic Analysis' (1992) 15 *Harvard Journal of Law & Public Policy* 223, 249; Boyle, above n 526; Anthony Mason, 'Law and Economics' (1991) 17 *Monash University Law Review* 167, 179; Richard Posner, 'Wealth Maximization Revisited' (1985) 2 *Notre Dame Journal of Law Ethics and Public Policy* 85, 103; Richard Posner, 'The Ethics of Wealth Maximisation: Reply to Malloy' (1988) *36 University of Kansas Law Review* 261; Edwin Baker, 'The Ideology of the Economic Analysis of Law' (1975) 5 *Philosophy and Public Affairs* 3; Lev, above n 472, 7.

[942] See, eg, Salbu, above n 941, 249; Ronald Dworkin, *Taking Rights Seriously* (1978) 180, 227, 272, Ronald Dworkin, *A Matter of Principle* (1985). See also Roger Howe and John Roemer, 'Rawlsian Justice as the Core of the Game' (1981) 71 *American Economic Review* 880; Eric Posner, 'Law, Economics, and Inefficient Norms' (1996) 144 *University of Pennsylvania Law Review* 1697. But see Posner, above n 601, 473-475; Michael Perry, *Morality, Politics, and Law* (1988) 63. Salbu argues that the misappropriation theory in the United States is ethically under inclusive under the Rawl's criteria of distributive justice because insider trading deprives people of the ability to compete fairly and results in skewed distributions. Further, he argues that justice requires a scenario whereby free and rational persons concerned to further their own interests would accept in an initial position of equality as defining the fundamental terms of their association. A distribution of income and wealth is just if there is no alternative distribution that would make the worst off people in society better off. Levmore defines fairness as achieved when insiders and outsiders are in equal positions. 'That is, a system is fair if we would not expect one group to envy the position of the other.' Posner suggest that Rawl's theory of distributive justice has almost no operational content. Similarly, Perry suggests that the requisite principles of justice – principles whose justification transcends the subjective circumstances – simply don't exist. However, Howe et al argue that the Rawlsian features must be viewed as included in the "as if" preference structure which society assigns its members. They suggest that in the end, the practical attractiveness of the Rawlsian proposal may be due to the lack of information to which the government has access. Taking another approach, Lee suggests that fairness operates as a brake upon self-interest. It is the normative basis for a variety of social conventions that prevent individuals from doing what would otherwise be in their own respective interest. One's normative view of fairness depends on one's adopted philosophy. For some people it is a corollary of a deontological obligation to treat others as equals. For others, the rules of fairness are a condition for the possibility of welfare-improving cooperative action. There may be a kind of good that we can only hope to achieve through cooperation and the logic of such cooperation includes rules we describe as fairness.

[943] Robert Frank, 'If Homo Economicus Could Choose His Own Utility Function, Would He Want One With A Conscience?' (1987) 77 *American Economic Review* 593, 603; Kaplow et al, *Fairness versus Welfare*, above n 815, 18; Kaplow et al, 'Fairness versus Welfare', above n 815. Frank indicates that it is neither necessary nor productive for modern economists to exclude behavioural factors such as conscience and other moral sentiments from utility maximization models.

[944] Baumol, above n 941.

disclosure, insider trading and selective disclosure debates outlined in Parts I to III of this Chapter. More detailed conceptual outlines are provided in the following sections.

2 *Equality of Access*

The morality of trading on asymmetrical information has been the subject of spirited debate among philosophers and legal scholars for centuries, beginning with Cicero two thousand years ago.[945] Some scholars argue that 'markets contain an internal morality, which supplies the normative justification for market transactions and suggest that a successful market will be characterized by fair ground rules.'[946] The autonomy of market participants requires a transacting party possessing material nonpublic information to share the information with the other parties, for example by way of a public disclosure.'[947] Others argue for a theory of equal access to information based on concepts of consent.[948] They suggest that rules are only fair if disinterested individuals who will be bound by them would agree to them in advance.[949] A 'rational consenter would insist on rules that gave all potential sufferers the same information at as nearly the same time as possible.'[950] 'People only like taking chances if they know the chances are *fair*.'[951] This requires that individuals have a roughly calculable chance to win and a similar probability to everyone else participating.[952]

Several commentators cite experimental work**,** which suggests that people do not act in a social vacuum. It is argued that 'people contribute to a shared good, and refuse to free

[945] Lawson, above n 485, 737, 753. Lawson points out that the equal access view has an impressive historical pedigree in the wider context of contract law. *Laidlaw v Organ* 15 US 178 (1817) is cited as an example.
[946] Lee, above n 687, 142.
[947] Lee, above n 687, 151, 191-192. Lee suggests that the traditional economic arguments against parity of information are overstated or, at least, rest on debatable assumptions.
[948] Scheppele, above n 486, 151-154; John Rawls, 'Justice as Fairness' (1958) 67 *Philosophy Review* 164; Ronald Dworkin, *Taking Rights Seriously* (1978) 180, 227, 272; Ronald Dworkin, *A Matter of Principle* (1985); Gauthier**,** above n 486; John Locke, *Two Treatises of Government* (1988). Scheppele discusses concepts of consent from Dworkin, John Locke, Rawls and Gauthier and suggests it requires consideration of who is harmed by insider trading and the distribution of benefits and losses and not just the sum totals averaged over a particular population.
[949] Scheppele, above n 486, 153-154.
[950] Scheppele, above n 486, 156-157, 162, 166; Norman Frolich, Joe Oppenheimer and Cheryl Eavey, 'Laboratory Results on Rawl's Distributive Justice' (1987) 17 *British Journal of Political Science* 1-22; Norman Frolich, Joe Oppenheimer and Cheryl Eavey, 'Choice of Principles of Distributive Justice in Experimental Groups' (1987) 31 *American Journal of Political Science* 606-636. Scheppele provides examples of equitable rules that require disclosure where there are radical inequalities in the parties' positions and in their search costs; for example, the requirement on an insured to disclose all material information under an insurance contract.
[951] Scheppele, above n 486, 156-157.

ride, far more often than economists predict.'[953] '[P]erceptions of fair dealing … have a distinct effect on the willingness of people to engage in forms of economic activity like investment.'[954] 'Investors pay enormous amounts of money to strangers for completely intangible rights, whose value depends entirely on the quality of the information that the investors receive and the sellers' honesty.'[955] Empirical evidence suggests that trust is an important factor underlying stock market participation.[956] Strong securities markets require laws and related institutions which give minority shareholders good information about the value of a company's business and 'confidence that the company's insiders won't cheat investors out of most or all of the value of their investment.'[957]

As outlined earlier, Brudney argues that the history of securities legislation suggests that Congress was seeking to protect public investors from exploitation by institutions who enjoy informational advantages that cannot be lawfully overcome or offset.[958] He advocates a ban on securities transactions whenever one party possesses an informational advantage that others cannot lawfully overcome. This is commonly known as the "unerodable information advantage" approach. Brudney acknowledges the need to promote economic and allocative efficiency. He does not seek to offset individual disparities of power, wealth, diligence or intelligence, and information may still be lawfully obtainable when a fee is payable for research.[959] This equal access approach differs from informational parity. As Justice Blackmun stated in *Chiarella*

> [T]here is a significant conceptual distinction between parity of information and parity of *access* to material information. The latter gives free rein to certain kinds of information

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[952] Scheppele, above n 486, 156-157.
[953] Cass Sunstein, *Free Markets and Social Justice* (1997) 53-4. See also Robert Ellickson, 'Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics' (1989) 65 *Chicago-Kent Law Review* 23, 48; Elizabeth Hoffman and Matthew Spitzer,'Entitlement, Rights and Fairness: An Experimental Examination of Subjects' Concepts of Distributive Justice' (1985) 14 *Journal of Legal Studies* 259; Daniel Kahneman, Jack Knetsch and Richard Thaler, 'Fairness and the Assumptions of Economics' (1986) 59 *Journal of Business Studies* 285; Daniel Kahneman, Jack Knetsch and Richard Thaler, 'Fairness as a Constraint on Profit Seeking: Entitlements in the Market' (1986) 76 *American Economic Review* 728; Robin Malloy, *Law and Market Economy: Reinterpreting the Values of Law and Economics* (2000) 66. See also Margaret Blair and Lynn Stout, 'Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law' (2001) 149 *University of Pennsylvania Law Review* 1735.
[954] Donald Langevoort, 'Words From on High about Rule 10b-5: Chiarella's History, Central Bank's Future' (1995) 20 *Delaware Journal of Corporate Law* 865, 885.
[955] Bernard Black, 'The Legal and Institutional Precondition for Strong Securities Markets' (2001) 48 *UCLA Law Review* 781, 782.
[956] Guiso et al, above n 492.
[957] Black, above n 955, 783.
[958] Brudney, above n 67, 357, 360.
[959] Brudney, above n 67, 356-361.

advantages that the former may foreclose, such as those that result from differences in diligence and acumen.[960]

Critics of the Brudney approach suggest that the unerodable advantage argument is unworkable and nonsensical, and is not a sound basis for drawing the line between legal and illegal informational advantages.[961] An investor's sense of unfairness is unlikely to be assuaged by knowing that information is theoretically publicly available if he or she spends the whole day searching for it. Investors are likely to feel a sense of unfairness regardless of whether the unshared information was acquired privately by the trading partner as a result of theft or disclosure made in a closed session, or the information is theoretically publicly available, but in practical terms is beyond the reach of the average investor.[962] Alternatively, Brudney's distinction between lawful and unlawful access is simply one of costs. People 'do not have or lack "access" in some absolute sense. There are, instead, different costs of obtaining information … The different costs of access are simply a function of the division of labor'[963] In any event, investors can decline to purchase superior information from analysts and simply accept the market price as given.[964] An efficient and efficacious disclosure system has to take account of the fact that the markets are serviced by an industry of professional information gatherers, sifters and assessors.[965]

[960] *Chiarella v United States*, 445 US 222 (1980) 252. The equality of access and informational parity approaches have generally been clearly distinguished by Australian commentators and the judiciary. See, eg, *R v Firns* (2001) 38 ACSR 223; CASAC, above n 61, 15.

[961] Krawiec, above n 527, 478. Krawiec suggests that taken to its logical extreme, this implies that all information is theoretically publicly available because an investor may become a corporate officer or director or purchase the company information· See also Wang, above n 598 (Material), 1299. Wang suggests that distinguishing between the parity of information and parity access is as elusive as the distinction between equality and equality of opportunity. Wang highlights that an enormous gray area exists between information obtained through superior ability or effort and that which is obtained through stealth or confidential connections. If an analyst is the first to discover some information, luck, diligence, and employment status may all have played a role in the discovery. Wang rhetorically asks whether either or both of the first two facts are tainted by the third.

[962] Krawiec, above n 527, 479.

[963] Easterbrook, above n 537, 330; Easterbrook et al, above n 445, 673-676, 694. Easterbrook and Fischel suggest that there are illogical investors who always suspect that the informed traders are getting secret advantages. They suggest that these paranoid traders can protect themselves at minimal cost. They can put their money in the hands of professional advisors or managers of mutual funds, thus getting for themselves whatever advantage accrues to the insiders. The existence of informational inequalities – real or imagined – is therefore an inadequate basis of mandatory disclosure.

[964] Fischel, above n 667, 146. As already discussed in Chapter Three within the insider trading and selective disclosure sections, uninformed investors are not protected against traders who have private information unless a market is strong form efficient. No evidence has been found suggesting that any international market is strong form efficient.

[965] Rider, above n 217, 28.

Others argue that the profound inequalities in securities markets are inconsistent with any notion of fairness. They suggest the moral difference between inequality of access and inequality of position is not evident.[966] They point out that inequalities in access to information mirror other societal inequalities.[967] In any event, unequal access to information 'is just one more among thousands of risks that will affect the [investment] return'.[968] It is the result 'of a lost gamble the risks of which were discounted for in the price that the investor paid at the time of the purchase.'[969] This risk is unsystematic and can be diversified away.[970]

Boyle suggests these arguments against informational parity operate on two assumptions.

> The first is that anyone in a position of power has some kind of natural right to the advantages he would be able to wring from that position if unrestrained by rules … [or alternatively] that a market comes with an automatic set of default positions and one of them is to "allow trading on superior information".[971]

He argues that professional economists often talk as though there is a natural suite of property rights that automatically accompany a free market, and they make strong and unexplained assumptions that certain types of activities such as trading on superior information will naturally be allowed while certain others such as trading on superior physical strength will not be.[972] He describes the first assumption as a baseline error equivalent to the argument that 'if we prohibit an athlete from using his strength to take money by force, "fairness means" that we must also prohibit him from using his strength to get a job on a football team'.[973] He suggests that because the debate is focused on information, it is ideologically feasible to subject it to egalitarian regulation. He describes the second as a false assumption 'that if we prohibit any person from profiting from any position of inequality, we are logically committed to a root and

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[966] Lawson, above n 485, 757-58.
[967] Krawiec, above n 527, 472-473, 476-479; Easterbrook, above n 537, 330; Choi, above n 661, 533, 534; Scott, above n 594, 805; Macey, above n 807, 10. Scott argues that parties are never in full parity in all regards and there will always be disparities in knowledge, intelligence, experience or capital. He suggests there is no way to determine among all these advantages and disadvantages, which are unfair and why. Similarly, Macey suggests that the fairness justification for insider trading, taken to its logical extreme, would ban virtually all trading activity because it will almost always be the case that one party has an "advantage" over the other in a given securities trade.
[968] Fox, above n 661, 670.
[969] Fox, above n 661, 670.
[970] Fox, above n 661, 671.
[971] Boyle, above n 601, 86.
[972] Boyle, above n 526, 1452.
[973] Boyle, above n 601, 70.

branch attack on all inequalities everywhere.'[974] Boyle defines this as a category mistake equivalent to the argument that

> [d]ogs have four legs and cats have four legs, but that does not imply that cats are dogs, or that the rules affecting cats must be applied to dogs – unless, of course, we have previously committed ourselves to treating all four-legged animals alike.[975]

Lee suggests that the arguments that 'equality of information is inconsistent with the inegalitarianism inherent in the securities market confuse heterogeneity with inequality'.[976] The market requires heterogeneity, or a divergence, of views to function, but advantages in wealth, education or knowledge are not required.[977]

3 *Market Fairness as a Policy Element Necessary to Minimise Fraud, to Protect Investors and to Maintain Investor Confidence*

'Publicity is justly commended as a remedy for social and industrial diseases. It is said to be the best of disinfectants; electric light the most efficient policeman'[978]

As outlined earlier in this Chapter, several scholars suggest that the central aim of securities law is to deter fraud.[979] The fraud minimisation rationale for disclosure regulation is generally made independently from efficiency arguments because market efficiency does not in itself prevent or minimise fraud.[980] Disclosure regulation cannot prevent fraud. However, regulation that promotes company disclosure in the public arena may deter fraud or may draw attention to potential issues. Disclosure frameworks that require public scrutiny of company developments, and that prohibit blacklisting of critics within the media or investor community, are likely, all other things being equal, to lead to earlier detection of corporate fraud and to thereby reduce potential losses.[981]

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[974] Boyle, above n 601, 86.
[975] Boyle, above n 601, 86.
[976] Lee, above n 687, 151.
[977] Lee, above n 687, 169; Robin Malloy, *Law and Market Economy: Reinterpreting the Values of Law and Economics* (2000) 151. Malloy suggests that equality of opportunity must be understood as directed at participatory access to the creative process and not as the substantive equivalence of participatory outcomes arising from the process. Creativity and wealth formation are promoted by diversity and difference rather than by conventional notions of duplication and repetition.
[978] Brandeis, above n 429, 62.
[979] Arlen et al, above n 458, 704; Seligman, above n 439, 7-8; Stout, above n 482**,** 700-01.
[980] Langevoort, above n 954, 897.
[981] Commonwealth, above n 33, Vol 1 68; Blanchard, above n 556, 326; McRobert, above n 551, 1279, 1332, 1352, 1358.

Other scholars suggest the main purpose of mandatory disclosure requirements is investor protection.[982] This argument impliedly accepts that in a voluntary company disclosure environment, uninformed investors are likely to suffer harm when trading against counterparties with inside or selectively disclosed company information.

As highlighted in the mandatory disclosure discussion, an increasing number of parties emphasise the need for investor confidence in the fairness of markets. It is suggested that the record number of self directed retirement plans and individuals owning securities reflects investor confidence in 'the structure and elemental fairness of the securities markets', in the future, and in the strength of the economy and the country as a whole.[983]

However, some academics reject all of the fairness-based justifications for mandatory disclosure including deterrence of fraud, investor protection, and investor confidence.[984] It is argued that while accurate information is necessary for allocative efficiency and fraud reduces allocative efficiency, '[o]ne cannot leap from the difficulties of market with asymmetric information to the conclusion that there is a need for regulation'.[985] Companies have incentives and methods to ensure that the information provide to investors is credible and accurate, and these provide investors with substantial protection.[986] It is argued in the alternative that requiring disclosure of outside information minimises or removes trading losses experienced by investors who trade with persons possessing valuable outside information.[987] However, this is only of consequence if the law for independent reasons favours the uninformed. While insider or outsider trading may offend notions of fair play, many investors expect inside information 'as part of the gamble of investing in the stock market.'[988] Indeed, an effort

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[982] Ford et al, above n 481, 519-502 [10.010]; Neagle et al, above n 428, 5-6.
[983] James Jalil, 'Proposals for Insider Trading Regulation After the Fall of the House of Enron' (2003) 8 *Fordham Journal of Corporate & Financial Law* 689, 710. Jalil highlights that public trust must be earned, and once lost is difficult to recapture.
[984] Easterbrook et al, above n 445; Romano, above n 451, 2381; Barry, above n 583, 1352-1353.
[985] Easterbrook et al, above n 445, 673-674. See also Romano, above n 451, 2381. Romano dismisses the fraud protection argument on the basis that evidence of rampant fraud prior to the introduction of regulation is thin.
[986] Easterbrook et al, above n 445, 675-676. Easterbrook and Fischel claim at pg 693 that proponents of mandatory disclosure have not established that there is lesser incidence of fraud with disclosure rules than with anti-fraud legislation alone and that after fifty years, the proponents of regulation have no scientifically acceptable evidence of a favorable cost-benefit ratio for any disclosure rules that rest on the benefits of reducing fraud or increasing confidence.
[987] Barry, above n 583, 1352-1353.
[988] Barry, above n 583, 1352.

to install confidence 'may mislead the unsophisticated by suggesting that the stock market is a more secure investment than it really is.'[989]

4 *Fairness Summary*

The market fairness concepts of equal access, fraud minimisation, investor protection, and investor confidence in the integrity of the market are inextricably intertwined. Equal access to company information is the primary fairness concept in the sense that investor protection, fraud minimisation and investor confidence depend on information access rights. When listed company information is provided privately or selectively rather than publicly disclosed, investor protection and investor confidence are diminished. Moreover, when company information is not provided in the public arena, public scrutiny and other control processes that deter corporate fraud or mitigate losses resulting from fraud cannot fully operate.

C Efficiency, Fairness and Rationality Concepts Critique and Conclusion

The ECMH contains inherent weaknesses and is under attack on both theoretical and empirical grounds. In particular, there is a growing body of scholarly material and empirical evidence, which suggests that all market participants including regulators, company management and institutional and retail investors act irrationally at times. Such behaviour is an inherent part of being human. None of us act like economic machines. The extent of irrational market behaviour during particular periods depends on complex and often inter-related factors. While investor education and disclosure policy may reduce irrational market activity, policy responses cannot counter all human biases and market behaviour driven by greed or fear.

Rather than assuming market efficiency, we need to better understand the processes that encourage market and economic efficiency.[990] In practice, the mechanisms to achieve and measure efficiency are messy.[991] Objective models and proxies to measure efficiency across entire markets and economies are difficult to construct and interpret. Moreover, as Beny suggests, 'the efficiency enquiry is rather elusive, as no single locus

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[989] Barry, above n 583, 1352.
[990] Lee, above n 844, 237.
[991] Gilson et al, above n 708, 742. Gilson and Kraakman suggest that scepticism grows with age!

of efficiency focuses the scholarly'[992] and policy debates. As argued more fully in Chapters Four and Six, the choice of efficiency goal or concept within disclosure debates is often not value free.[993]

The ultimate goal of the efficient market theory and the ECMH is economic or allocative efficiency. Similarly, the appropriate disclosure policy efficiency goal is long-term economic efficiency. A high level efficiency goal and a long perspective are needed to enable policy decisions to be assessed on a broad basis incorporating competing efficiency measures and short and long term costs and benefits. A long-term economic efficiency rationale also complements the fairness rationales because empirical research on global capital markets consistently links economic growth with broad capital market participation, high company disclosure standards, market transparency and protection of minority shareholder rights.

The empirical studies suggest that efficiency and fairness concepts within capital markets are multi-layered and endogenous, and investor confidence is a necessary precondition to optimise long-term economic efficiency. As Meier-Schatz indicates, 'capital formation, disclosure rules and investor confidence are closely interrelated … [The investor confidence argument] stands at the crossroads of efficiency and fairness considerations … a regulatory system for protecting investors may … concomitantly provide an efficient allocation of financial resources.'[994]

The impacts of informational access measures or factors and the importance of investor protection and confidence within markets are difficult to define and empirically assess. Nevertheless, empirical studies confirm that many people make investment choices incorporating fairness principles.[995] The empirical research also suggests that in

[992] Beny, above n 632, 239. See also Saari, above n 632, 1056; Allen Ferrell, 'If We Understand the Mechanisms, Why Don't We Understand Their Output?' (2003) 28 *Journal of Corporation Law* 503. Saari suggests that there is no empirical evidence of the precise mechanisms by which market efficiency is achieved. Ferrell indicates that the fact that we do not understand the output of the mechanisms suggests that we do not understand the mechanisms very well. He indicates that much research or work remains to be done to better understand security pricing and the role legal institutions and practices play in that process.

[993] Beny, above n 632, 239; Langevoort, above n 872, 887.

[994] Christian Meier-Schatz, 'Objectives of Financial Disclosure Regulation' (1986) 8 *Journal of Comparative Business and Capital Market Law* 219, 226.

[995] See, eg, Elizabeth Hoffman and Matthew Spitzer, 'Entitlement, Rights and Fairness: An Experimental Examination of Subjects' Concepts of Distributive Justice' (1985) 14 *Journal of Legal Studies* 259; Kahneman et al, above n 953; Sunstein, above n 953, 53-54; Robert Bloomfield, Robert Libby and M

markets with significant information asymmetry, rational uninformed investors lose confidence in the market and restrict their participation.[996] If most or all retail and non-favoured institutional investors exit a market, this is likely to result in larger trading spreads, reduced liquidity, higher capital costs and ultimately lower economic efficiency.[997]

V CHAPTER THREE: CRITIQUE AND CONCLUSION

There is little consensus among scholars on what efficiency and fairness mean within markets; there is only limited research on the precise mechanisms to best achieve these goals across an entire market; there are complex interrelationships and dependencies between the various fairness and efficiency concepts; and there are sometimes significant discrepancies for long periods of time between price, market and economic efficiency measures. Nevertheless, the empirical research presents a surprisingly consistent story about the potential economic efficiency benefits for countries that require corporate disclosure in the public arena.

The research outlined throughout Chapter Three includes a broad range of studies investigating many factors using different designs and measures. The studies on global securities markets and corporate disclosure suggest there are links between extensive disclosure requirements, the quality of law enforcement, reduced information asymmetry, widespread investor participation, public trust, and effective legal protections for minority shareholders. Other empirical research confirms that many people make investment choices incorporating fairness principles. These findings suggest that transparent public disclosure is needed to promote belief in fairness (in the sense of equality of access or serious practical obstacles to obtaining useful information) and to sustain investor confidence.[998]

Nelson, 'Confidence and the Welfare of Less-Informed Investors' (1999) 24 *Accounting, Organizations and Society* 623.

[996] Choi, above n 661, 535; Langevoort, above n 549, 1049-1050; Fox, above n 661, 676; Kidd, above n 661, 121-122; Brudney, above n 67, 356.

[997] See, eg, SEC, Institutional Investor Study Report (H.R. Doc. No. 64) 92d Cong., 1st Sess, 439-41 (1971) 1461. The suggested outcomes are also consistent with the global empirical studies outlined through the Chapter.

[998] See, eg, Seligman, above n 439, 9 Beny, above n 632, 239; Wang, above n 598 (Material), 1229; Easterbrook, above n 537, 338; Coffee, above n 444, 719-720, 743-747; Cox, above n 536, 644; Fox, above n 661, 657.

The insider trading research suggests that markets that establish and effectively enforce insider-trading regulation achieve superior economic efficiency outcomes than markets that don't. Markets with enforced insider trading law are generally linked with enhanced liquidity, more informative stock prices, lower costs of capital, and improved capital allocation or economic efficiency. The selective disclosure studies suggest that markets that adopt selective disclosure regulation enhance market fairness and achieve possible economic efficiency gains as a result of reduced information asymmetry across the market. Finance and accounting scholars are increasingly focusing on the links between public disclosure of company information, reductions in information asymmetry and lower costs of capital.[999] As Botosan suggests, while 'no one academic study is perfect, the accumulated evidence across many studies lends considerable support to the hypothesis that enhanced disclosure reduces costs of capital'.[1000]

La Porta et al found evidence suggesting that

> countries with better investor protection, measured by both character of legal rules and the quality of law enforcement, have more valuable markets, larger numbers of listed securities per capita, and a higher rate of initial public offering activity than do countries with worse investor protection.[1001]

They argue that companies in countries with better minority shareholder protection are valued more highly.[1002] In a later study they found evidence suggesting that laws in a country mandating disclosure and facilitating private enforcement through liability rules benefit the stock market.[1003] They suggest the combined results 'point to the importance of regulating the agency conflict between controlling shareholders and outside investors to further the development of capital markets.'[1004] La Porta et al conclude that the answer to the question of whether securities laws matter is a definite yes.

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[999] Diamond et al, above n 508; Leuz et al, above n 508, 121; Easley et al, above n 508, 1553, 1555-1556, 1578; Botosan, above n 508, 39; Cooper, above n 508, 41; Hail et al, above n 502, 485, 524; Lambert et al, above n 489, 412; Lambert et al, above n 508.

[1000] Botosan, above n 508, 39.

[1001] La Porta et al, above n 494 (Legal), 1131.See also La Porta et al, above n 494 (Government), 222; La Porta et al, above n 494 (Law), 1152.

[1002] La Porta et al, above n 494 (Legal), 1166-1169.

[1003] La Porta et al, above n 496, 1, 27-28.

[1004] La Porta et al, above n 496, 28. See also Choi, above n 498, 1726; Cheffins, above n 498.

Ultimately, the success of developed markets in allocating resources efficiently depends on a multi-layered complex structure of institutional and behavioural factors. Institutional investors are not the only, or necessarily the most effective, corporate monitors.[1005] Corporate disclosure in the public arena is needed to enable widespread monitoring of corporate and market conduct, assist with the minimisation of fraud, and to promote robust competition necessary to achieve economic efficiency. Corporate reporting in the public arena enhances market and company governance and accountability mechanisms.[1006] Many of the largest global corporate collapses and losses have involved failures in professional gatekeeper processes and poor disclosure practices, with the broader public (including investors, employees, regulators, scholars and the media) often not fully informed about the negative developments and critical commentary prior to the collapses.[1007]

The arguments that expressly or impliedly suggest that retail investors are protected from insider trading or selective disclosure because of market efficiency, or that these investors free ride on the back of professional investors, are not credible. Moreover, the argument that selective disclosure to favoured investors is necessary to provide incentive to analysts to produce research, which in turn is necessary to enhance economic efficiency, is tenuous. The connections between access to company information, selective disclosure, research production, and economic efficiency, are diffuse and uncertain. In any event, many of the arguments in relation to selective disclosure, analyst incentives and company access fail to differentiate between investors who provide research to the broader market and those who don't. Access to private company information in Australia is not based on any requirement to provide research to the third parties.

[1005] Brudney, above n 67, 334; Coffee, above n 701, 1288; Craswell et al, above n 550, 301, 320; Fox, above n 661, 654, 676; Maug, above n 597, 1569; Choi, above n 661, 548; Fisch et al, above n 672, 1088, 1090; Ayres et al, above n 473, 15, 24; Bipin Ajinkya and Michael Gift, 'Corporate Managers' Earnings Forecasts and Symmetrical Adjustments of Market Expectations' (1984) 22 *Journal of Accounting Research* 425; Fidrmuc et al, above n 550, 2933.
[1006] Lowenstein, above n 560, 1361-1362; Fox, above n 444 (Disclosure), 127; Blanchard, above n 556, 326; John McMillan, 'Market Design: The Policy Uses of Theory' (2003) 93 *American Economic Review* 139, 139; Donald Langevoort, 'Technological Evolution and the Devolution of Corporate Finance Reporting' (2004) 46 *William & Mary Law Review* 1, 32.
[1007] William Beaver, 'Enron: Lessons and Implications: What Have We Learned from the Recent Corporate Scandals that We Did Not Already Know?' (2002) 8 *Stanford Journal of Law, Business and Finance* 155 159; Crow et al, above n 41; Donald Langevoort, 'Lessons from Enron, How Did Corporate

Company information should be directly accessible by investors and not filtered through others.[1008] Most analyst reports are founded on or incorporate information provided by company managers, including information provided publicly and at closed company briefings. Equal access demands are only made in relation to information that companies choose to disclose to some investors. Equality of access does not prevent anyone from ferreting out, processing, disseminating or trading on publicly available or legally obtainable information.[1009] Informational advantages among traders can and should be gained through insightful analysis of public information.[1010] Moreover, information does not need to be private for analysts to make money. Analyst services will continue to be required and compensated when this involves the formulation of 'independent and accurate expectations in response to information.'[1011]

Disclosure policy decisions should be made with open eyes and not based on accepted rhetoric.[1012] Policy makers need to be aware that regulation mandating access to information has enormous financial consequences. Arguments and proposed institutional structures based on simplistic views or assumptions about the roles of particular groups of market participants are more likely to be driven by profit concerns than efficiency or fairness issues.[1013] Private information allows some investors to be better informed than their counterparties,[1014] providing some investors with strong monetary and other incentives to oppose full disclosure on a timely basis.

Incentives are an important element of the relationships between companies and favoured investors and between intermediaries and retail investors. However, the real question for policy makers is the extent to which company, institutional and individual incentives are aligned with the public interests of Australia.[1015] Markets that allow privileged access to company information based on favoured relationships are unlikely

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and Securities Law Fail? Managing the "Expectations Gap" In Investor Protection: The Sec and the Post-Enron Reform Agenda' (2003) 48 *Villanova Law Review* 1139, 1142; Commonwealth, above n 33.

[1008] Arthur Zeikel, 'On the Threat of Change' (Nov/Dec 1975) *Financial Analysts Journal* 17, 19.

[1009] Marc Steinberg and Jason Myers, 'Lurking in the Shadows: The Hidden Issues of the Securities and Exchange Commission's Regulation FD' (2002) 27 *Journal of Corporation Law* 173, 185.

[1010] Goshen et al, above n 473, 714, 721, 725, 729-730, 738.

[1011] Lee, above n 687, 185.

[1012] Langevoort, above n 549, 1054.

[1013] Barbara Merino and Mailyn Neimark, 'Disclosure Regulation and Public Policy A Sociohistorical Reappraisal' (1982) 1 *Journal of Accounting and Public Policy* 33.

[1014] Nils Hakansson, 'On The Politics of Accounting Disclosure and Measurement: An Analysis of Economic Incentives' (1981) 19 *Journal of Accounting Research* 1, 26-27.

[1015] See footnote 935 for discussion on the term "the public interest of Australia".

to be optimally fair or efficient.[1016] The global financial and economic crises have clearly highlighted the externalities that can arise when market activity encompasses conflicts of interest, short term profit incentives, poor market transparency, information asymmetry, a lack of regulatory oversight, or weak governance controls.[1017]

Regulation and processes that promote transparent corporate disclosure in the public arena are likely to be the optimal approach to incentivise genuine research and independent analysis, encourage healthy competition, minimise conflicts of interest, and enhance long term economic efficiency.[1018] Competition among investors should be based on superior analytical skills rather than on who can get the best access to company management, curry sufficient favour with the management to obtain the best information, and write sufficiently favourable reports to maintain regular access.[1019] A disclosure framework that emphasises and enforces equal access to information promotes genuine competition among *all* investors who are able to process, analyse and trade on company information.

While there are limits to what company disclosure regulation can achieve, carefully crafted and effectively enforced rules can promote and enhance the transparency and timeliness of corporate disclosures. To the extent that mandatory disclosure achieves these aims, the regulation is well justified. However, the rationales are weakened, or possibly negated, if company information continues to be provided on a tiered, private, delayed or disguised basis.

Chapter Four provides further discussion and critique on equal access and efficiency.

[1016] See footnotes 756, 773 & 782. Analysts from Goldman Sachs JB Were in Australia admitted that they seek to curry favour with management in order to preserve their information networks. Non-favoured analysts and investors continue to be blacklisted in Australia & analysts confirm that they have experienced or they fear exclusion from access to company management and participation in capital raisings when they make a sell recommendation.
[1017] See, eg, FSA, above n 554; Carvajal et al, above n 554.
[1018] Posner, above n 562; Levmore, above n 562, 645, 605.
[1019] Unger, above n 12, 1122-1124; Lopez-Fernandini, above n 351, 1373.

CHAPTER FOUR: LISTED COMPANY DISCLOSURE REGULATION: LEGAL CONTEXT

'If the horn honks and the mechanic concludes that the whole electrical system is working, he is in deep trouble …'[1020]

Chapter Four examines the legal context of the Australian regulation in more depth, building on the regulatory introduction provided in Chapter Two and the theoretical framework outlined in Chapter Three. It reviews the regulatory and enforcement regimes, the carve-out provisions, policy reports, and the disclosure framework on an integrated basis. It highlights enforcement issues, uncertainties around important legal terms within the disclosure and insider trading regimes, hindrances to equal access, and potential limits on investor protection under the company disclosure and insider trading regimes.

ASIC has successfully initiated enforcement actions under the periodic disclosure, continuous disclosure and insider trading regimes. Convictions under the continuous disclosure and insider trading regimes have increased over the last decade in comparison with previous decades. However, as highlighted in Chapter Two, the status and enforceability of the ASX disclosure listing rules are unclear, and most of the court actions to date have alleged insider trading rather than a breach of the periodic or continuous disclosure provisions. I call for a bold and effective corporate disclosure regulatory framework. I suggest this requires greater regulatory emphasis on compliance with, and enforcement of, the periodic and continuous disclosure obligations.

A major problem with the proposed regulatory emphasis on compliance with the periodic and continuous disclosure rules are uncertainties around what these obligations encompass and associated enforcement difficulties. The greatest legal uncertainties arise from the requirements within the insider trading and continuous disclosure regimes that the information is material but not "generally available". I illustrate these uncertainties by reviewing insider trading and continuous disclosure case law and insider trading policy reports. The "generally available" provisions within the insider trading regime have been described as internally inconsistent by the

[1020] Robert Pirsig, *Zen And The Art Of Motorcycle Maintenance* (1974).

judiciary, and as indeterminate by members of CAMAC.[1021] The uncertainties that persist around the "generally available" provisions extend to the materiality requirement as these tests are closely linked. While amendments to the "generally available" carve-outs have been proposed and widely discussed, no legislative changes have been made to date. I argue that many of the issues around the "generally available" and materiality provisions arise because of a lack of definition or clarity around the efficiency rationale.

Inclusion of the "generally available" and materiality elements within the statutory insider trading and continuous disclosure provisions raises questions about the links between these regimes. The relationship between the insider trading and continuous disclosure regimes is important because any enforcement actions involving selective disclosure must be initiated under one or both of these regimes. Judicial commentary indicates that the regimes are not aligned. However, there has been only minimal case law on the continuous disclosure "generally available" and materiality elements, making determinations on the nature and scope of the continuous disclosure obligations difficult. The combined uncertainties around the insider trading and continuous disclosure regimes make the extent to which selective disclosure is prohibited and enforceable in Australia largely indeterminate. As discussed more fully in Chapter Five, this leaves considerable scope for selective disclosure practices from listed companies.

Finally, I argue that company disclosure policy decisions should be made on an integrated rather than a piecemeal basis. From an investor's perspective, the efficacy of the company disclosure and insider trading regulation succeeds or fails on a comprehensive basis. However, there is little consensus among policy makers, the judiciary and academics on the links across the periodic disclosure, continuous disclosure and insider trading regimes. I conclude that the comprehensive listed company disclosure framework incorporates many gaps and ambiguities, leaving investors with potentially minimal protection.

The Chapter is in five parts:

[1021] *Ampolex Ltd V Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* (1996) 14 ACLC 1514, 1522; *R v Firns* (2001) 38 ACSR 223, 234; CAMAC, above n 71, 48.

1. Part I provides a summary of the enforcement actions under periodic disclosure, continuous disclosure and insider trading regulation.
2. Part II outlines and critiques insider trading and continuous disclosure case law on the "generally available" and materiality elements.
3. Part III discusses the CAMAC review of the insider trading provisions and the subsequent Position and Consultation Paper.
4. Part IV explores the relationships between the periodic disclosure, continuous disclosure and insider trading regimes.
5. Part V provides critique and concludes.

I ENFORCEMENT REGIMES

'The deterrence impact of rigorous statutes recedes drastically as the likelihood of successful usage lessens. Hence, statutes that are intended to enhance market integrity and investor protection have relatively negligible effect if there exists widespread non-compliance.'[1022]

A Periodic Disclosure Regulation Enforcement

Both the ASX and ASIC monitor listed company annual reports for compliance with accounting standards and governance regulation.[1023] The ASIC Annual Report for 2008-09 indicates that the Commission reviewed the financial reports of over 100 listed companies.[1024] The ASX has also occasionally used its powers of suspension and delisting in relation to smaller listed companies that failed to lodge half year and annual reports.[1025] The ASX and ASIC generally endeavour to achieve a regulatory outcome through settlement rather than resorting to litigation.[1026] Companies are asked to rectify

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[1022] Steinberg, above n 473, 676.
[1023] ASX, above n 366, Attachment 3; ASIC, 'Companies Make Changes Following ASIC Review' (Press Release, 13 April 2004) 04-103; ASIC, 'ASIC Releases Preliminary Results of 2004-2005 Financial Reporting Surveillance Project' (Press Release, 17 February 2005) 05-31.
[1024] *ASIC Annual Report 2008-09* 30. The annual report review focused on going concern assessments, impairment of assets, fair value determination, off-balance sheet arrangements, and financial instrument risk disclosures.
[1025] *Re Captech Group Ltd and ASIC* (2003) 47 ACSR 381; ASX Introduction to Listing Rules; ASX Listing Rules 17.2 and 17.3.
[1026] Under s 232EC of the *Corporations Act 2001* (Cth), ASIC can refer a financial report to the Financial Reporting Panel if they believe a report does not comply with a financial reporting requirement. A lodging entity may also refer a report to the Panel with ASIC's permission under s 323EG, when they have been informed by ASIC that in their opinion the report does not comply with financial reporting requirements. The Panel decision is non-binding and both parties retain the right to subsequently initiate legal proceedings. The Court may have regard to the Panel's report in considering whether the report complies with financial reporting requirements.

any identified issues.[1027] Nevertheless, listed companies and their directors have been prosecuted for breaches of the statutory annual reporting provisions.

For example, in *ASIC v MYOB Ltd*,[1028] ASIC sought a declaration that MYOB had contravened ss 304 and 305 of the *Corporations Law* because the acquisition of assets in the financial statements for the half year ended 30 June 2000 had not been prepared in accordance with AASB 1015. However, Justice Hansen dismissed this application, holding that AASB 1015 did not apply to the ongoing balances of previously acquired assets. In *ASIC v John Barrie Loiterton and Ors* [2004] NSWSC 172, ASIC initiated civil proceedings against the directors of Clifford Corporation Limited and the Clifford Group of companies for breaches of ss 232, 318, 292, 295A, 298 and 1002G of the *Corporations Law* in the preparation and publication of the statutory accounts. These actions were successful. Justice Bergin held that the full year consolidated accounts of Clifford Corporation included purported profits from pre-acquisition fees and did not give a true and fair view of the profit and loss of the Group.[1029] In addition, the notes to the accounts did not comply with AASB 1017 on related party disclosures.

Interestingly, in *QBE Insurance Group Ltd and Ors v ASC and Anon*,[1030] Justice Lockhart dismissed applications by QBE and NRMA for a declaration that paragraph 23 of AASB 1023 pursuant to s 313 of the *Corporations Law* was invalid. Applications seeking orders to set aside the Australian Securities Commission (ASC)[1031] decision to refuse their s 313 applications were also dismissed. Justice Lockhart stated that if, in the opinions of the directors of QBE and NRMA, the profit and loss account prepared in compliance with paragraph 23 of AASB 1023 would not give a true and fair view of the company's profit and loss for a financial year, the directors would be obliged to add information or appropriate notes complying with s 299(10) of the *Corporations Law*.[1032]

[1027] Philip Brown and Ann Tarca, 'Achieving High Quality, Comparable Financial Reporting: A Review of Independent Enforcement Bodies in Australia and the United Kingdom' (2007) 43 *Abacus* 438, Appendix A. Appendix A lists 42 annual and interim reporting cases publicised by ASIC during the period 1 July 1998 until 30 June 2004. Of these, only 4 involved court actions.
[1028] *ASIC v MYOB Ltd* (2002) 41 ACSR 44.
[1029] *ASIC v John Barrie Loiterton and Ors* [2004] NSWSC 172 [585-587].
[1030] *QBE Insurance Group Ltd and Ors v ASC and Anon* (1992) 8 ACSR 631.
[1031] The Australian Securities Commission was the predecessor to ASIC.
[1032] *QBE Insurance Group Ltd and Ors v ASC and Anon* (1992) 8 ACSR 631. Paragraph 23 of AASB 1023 concerned accounting for the revaluation of non-current assets. This standard required insurance companies to bring to account in the profit and loss unrealised gains and losses on investments at net

No evidence was found of any enforcement of the periodic disclosure listing rules by Australian regulators other than a suspension in the listing of smaller companies for a failure to provide periodic reports within the required period.[1033] In addition, no evidence was found of any enforcement by the ASX or ASIC relating to the statutory rules on half-year accounts or management discussion and analysis in periodic reports.

B Continuous Disclosure Regulation Enforcement

As outlined in Chapter Two, the ASX doesn't enforce the continuous disclosure listing rules. Instead, suspected breaches of these rules are referred to ASIC for action.[1034] ASIC has a range of enforcement options under the statutory continuous disclosure provisions. Criminal and civil remedies are available and infringement notices may be issued for more minor offences. ASIC may also accept enforceable undertakings as an alternative to litigation.

1 *Court Actions*

ASIC has initiated three successful court prosecutions under the statutory continuous disclosure provisions; *Australian Securities and Investments Commission v Southcorp Limited (No 2)* (Southcorp action),[1035] *Australian Securities and Investments Commission v Chemeq Limited* (Chemeq case)[1036] and *Australian Securities and Investments Commission v Macdonald (No 11)* (Hardie case).[1037] In the first two cases, the defendant companies pleaded guilty and were fined under the civil penalty provisions. The Hardie case was contested.

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market value as at balance date. This requirement applied irrespective of the length to maturity of the investments and whether the gains or losses were real or permanent.

[1033] *2009 ASX Market Supervision Annual Report.* Page 10 of the annual report indicates there were 89 ASX initiated suspensions in 2008/09 due to a breach of the Listings Rules for reasons such as non-lodgement of periodic reports by the due date. The ASXSM annual report is only available for 2009 and the release of data on ASX initiated suspensions appears to be a new initiative. I requested such information in 2006 and was informed by the customer service area of the ASX that it was not available.

[1034] Lawrence, above n 399, 3-4.

[1035] (2003) 130 FCR 406.

[1036] (2006) 58 ACSR 169.

[1037] (2009) 71 ACSR 368.

The Southcorp action was based on an email sent by Southcorp's executive general manager of corporate affairs to analysts on 18 April 2002. The email disclosed that the group's profit for the 2003 year would be diminished to the extent of $30 million by the poor 2000 vintage. However, this fact was not disclosed to the market through the ASX. From the time the email was sent until a trading halt was called at 1.07 pm on 19 April 2002, the Southcorp share price fell seven percent.[1038] Southcorp subsequently admitted that it had contravened ASX Listing Rule 3.1 and s 674(2) of the Act because at the time the information was selectively released to the analysts, the information had not been announced through the ASX and was not generally available to the market.[1039] The civil penalty applied by the court was $100 000 from a maximum penalty at the time of $200 000.[1040]

The Chemeq case involved two admitted contraventions of s 674(2); the first involved a failure to notify the ASX about the increased costs of constructing and commissioning its manufacturing facility at East Rockingham between 10 February 2003 and 30 April 2004, and the second involved a failure to disclose adequate information between 1.22 am on 6 October 2004 and 3.36 pm on 7 October 2004 about the commercial impact of a patent granted in the US in 2004.[1041] Chemeq was fined $150 000 in respect of the first contravention from a maximum penalty at the time of $200 000 and $350 000 in respect of the second contravention from a maximum penalty of a million dollars.[1042]

The Hardie case included two contraventions of the continuous disclosure obligations. The first related to a resolution by the James Hardie Industries Limited (JHIL) board on 15 February 2001 to execute a deed of covenant and indemnity (DOCI). Justice Gzell of the NSW Supreme Court held that JHIL negligently failed to disclose the DOCI information in contravention of ASX Listing Rule 3.1 and s 1001A(2) of the

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[1038] *Australian Securities and Investments Commission v Southcorp Limited (No 2)* (2003) 130 FCR 406, 416. This equated to a reduction in the market capitalisation of Southcorp Limited of more than $332 million.

[1039] *Australian Securities and Investments Commission v Southcorp Limited (No 2)* (2003) 130 FCR 406, 406. Justice Lindgren outlined the legislative history, the current continuous disclosure legislation and listing rules, the facts, and the considerations relevant to level of penalty.

[1040] *Australian Securities and Investments Commission v Southcorp Limited (No 2)* (2003) 130 FCR 406.

[1041] *Australian Securities and Investments Commission v Chemeq Limited* (2006) 58 ACSR 169, 183.

[1042] *Australian Securities and Investments Commission v Chemeq Limited* (2006) 58 ACSR 169, 198.

Corporations Law as carried into the Act.[1043] The second was a failure by James Hardie Industries NV (JHINV) to notify the ASX of the ABN 60 Foundation (Foundation) information. On 25 March 2003 JHINV resolved:

- that JHINV execute a trust deed establishing the Foundation;
- to approve a capital reduction by JHIL;
- to request JHIL to issue 1 000 shares to the Foundation;
- that the fully paid shares held by JHINV be cancelled for no consideration; and
- that it enter into a deed of covenant indemnity and access.

Justice Gzell held that JHINV failed to notify the ASX of this information in accordance with ASX Listing Rule 3.1 between 25 March and 20 June 2003, thereby contravening s 674(2) of the Act.[1044]

More recently, an action by ASIC against Fortescue Metals alleging contravention of s 674 of the Act was dismissed.[1045] ASIC submitted that Fortescue Metals Group Ltd (FMG) through Forrest, the CEO, had no genuine and or reasonable basis for making the claim within an ASX announcement that framework agreements with China Railway Engineering Corporation, China Harbour Engineering Company and China Metallurgical Construction (Group) Corporation were binding build and transfer agreements. However, Justice Gilmour found that 'FMG, its board and Forrest held their opinion as to the meaning and legal effect of the framework agreements honestly and reasonably'.[1046] ASIC has filed a notice of appeal indicating that it considers that the findings of Justice Gilmour raise important issues as to the proper interpretation and application of provisions governing company announcements and these issues warrant review by an Appeal Court.[1047]

[1043] *Australian Securities and Investments Commission v Macdonald (No 11)* (2009) 71 ACSR 368 [1274-1275].
[1044] *Australian Securities and Investments Commission v Macdonald (No 11)* (2009) 71 ACSR 368 [1312-1313].
[1045] *Australian Securities and Investments Commission v Fortescue Metals Group Ltd [No 5*] [2009] FCA 1586.
[1046] *Australian Securities and Investments Commission v Fortescue Metals Group Ltd [No 5*] [2009] FCA 1586 [54].
[1047] ASIC, 'ASIC Appeals Federal Court Decision in Fortescue Metals Group Civil Penalty Proceedings' (Press Release, 4 February 2010) 10-13AD.

2 *Infringement Notices*

In 2004, an infringement notice procedure was introduced for relatively minor breaches of continuous disclosure law.[1048] The scheme was introduced to provide ASIC with a timely enforcement process with redress that is 'proportionate and proximate in time to the alleged breach'.[1049] Since 2006, ASIC has regularly used its infringement notice powers, with 12 notices issued to date. Notices have been made against:

1. Solbec Pharmaceuticals Limited for an alleged failure to notify the ASX in detail of the nature of the results of an animal study relating to its cancer drug, Coramsine™;[1050]
2. QRSciences Holdings Limited for an alleged failure to disclose to the ASX that an underwriter to a fund raising on 31 January 2005 had withdrawn;[1051]
3. SDI Limited for an alleged failure to update the ASX of its revised net profit forecast on 2 May 2005;[1052]
4. Avastra Limited for an alleged failure to inform the ASX of a significant delay in the publication of results of a clinical trial on 26 April 2005;[1053]
5. Astron Limited for an alleged failure to inform the ASX of a significant increase in the mineral resource estimate for its Donald Mineral Sands Project;[1054]
6. Avantogen Limited for an alleged failure to inform the ASX of information regarding the unsuccessful outcome of a phase II clinical trial of its Pentrys anti-cancer vaccine;[1055]
7. Promina Group Limited for an alleged failure to inform the market about a takeover proposal from Suncorp Metway Limited after the information ceased to be confidential;[1056]
8. Raw Capital Partners Limited for an alleged failure to properly inform the market about the loss of a significant IT service contract;[1057]

[1048] *Corporations Act 2001* (Cth) Part 9.4AA.
[1049] ASIC, *Continuous Disclosure Obligations: Infringement Notices – An ASIC Guide* (May 2004) 4
[1050] ASIC, 'ASIC Issues First Infringement Notice For Continuous Disclosure Breach' (Press Release, 1 August 2005) 05/223.
[1051] ASIC, 'ASIC Disclosure Penalty For Perth Company' (Press Release, 17 February 2006) 06/42.
[1052] ASIC, 'Melbourne Company Pay Disclosure Penalty' (Press Release, 21 April 2006) 06/124.
[1053] ASIC, 'Sydney Life Sciences Company Pays Disclosure Penalty' (Press Release, 15 May 2006) 06/156.
[1054] ASIC, 'Chemical Company Pays $66,000 Penalty' (Press Release, 18 July 2006) 06/242.
[1055] ASIC, 'Biotechnology Company Pays $33,000 Fine' (Press Release, 8 December 2006) 06-428.
[1056] ASIC, 'Promina Pays $100,000 Fine' (Press Release, 20 March 2007) 07-69.
[1057] ASIC, 'Information Technology Services Company Pays $33,000 Fine' (Press Release, 1 August 2007) 07-207.

9. Centrex Metals Limited for an alleged failure to notify the ASX about the signing of a binding Heads of Agreement with Baotou Iron & Steel Company Limited concerning the supply of hematite;[1058]
10. Sub-Sahara Resources NL for an alleged failure to properly inform the market about metallurgical test results;[1059]
11. Rio Tinto Limited for an alleged failure to notify the ASX of an acquisition of Alcan Inc once the information about the acquisition ceased to be confidential;[1060]
12. The Commonwealth Bank of Australia for an alleged failure to notify the ASX about a significant deterioration in its expected loan impairment expense for the financial year ending 30 June 2009.[1061]

All of these companies elected to comply with the infringement notice and pay the relevant amount without admitting liability.[1062] The penalty payable is determined by the market capitalisation of the company and whether the company has a prior conviction under ss 674(2) or 675(2). Assuming no previous conviction, a company is fined $100 000 when its market capitalisation exceeds $1 000 million (Tier 1), $66 000 when its market cap exceeds $100 million (Tier 2) and $33 000 when its market capitalisation is below $100 million (Tier 3).[1063] Of the twelve infringement notices, three have been issued against Tier 1 companies,[1064] one against a Tier 2 company,[1065] and the remaining eight have been made against Tier 3 companies.

3 *Enforceable Undertakings*

In 1996, ASIC argued in its submission to a CASAC review that the availability of enforcement options other than litigation would encourage compliance with the continuous disclosure regulation. In response, CASAC recommended that ASIC should

[1058] ASIC, 'Mineral Exploration Company Pays $33,000 Fine' (Press Release, 12 March 2008) 08-50.
[1059] ASIC, 'Mineral Exploration Company Pays $33,000 Fine' (Press Release, 29 March 2008) 08-87.
[1060] ASIC, 'Rio Tinto Complies With ASIC Infringement Notice' (Press Release, 5 June 2008) 08-117.
[1061] ASIC, Commonwealth Bank Pays $100,000 Penalty' (Press Release, 14 October 2009) 09-199.
[1062] An admission of liability is not required under s 1317DAJ(2)(b) of the *Corporations Act 2001* (Cth).
[1063] The penalty amount under s 1317DAE varies according to the market capitalisation of the company, and whether the company has a prior conviction under s 674(2) or 675(2).
[1064] ASIC, 'Promina Pays $100,000 Fine' (Press Release, 20 March 2007) 07-69; ASIC, 'Rio Tinto Complies With ASIC Infringement Notice' (Press Release, 5 June 2008) 08-117; ASIC, Commonwealth Bank Pays $100,000 Penalty', (Press Release, 14 October 2009) 09-199.
[1065] ASIC, 'Chemical Company Pays $66,000 Penalty' (Press Release, 18 July 2006) 06/242.

have the power to demand enforceable undertakings. The legislators agreed. ASIC may currently accept an enforceable undertaking under s 93AA of the *Australian Securities and Investments Commission Act* 2001 (Cth).

An ASIC Guide indicates that an

> enforceable undertaking can be initiated by a company, an individual or a responsible entity, or as a result of a discussion between that party and ASIC. [However, ASIC] do not have the power … to require a person to enter into an enforceable undertaking. Similarly, a person cannot compel [ASIC] to accept an enforceable undertaking.[1066]

There is considerable flexibility in the drafting of undertakings and there is no limit to the civil penalty that may be imposed. ASIC can enforce compliance with an undertaking by seeking a court order.

ASIC has accepted enforceable undertakings in relation to alleged continuous disclosure failures. In 1998, an enforceable undertaking was made against Crown Ltd for an alleged failure to disclose accumulated operating losses in the 1998 financial year and receipt of a notice that the company was in breach of a debt to equity covenant in its casino license.[1067] In 2001, Pahth Telecommunications Ltd[1068] and Plexus International Limited[1069] agreed to enforceable undertakings requiring disclosure audits following alleged failures to disclose revenue and profit downgrades or changes. Similarly, Uecomm agreed to review its continuous disclosure compliance proceedings after allegedly failing to continuously advise the market of its expected trading results.[1070]

In December 2006, ASIC accepted an enforceable undertaking from the Multiplex Group relating to its failure to immediately disclose a material change in profit on the Wembley National Stadium project in London on 2 February 2005. The undertaking secured a $32 million compensation fund for investors affected by the company's

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[1066] ASIC, *Enforceable Undertakings – An ASIC Guide* (March 2007) [1.5] Paragraph 1.6 of the guide outlines the major differences between undertakings given to ASIC and a court.

[1067] ASIC Press Release, 11 September 1998.

[1068] ASIC, 'ASIC Accepts Disclosure Undertaking From Pahth Telecommunications Limited' (Press Release, 2 February 2001).

[1069] ASIC, 'ASIC Accepts Disclosure Undertaking From Plexus International Limited' (Press Release, 5 April 2001) 01/121.

[1070] ASIC, 'Uecomm to Undertake Disclosure Audit' (Press Release, 17 October 2002) 02/379.

failure to meet its continuous disclosure obligations and provided for Multiplex's disclosure policies to be monitored by an independent expert.[1071]

An enforceable undertaking was also made against TZ Limited for an alleged failure to disclose price sensitive information to the ASX in September 2007.[1072] The undertaking required the engagement of an external consultant to ensure disclosure in accordance with industry best practice.[1073]

4 *Shareholder Actions*

No individual shareholder actions have succeeded to date.[1074] In *Riley v Jubilee Mines NL*,[1075] a shareholder plaintiff was initially awarded $1.8 million in damages for losses resulting from a failure by WMC to comply with its continuous disclosure obligations. However, in 2009 this finding was overturned on appeal.[1076] Chief Justice Martin held that 'an announcement by Jubilee of all relevant information pertaining to the WMC drill hole data would not, or would not have been likely to, influence persons who commonly invest in securities in deciding whether or not to buy or sell its shares.'[1077] In other words, the information did not satisfy the materiality requirement. Chief Justice Martin upheld other grounds for appeal including those relating to the content of the ASX announcement and the amount of damages awarded.[1078] Justice Le Miere concurred with the Chief Justice.[1079] Justice McClure upheld the appeal on the grounds of materiality and negligence.[1080]

[1071] ASIC, 'ASIC Accepts An Enforceable Undertaking From The Multiplex Group' (Press Release, 20 December 2006) 06/443. ASIC pointed out that compensation was not guaranteed and the maximum penalty was $1 million under the civil penalties regime.

[1072] The company indicated that an announcement to the ASX about purchase orders for the company's technology was not made for six days because the orders were not considered to be price sensitive information and consents under confidentiality agreements were sought prior to the announcement.

[1073] ASIC, 'ASIC Accepts Enforceable Undertaking From TZ Limited' (Press Release, 4 July 2008) 08/149.

[1074] Individuals have successfully sued for compensation under the misleading and deceptive conduct provisions. For example, in *GPG (Australia Trading) Pty Ltd v GIO Australia Holdings Ltd & Anor* (2001) 40 ACSR 252, GPG was awarded damages for losses resulting from misleading and deceptive conduct by GIO under s 12DA of the Australian *Securities and Investment Commission Act* 1989 (Cth). GIO omitted to disclose to the market that it knew about the likelihood of further reinsurance losses and increased provisioning.

[1075] (2006) 59 ACSR 252.

[1076] *Jubilee Mines NL v Riley* [2009] WASCA 62.

[1077] *Jubilee Mines NL v Riley* [2009] WASCA 62 [123].

[1078] *Jubilee Mines NL v Riley* [2009] WASCA 62 [114][123] [129][136].

[1079] *Jubilee Mines NL v Riley* [2009] WASCA 62 [199].

[1080] *Jubilee Mines NL v Riley* [2009] WASCA 62 [197].

However, shareholders have received compensation through class actions alleging failures to continuously disclose. In late 2007, a class action against Telstra for a breach of its continuous disclosure requirements was settled for $5 million.[1081] The plaintiffs alleged that the company provided materially price-sensitive information at a private briefing to selected investors on 11 August 2005. The investors, who bought shares between 11 August and 7 September when Telstra made an announcement to the ASX on the briefing content, sought compensation on the basis that the share price was inflated during this period.

A few months later, settlement was reached on a class action against Aristocrat Leisure. The plaintiffs sought damages for investor losses resulting from misleading and deceptive conduct and a breach of the continuous disclosure obligations by the company in relation to a series of profit forecasts provided to the market.[1082] The action was settled for $145 million,[1083] with Aristocrat incurring a net cost after expenses and taxes of approximately $40 million.[1084]

More recently, a number of smaller claims have been settled. For example, settlement was reached on 28 November 2008 on a claim on behalf of shareholders who purchased Downer EDI Limited shares prior to 8 August 2006 at a time when Downer had recognised revenue in respect of a disputed progress claim.[1085] Further disclosure-related class actions are proceeding, including suits against Multiplex,[1086] AWB,[1087]

[1081] ASX, 'Court Approves Telstra Settlement' (Press Release, 13 December 2007); Susannah Moran, 'Telstra Settles Class Action', *The Australian* (Sydney), 12 November 2007.

[1082] Elizabeth Sexton, 'Aristocrat Admits Overstating Profit', *Sydney Morning Herald* (Sydney), October 5, 2007; Elizabeth Sexton, 'All Eyes On Class Action', *Sydney Morning Herald* (Sydney), October 5, 2007.

[1083] *Dorajay Pty Ltd v Aristocrat Leisure Limited* [2008] FCA 1311 (Unreported, Stone J, 26 August 2008).

[1084] Aristocrat Leisure Limited, 'Federal Court Class Action: Settlement Update' (28 August 2008) ASX Company Announcement Platform.

[1085] IMF (Australia) Ltd, 'Company Update' (28 November 2008) ASX Company Announcement Platform; IMF (Australia) Ltd, 'New Funding Agreement – Downer EDI Limited' (8 May 2007) ASX Company Announcement Platform.

[1086] F Chong, 'Court Paves Way on Multiplex Suit', *The Australian* (Sydney), 22 December 2007. The class action against Multiplex claims that the company failed to keep the market informed of cost and delay issues associated with the Wembley project and the likely effect on the company's profits. More specifically, Multiplex was aware of delays in the construction schedule and cost blowouts by August 2004, but did not inform the market of these until 2005.

[1087] T Chappell, 'Class Action Goes Ahead Against AWB', *The Age* (Melbourne), 14 April 2007. The plaintiffs in the action against AWB seek compensation for monies lost as a result of AWB failing to continuously inform the market about its activities in Iraq and material facts that could reasonably be

Centro Retail Ltd and Centro Properties Ltd,[1088] ABC Learning[1089] Oz Minerals[1090] and Transpacific Industries Group.[1091]

C Insider Trading Regulation Enforcement

ASIC has successfully initiated insider-trading prosecutions against 16 individuals or entities since the beginning of 2002.[1092] Eight of these involved insider trading on nonpublic information concerning a proposed takeover or merger (O'Reilly, Panchal, Petsas, Miot, Frawley, Rivkin, Hannes and Doff),[1093] four involved trading on company earnings information prior to its official release (McKay, Hall, Sweetman and Reddell),[1094] one involved trading on private information about a gold mine project (Woodland),[1095] two related to insider trading prior to administration or liquidation

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expected to have affected the AWB share price. The claimants seek an estimated $25 million of direct losses as well as opportunity losses.

[1088] IMF (Australia) Ltd, *2008 Annual Report.* The action against Centro Retail Ltd and Centro Properties allege the companies failed to keep the market informed of material information between 7 August and 15 February 2008 during which period the plaintiffs purchased securities.

[1089] IMF (Australia) Ltd, *2009 Annual Report* 14. This claim alleges that ABC Learning failed to disclose information concerning its financial position to the ASX.

[1090] IMF, above n 1089, 14. This action alleges that material information was not disclosed to the ASX.

[1091] Bill Lindsay, 'IMF Funds Claims Against Waste-Management Firm Transpacific Industries Group', *The Australian* (Sydney), 8 March 2010. This action alleges that Transpacific Industries Group breached its continuous disclosure obligations between 28 February 2008 and 16 February 2009.

[1092] ASIC, 'Sydney Man Enters Guilty Plea to Insider Trading Charges' (Press Release, 6 April 2010) 10-72AD (Hartman); ASIC, 'New South Wales Man Pleads Guilty to Insider Trading' (Press Release, 15 December 2009) 09-254AD (Stephenson); ASIC, 'Former Director of Lion Selection Pleads Guilty to Insider Trading' (Press Release, 23 November 2000) 09-235 (O'Reilly); ASIC, 'Former Company Secretary Pleads Guilty to Insider Trading' (Press Release, 4 February 2009) 09-10 (Panchal); ASIC, 'Melbourne Sharetrader Pleads Guilty To Insider Trading' (Press Release, 19 November 2007) 07-303 (Woodland); ASIC, 'Brisbane Research Analyst Pleads Guilty To Insider Trading Charge' (Press Release, 6 June 2007) 07-154 (Reddell); *R v McKay* (2007) 61 ACSR 470 (McKay); *R v Hall* (No 2)[2005] NSWSC 890 (Hall)*;ASIC* v Petsas (2005) 23 ACLC 269 (Petsas and Miot); *R v Frawley* [2005] NSWSC 585 (Frawley)*;R v Doff* (2005) 54 ACSR 200 (Doff); ASIC, 'Former Harts Executive Director Jailed For Insider Trading' (Press Release, 17 December 2004) 04-415 (Sweetman); *R v Rivkin* (2003) 45 ACSR 366 (Rivkin); ASIC, 'Perth Man Sentenced On Insider Trading' (Press Release, 1 August 2003) 03-240 (MacDermott); *R v Hannes* (2002) 43 ACSR 508 (Hannes). See also *ASIC v Vizard* (2005) 54 ACSR 394.

[1093] ASIC, 'Former Company Secretary Pleads Guilty to Insider Trading' (Press Release, 4 February 2009) 09-10; *ASIC v Petsas* (2005) 23 ACLC 269; *R v Frawley* [2005] NSWSC 585; *R v Rivkin* (2003) 45 ACSR 366; *R v Hannes* (2002) 43 ACSR 508; *R v Doff* (2005) 54 ACSR 200.

[1094] *R v Hall* (No 2)[2005] NSWSC 890; *R v McKay* (2007) 61 ACSR 470; ASIC, 'Former Aristocrat Media Relations Consultant Pleads Guilty To Insider Trading' (Press Release, 28 November 2006) 06-413; ASIC, 'Former Harts Executive Director Jailed For Insider Trading' (Press Release, 17 December 2004) 04-415; ASIC, 'Brisbane Research Analyst Pleads Guilty To Insider Trading Charge' (Press Release, 6 June 2007) 07-154; ASIC, 'Brisbane Research Analyst Sentenced On Insider Trading Charge' (Press Release, 26 July 2007) 07-203.

[1095] ASIC, 'Melbourne Sharetrader Pleads Guilty To Insider Trading' (Press Release, 19 November 2007) 07-303. Woodland pleaded guilty to one count of insider trading and one count of communicating inside information to other persons.

(Stephenson and MacDermott)[1096] and one involved an equities dealer with inside information about an asset management company's trading intentions (Hartman).[1097] Of the four earnings-related cases, one involved trading prior to a major announcement (McKay),[1098] two involved directors trading prior to the announcement of an earnings downgrade (Hall and Sweetman),[1099] and one involved a research analyst trading on earnings news prior to its public release (Reddell).[1100]

Additional criminal insider trading charges have been alleged by ASIC, with court hearings planned during 2010.[1101]

The only successful insider trading case initiated by ASIC under the civil penalty provisions is *ASIC v Petsas*.[1102] This case involved a client relationship manager at a bank passing on confidential information to a client about a pending corporate merger. The defendants, Petsas and Miot, admitted they had contravened the insider trading provisions and were ordered to pay pecuniary penalties and compensation of the profits made.[1103] It is not clear why civil penalties were sought in this particular case.

[1096] ASIC, 'New South Wales Man Pleads Guilty to Insider Trading' (Press Release, 15 December 2009) 09-254AD; ASIC, 'Perth Man Sentenced On Insider Trading' (Press Release, 1 August 2003) 03-240

[1097] ASIC, 'Sydney Man enters Guilty Plea to Insider Trading Charges' (Press Release, 6 April 2010) 10-72AD.

[1098] *R v McKay* (2007) 61 ACSR 470; ASIC, 'Former Aristocrat Media Relations Consultant Pleads Guilty To Insider Trading' (Press Release, 28 November 2006) 06-413.

[1099] *R v Hall* (No 2)[2005] NSWSC 890; ASIC, 'Former Harts Executive Director Jailed For Insider Trading' (Press Release, 17 December 2004) 04-415.

[1100] ASIC, 'Brisbane Research Analyst Pleads Guilty To Insider Trading Charge' (Press Release, 6 June 2007) 07-154; ASIC, 'Brisbane Research Analyst Sentenced On Insider Trading Charge' (Press Release, 26 July 2007) 07-203.

[1101] ASIC, "Former Director Charged with Insider Trading", Media Release 10-108AD (26 May 2010); ASIC, 'Two NSW Men Charged With Insider Trading' (Press Release, 16 February 2010) 10-25AD. Media Release 10-108AD states that one individual has been charged with 12 contraventions of s 1043A. Media Release 10-25AD indicates that 10 charges of insider trading have been laid against two individuals, with no pleas yet entered. Seven of these charges involve inside information on a pending takeover bid and three relate to inside information on pending earnings or other ASX announcements.

[1102] *ASIC* v Petsas (2005) 23 ACLC 269 - this case included convictions against Petsas and Miot. See also *ASIC v Vizard* (2005) 54 ACSR 394.

[1103] *ASIC* v Petsas (2005) 23 ACLC 269. Both the defendants, Petsas and Miot purchased call options in one of the merging companies resulting in significant realised profits.

D Enforcement Regimes Critique and Conclusion

'It is not merely of some importance but is of fundamental importance that justice should not only be done, but should manifestly and undoubtedly be seen to be done.[1104]

Several scholars have commented on disclosure-related enforcement in Australia.[1105] Some highlighted that legislation can be 'misleading where its "bark is not co-extensive with its bite".'[1106] One study of court based enforcement actions under Australian corporate and securities law found that ASIC is 'more likely to pursue enforcement actions against smaller … companies in relation to routine offences that are seemingly overlooked in relation to larger … companies.'[1107] Dignam and Galanis argued that while Australia has 'comparable legislative disclosure standards to those in the UK and the US … these disclosure requirements have not been properly enforced'[1108] and this 'lax enforcement undermines legal protection of investors.'[1109] They suggested that when 'there is insufficient public information available, the close and private relationships of an insider system … arise[s], rather than the arm's-length relationships of an outsider system.'[1110] These scholarly arguments were made a few years ago. As outlined in Chapter Two, Australia no longer has comparable legislative disclosure standards to those in the UK and US.[1111] On the other hand, disclosure-related enforcement actions in Australia have increased in recent years, some of these

[1104] Lord Hewart, *Rex v Sussex Justices* 9 Nov 1923 (Kings Bench Reports, 1924, vol 1, p 259).
[1105] Golding et al, above n 616, 426; Andrew Cassidy and Larelle Chapple, 'Australia's Corporate Disclosure Regime: Lessons From the US Model' (2003) 15 *Australian Journal of Corporate Law* 81, 81-82. Cassidy and Chapple argued that the lack of continuous disclosure related enforcement actions 'sit[s] awkwardly with the justification for mandatory disclosure regulation. In contrast, Golding and Kalfus argued that the low number of continuous disclosure proceedings reflected high levels of compliance and vigorous enforcement strategies.
[1106] Semaan et al, above n 612, 235.
[1107] Helen Bird, Davin Chow, Jarrod Lenne and Ian Ramsay, 'ASIC Enforcement Patterns' (Working Paper, Centre for Corporate Law and Securities Regulation, University of Melbourne, 2003) 108.
[1108] Alan Dignam and Michael Galanis, 'Australia Inside-Out: The Corporate Governance System of the Australian Listed Market' (2004) 28 *Melbourne University Law Review* 623, 645.
[1109] Dignam et al, above n 1108, 648.
[1110] Dignam et al, above n 1108, 642. Dignam and Galanis argued that two fundamental parameters characterise financial systems: the degree of financial intermediation and the degree of financial securitisation. To characterise a system as one or the other is to describe the degree of intermediation or securitisation. In an insider system, the degree of intermediation is high and the degree of financial securitisation is low; in an outsider system, the reverse is true. They concluded that the Australian listed market was characterised by: significant blockholders engaged in private rent extraction; institutional investor powerlessness; a strong relationship between management and blockholders, which resulted in a weak market for corporate control; and a historical weakness in public and private securities regulation, which allowed the creation and perpetration of crucial blocks to information flow. These scholarly arguments were made a few years ago.
[1111] As outlined in Chapter Two, the United Kingdom and the United States have statutory periodic disclosure regimes including full year, half and quarterly reporting. These reports include mandatory risk

actions have been against larger companies, and ASIC has indicated that more actions are in the pipeline.[1112]

Under the new supervisory arrangements, the ASX remains responsible for the supervision of listed companies and compliance with the disclosure listing rules. It is too early to assess how the shift of responsibility for market surveillance of market misconduct from the ASX to ASIC will effect compliance with, and enforcement of, the company disclosure and insider trading provisions.

1 *Periodic Disclosure*

ASIC has initiated litigation relating to the financial statements within annual reports and failures to comply with accounting standards. However, no evidence could be found of any enforcement of the periodic disclosure listing rules by Australian regulators other than a suspension in the listing of some companies for a failure to provide periodic reports by the required date.[1113] In addition, no evidence was found of any enforcement of the statutory rules on management discussion and analysis in the periodic reports.

The preliminary final reports currently provide the most comprehensive information to Australian investors on a timely basis. Thus, regulatory monitoring and enforcement of this report should be a high priority within the disclosure framework. While the listing rules on half yearly and annual reporting are broadly similar to the statutory requirements, those governing preliminary final reporting are not replicated in statute.

As noted in Chapter Two, the Australian company disclosure model is not used overseas. In the UK, the FSA rather than the London Stock Exchange is responsible for enforcement of the listing rules governing quarterly, half-yearly and preliminary final reporting.[1114] Similarly, the SEC in the US actively monitors and enforces the reporting

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disclosures and management discussion and analysis. In addition, the United States has enforced open briefing access policies.

[1112] Belinda Gibson, 'Responsible Handling of Market Information- Inside Information and Rumours' (Speech delivered at a University of Sydney Faculty of Economics and Business Conference on Aspects of Market Integrity – Where Next? Sydney, Hilton Hotel, 1 October 2009).

[1113] ASX, above n 1033.

[1114] *Financial Services and Markets Act* 2000 (UK) ss 72, 91; United Kindom Listing Authority Listing Rule 9.7A.1.

regulation including the quarterly and preliminary final reports.[1115] The SEC also enforces the regulation on management, discussion and analysis within the periodic reports.[1116]

2 *Continuous Disclosure*

The ASX does not formally enforce the continuous disclosure listing rules. Instead, suspected breaches of the rules are referred to ASIC for action. While some of the successful continuous disclosure actions were initiated as referrals from the ASX, all of the charges are based on the statutory provisions. This is important because the statutory provisions differ from ASX Listing Rule 3.1, with additional elements of intention and a requirement that the information is not "generally available". The legal effects of the differences are still to be tested in the courts.

All of the successful continuous disclosure actions have occurred since 2000. This includes three successful court actions. However, the primary enforcement mechanism used by ASIC has been the infringement notice process. An ASIC Guide on the infringement notice scheme indicates that when determining whether use of the scheme is appropriate, ASIC considers all relevant facts and circumstances and has regard to the seriousness of the alleged breach.[1117] In determining the seriousness of an alleged breach, ASIC has regard to a number of factors including:

- the impact of the alleged breach on the entity's securities including any change in the price of the securities and/or the number of securities traded;
- the materiality of the information;
- whether the information went to the heart of the entity's continued operations;
- whether the conduct giving rise to the alleged breach was negligent, reckless or deliberate;

[1115] See accounting and auditing enforcement actions on the US Securities and Exchange Commission (SEC) website at <http://www.sec.gov/divisions/enforce/friactions.shtml> accessed on 1 March 2008. This website provides details on many actions taken by the SEC relating to the content of quarterly reports (10-Q's) and preliminary final reports (10-K's).

[1116] See eg, *In the Matter of Sony Corporation and Sumio Sano:* Release No. 40305 (5 August 1998) < http://www.sec.gov/litigation/admin/3440305.txt> at 27 April 2010; *In the Matter of Bank of Boston Corporation*, Administrative Proceeding File No. 3-8270 (1995) < http://www.sec.gov/litigation/aljdec/id81bpm.txt> at 27 April 2010.

[1117] ASIC, above n 1049, 6.

- the adequacy of the entity's internal controls, and whether they were complied with;
- whether the entity sought and followed professional advice in relation to disclosure; and
- whether the entity took immediate steps to correct the failed disclosure.[1118]

The links between these stated factors and the cases prosecuted under the infringement notice scheme and as court actions are not obvious. More detail in the ASIC media releases explaining the application of these factors would be beneficial for all parties.

The infringement notice scheme has been criticised by a range of parties.[1119] To date, no companies have contested the notices issued against them. The size of the current fines and the litigation and reputational costs or risks involved in fighting an allegation in court are generally unwarranted when balanced against a fee of $33-100 000 and no admission of liability.[1120] This is particularly so for the Tier 3 smaller capitalised companies subject to a fixed fine of $33 000, the group of companies that have been the subject of most of the notices to date.

Finally, some shareholders have successfully gained compensation through class actions alleging failures to comply with the continuous disclosure obligations. The advent of successful class actions is likely to alter the corporate disclosure enforcement environment. However, the nature and extent of this change are still to be determined.[1121] The risks or uncertainties for potential class action plaintiffs are significant and the number of scenarios that might lead to potential actions remains limited. Likely settlements need to be large enough to cover the procedural costs and risks associated

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[1118] ASIC, above n 1049, 6-7.

[1119] See, eg, Robert Baxt, 'The New "Fining" Power for the Australian Securities and Investments Commission' (2004) 32 *Australian Business Law Review* 61, 62; Michelle Welsh, 'Eleven Years On - An Examination of ASIC's Use of an Expanding Civil Penalty Regime' (2004) 17 *Australian Journal of Corporate Law* 22.

[1120] See Rebecca Langley, 'Over Three Years On: Time For Reconsideration of the Corporate Cop's Power to Issue Infringement Notices for Breaches of Continuous Disclosure' (2007) 25 *Company and Securities Law Journal* 439, 460. Elizabeth Pakchung, a Partner at Blake Dawson, confirmed that client companies believe that it is not worth fighting an infringement notice for the amount involved: 'Continuous Disclosure: Key Issues for Companies and Their Advisors' (Speech delivered at a seminar arranged by the Centre for Corporate Law and Securities Regulation of the University of Melbourne, Sydney, 16 July 2008).

[1121] A straw poll by IMF (Australia) Ltd of institutional investors found that the primary driver for involvement in disclosure related class actions is the potential deterrent effect rather than the settlement monies: John Walker, Managing Director of IMF (Australia) Ltd: 'Continuous Disclosure: Key Issues for Companies and Their Advisors' (Speech delivered at a seminar arranged by the Centre for Corporate Law and Securities Regulation of the University of Melbourne, Sydney, 16 July 2008).

with multi-party actions. In addition, key elements that need to be established for successful disclosure related class actions in Australia are still uncertain. It is not yet clear:

- how shareholder losses must be determined;
- whether the purchase of securities at an inflated price is sufficient to establish loss;
- on what basis investor reliance is assessed and whether market reliance is sufficient or reliance by individual shareholders needs to be proved;
- what causation links are required; and
- how materiality must be established.[1122]

The successful shareholder class actions to date have been settled to avoid long court actions focused on these elements.

3 *Insider Trading*

The ASIC record of successful insider trading prosecutions against approximately two individuals or entities a year since 2002 is higher than the levels achieved in the 1980s and 1990s.[1123] However, obtaining the evidence to establish the required elements for an insider trading action in Australia is difficult.[1124] ASIC has to make prosecution choices with significant uncertainties around the nature and scope of the provisions,[1125] and must decide whether to restrict actions to circumstances that fall within the more certain areas of the provisions or proceed with a test case.

Insider trading enforcement difficulties arise on a global basis. The SEC and the FSA indicate that 'piecing together an insider trading case can be a complex and painstaking process.'[1126] They point out that most insiders take care to cover their tracks and cases

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[1122] Walker, above n 1121.

[1123] ASIC, 'ASIC Releases Guidance on Directors' Share Trading' (Press Release, 27 June 2008) 08-139; Juliette Overland, 'Two Steps Forward, One Step Back: Assessing Recent Developments in The Fight Against Insider Trading' (2006) 24 *Company and Securities Law Journal* 207, 210.

[1124] Gething, above n 622, 618; Geoffrey Newman, 'Exchange Targets Insider Trades', *The Australian* (Sydney), 16 December 05, 19; Welsh, above n 1117, 192.

[1125] Rubenstein, above n 626, 104.

[1126] Linda Thomsen**,** Director Division of Enforcement, United States Securities and Exchange Commission**,** 'Testimony Concerning Insider Trading Before the US Senate Committee on the Judiciary' (26 September 2006). See also Margaret Cole, Director of Enforcement Financial Services Authority, 'Insider Dealing in the City' (Speech delivered at the London School of Economics, London, 17 March 2007).

must often be built on circumstantial inferences of suspected misconduct.[1127] The SEC highlights that '[b]uilding an insider trading case based on circumstantial evidence can be frustrating, risky and time-consuming.'[1128] The FSA indicates that the 'two most common reasons for closing insider trading investigations are (i) the absence of evidence of links between the dealer and any insiders and (ii) the absence of evidence of the passage of inside information.'[1129]

An individual's response to the company disclosure and insider trading enforcement records depends on their view of what constitutes a breach of the periodic disclosure, continuous disclosure and insider trading regimes. Investor and ASIC stakeholder views on the disclosure culture and enforcement regimes are generally negative, as outlined in Chapter Five. However, these criticisms may need tempering in light of the ambiguities around the company disclosure and insider trading provisions. The greatest regulatory uncertainties arise from the "generally available" and materiality provisions.

II REGULATORY UNCERTAINTIES: THE GENERALLY AVAILABLE AND MATERIALITY PROVISIONS

'The Australian insider trading provisions are hopelessly complex. They defy anybody to understand them properly.'[1130]

The nature and scope of the continuous disclosure and insider trading provisions in Australia are largely determined by the requirements that the information is material but not "generally available". Interpretation or application of these tests (known as carve-outs) overlap.

[1127] Thomsen, above n 1126; Cole, above n 1126.
[1128] Thomsen, above n 1126.
[1129] Financial Services Authority (FSA), *Market Watch*, Issue 26 April 2008, 6-7. From Mach 2009, companies in the United Kingdom have been required to record all telephone communications and electronic communications relating to client orders and the conclusion of transactions in the equity, bond and derivatives markets.
[1130] Kenneth Robson, *Robson's Annotated Corporations Law* (3rd ed, 1998).

A Generally Available Carve-Outs

Under s 1042C(1) of the insider trading provisions, information is "generally available" if

a) 'it consists of readily observable matter' (*readily observable matter test*);[1131] or

b) 'it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in … financial products of a kind whose price might be affected by the information; and since it was made known, a reasonable period for it to be disseminated among such persons has elapsed' *(published information test*);[1132] or

c) it 'consists of deductions, conclusions or inferences made or drawn from'[1133] readily observable matter or published information *(analysis test*).[1134]

The provisions within the continuous disclosure regime are broadly equivalent.[1135] Under s 676, information is "generally available" if:

(2)(a) 'it consists of readily observable matter' (*readily observable matter test*);[1136] or

(2)(b) 'it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in securities of a kind whose price might be affected by the information;[1137] and since it was … made known, a reasonable period for it to be disseminated among such persons has elapsed.' (*published information test*);[1138] or

(3) 'it consists of deductions, conclusions or inferences made or drawn from' readily observable matter or published information *(analysis test*).[1139]

[1131] *Corporations Act 2001* (Cth) s 1042C(1)(a).
[1132] *Corporations Act 2001* (Cth) s 1042C(1)(b).
[1133] *Corporations Act 2001* (Cth) s 1042C(1)(c).
[1134] *Corporations Act 2001* (Cth) s 1042C(1). Where communication is merely circumstantial, it is difficult for the prosecution to establish the required means rea: *Myers v Cladianos* (1990) 2 ACSR 73.
[1135] The formatting of ss 676 and 1042C(1) is slightly different. The first two types of "generally available" information under s 1042C(1) are included within s 676(2)(a) and (b), while the third type, 'deductions, conclusions or inferences', is included within s 676(3). The reasons for the different formats are not clear but the differences do not appear to be significant in terms of application or interpretation of the relevant sections. Section 1001C was replaced by s 676 with enactment of the *Financial Services Act 2001* (Cth).
[1136] *Corporations Act 2001* (Cth) s 676(2)(a).
[1137] *Corporations Act 2001* (Cth) s 676(2)(b)(i).
[1138] *Corporations Act 2001* (Cth) s 676(2)(b)(ii).
[1139] *Corporations Act 2001* (Cth) s 676(3).

1 *Published Information Test*

The published information test or carve-out incorporates several sub-elements:

- the manner in which the relevant information must be disseminated;
- the investors to whom the information must be disseminated; and
- the period for which the information must be disseminated prior to trading.

(a) Manner of Dissemination

Section 1042C(1)(b) does not provide any guidance on the manner in which the information must be disseminated. However, in *Kinwat Holdings Pty Ltd v Platform Pty Ltd*,[1140] the filing of an affidavit on public record, a newspaper article, and a letter to the stock exchange were held to be dissemination under the published information test. In *R v Firns*[1141] information released in open court constituted public dissemination. Mason P suggested in *R v Firns* that what constitutes published or readily observable information is significantly changed by the advent of new technologies such as the world wide web. The *R v Firns* case is outlined and discussed later in this Part.

(b) Dissemination to Whom

The phrase 'persons who commonly invest' was included within s 1042C(1)(b) to ensure dissemination of the relevant information to a cross-section rather than to only a small sector of investors.[1142] Nevertheless, some commentators argue that dissemination to institutional investors may be sufficient because this allows rapid impounding of the relevant information into the share price.[1143]

In *Riley v Jubilee Mines NL*,[1144] Sanderson M indicated that the words "persons who commonly invest" do not 'ask what a member of the general public might make of the information … what is to be considered is the perspective of the persons who "commonly", as opposed to occasionally, or rarely, invest in securities.'[1145]

[1140] (1982) 1 ACLC 194.
[1141] (2001) 38 ACSR 223.
[1142] Explanatory Memorandum, above n 53, [328].
[1143] See, eg, Martin Earp and Gai McGrath, *Listed Companies: Law & Market Practice* (1996) 309-310; Walker et al, above n 441, 572.
[1144] (2006) 59 ACSR 252.

(c) Dissemination Period

The "reasonable period" requirement was included to 'prevent an insider getting an unfair start on other market participants.'[1146] This requirement allows a cross section of investors time to absorb the information before the insider is permitted to trade. Policy makers and legislators have generally declined to provide bright line guidance on the required period of time.[1147] The means of dissemination, complexity of the information, trading volumes, investor interest in the relevant security, and market conditions, all impact on the speed and accuracy of the absorption of information into security prices. When information is not released through the ASX, investors may not know that particular information is available or where it is available.[1148]

When materially price-sensitive information is released through the ASX, the relevant securities are suspended from trading for ten minutes after release to allow investors to absorb the information prior to trading. However, some companies prefer to release significant news, such as half yearly or preliminary final results, outside of market trading hours to allow more complete absorption by the market prior to trading.[1149]

2 *Readily Observable Matter and Analysis Tests*

The readily observable matter and analysis carve-outs were drafted to ensure that individuals are not penalised for using initiative and diligence. Investors are permitted to trade on information garnered from astute observation or from independent research of "generally available" information.[1150] More specifically, the readily observable matter exclusion seeks to ensure that trading is permitted on information or facts that are 'directly observable in the public arena' even when the information does not fall within the published information test.[1151] The analysis exclusion seeks to ensure that trading is permitted on information that is based on 'deductions and conclusions which

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[1145] *Riley v Jubilee Mines NL* (2006) 59 ACSR 252, 267.
[1146] Explanatory Memorandum, above n 53, [328].
[1147] Griffiths Report, above n 56, [4.5.8]; *R v Firns* (2001) 38 ACSR 223, 233; Lyon et al, above n 488, 36.
[1148] Robert Baxt, Ashley Black and Pamela Hanrahan, *Securities and Financial Services Law* (6th ed, 2003) 521. See also Wang et al, above n 598, Vol 1 [4-78, 4-79].
[1149] Ten minutes is generally not sufficient, even for the most diligent and skilled investors, to fully absorb complex earnings releases.
[1150] Explanatory Memorandum, above n 53, [326-327].
[1151] Explanatory Memorandum, above n 53, [326, 328]; *R v Firns* (2001) 38 ACSR 223, 233. The Explanatory Memorandum suggests that without the readily observable exception, a person could be liable for insider trading by trading in securities on the basis of an observation of excess stocks in a yard.

investors, brokers or other market participants may make based on independent research of generally available information'.[1152]

Uncertainties on the nature and scope of the "generally available" tests are highlighted in insider trading and continuous disclosure case law.[1153]

3 *Generally Available Case Law*

(a) R v Hannes[1154]

Hannes was employed as an executive director of Macquarie Bank. The bank was advising on a takeover of TNT. However, Hannes was not part of the takeover team and he had no authority to access the confidential bid related information.

On 17 September 1996, a person identifying himself as M Booth instructed Ord Minnett brokers to acquire purchase options in TNT at a strike price of $2 with a maturity date in November 1996. On 2 October 1996, the takeover for TNT was announced at a share price of $2.45, resulting in a profit on the options in the order of $2 million. On 11 August 1999, Hannes was convicted of several charges including one of insider trading. Hannes successfully appealed to the New South Wales Court of Criminal Appeal (CCA) and the appeal was allowed with a new trial ordered on all counts.[1155] However, Chief Justice Spigelman found, with Justices Studdert and Dowd agreeing, that there had been no error of law in relation to the information, readily observable matter, generally available and materiality elements of the insider trading charge.[1156]

[1152] Explanatory Memorandum, above n 53, [327]; *R v Firns* (2001) 38 ACSR 223, 233.
[1153] Lyon et al, above n 488; Gething, above n 622, 613-614. Gething provides the example of a person who discovers the existence of mineral deposits under land owned by a listed company using metal detection machines from a plane. He suggests that this investor may be liable if he or she buys shares in the listed company because the information is not readily observable in the public arena. Whether Gething's conclusion is correct depends on the interpretation of what is in the public arena. The information may be readily observable on the basis that other investors are able to fly over the land within public airspace and to make the same observations.
[1154] *R v Hannes* (2000) 36 ACSR 72; *R v Hannes* (2002) 43 ACSR 508.
[1155] *R v Hannes* (2000) 36 ACSR 72, 72.
[1156] *R v Hannes* (2000) 36 ACSR 72, 73. Hannes was found guilty of insider trading at the retrial by the New South Wales Supreme Court presided over by Justice James and was sentenced to 2 years and 6 months imprisonment. After serving this sentence, Hannes appealed the convictions and sentences, but the New South Wales Court of Criminal Appeal dismissed the appeal on all counts.

Chief Justice Spigelman indicated that brokers' reports that referred to TNT as a takeover candidate prior to the relevant insider trading event were deductions, conclusions, and inferences made from matter that was generally available.[1157] However, the brokers' reports and newspaper articles on TNT's vulnerability to a take-over and the estimated valuations were not relevant to the issue of generally availability.[1158] The broker's analyses were not of the character of the particularised information because the information in the brokers' reports was not about the *prospect* that there *would be* a takeover at a price above $2. Furthermore, there was no evidence indicating the information that TNT had appointed Macquarie Capital Finance as advisers was "generally available".[1159]

(b) R v Firns[1160]

Carpenter Pacific Resources (C) was a listed company on the ASX. The main business of C was holding exploration licenses in Papua New Guinea, including one held through a subsidiary M. In December 1993, the Papua New Guinea Government introduced a new regulation that effectively stripped away most of the value of the exploration licence of M.[1161] In March 1994, M appealed the validity of the regulation in the courts in Papua New Guinea and lost at first instance.[1162] M then appealed to the Supreme Court of Papua New Guinea. On Friday, 28 July 1995 at around 9.30 am, the Supreme Court of Papua New Guinea announced in open court that the appeal had been upheld and the regulation was invalidated.[1163]

Firns was notified of the court decision by his father, a director of C, around 10.00am on 28 July. He purchased two lots of shares in C the same day. C notified the market of the court decision through the ASX on Monday 31 July at around 1.30 pm.[1164]

Firns was convicted in the New South Wales District Court of two insider trading charges under s 1002 G of the *Corporations Law*. In a subsequent appeal to the New South Wales Court of Criminal Appeal, the key issues were, first, whether the

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[1157] *R v Hannes* (2000) 36 ACSR 72, 118.
[1158] *R v Hannes* (2000) 36 ACSR 72, 122.
[1159] *R v Hannes* (2000) 36 ACSR 72, 118.
[1160] (2001) 38 ACSR 223.
[1161] *R v Firns* (2001) 38 ACSR 223, 223.
[1162] *R v Firns* (2001) 38 ACSR 223, 223.
[1163] *R v Firns* (2001) 38 ACSR 223, 223.
[1164] *R v Firns* (2001) 38 ACSR 223, 223.

information traded on by Firns was “generally available” under the readily observable matter test, and secondly, whether the trial judge had misdirected the jury by informing it that the issue was whether the court decision was readily observable in Australia.[1165]

R v Firns: Key Facts

Date	Facts	Carpenter Share Price
28 Jul 1995 (Fri)	At 10.30 am Firns, the son of an executive director of C, used a false identity to purchase 400 000 shares in Carpenter in his wife’s name at 2.5 cents per share and 338 000 shares in the name of a friend at 3 cents per share.[1166]	2.5 - 3 cents per share (“cps”)
31 Jul 1.30 pm (Mon)	Carpenter notified the ASX of the Supreme Court of Papua New Guinea judgment.[1167]	
Mid-Aug 1995	The 738 000 shares were sold for 9-12 cents per share[1168]	9-12 cps

Mason P and Justice Hidden held that the decision of the Supreme Court of Papua New Guinea was readily observable because ‘everything that happens in open court is capable of being observed and reported upon’.[1169] The ‘information embodied in the … judgment was available, understandable and accessible to a significant group of the public, that is, those present and capable of being present in court.’[1170] Justice Carruthers dissented from this finding.

Mason P acknowledged that the primary policy rationale for introducing insider trading regulation was to ensure that the market operates fairly with all participants having equal access to relevant information. His Honour noted the view of the Griffiths Committee that even if insider trading enhances market efficiency by faster dissemination of information, the negative effects of insider trading on investor confidence outweigh these efficiency benefits.[1171] However, Mason P suggested that the clear initial policy approach to promote market fairness was obscured in the legislative

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[1165] *R v Firns* (2001) 38 ACSR 223, 223.
[1166] *R v Firns* (2001) 38 ACSR 223, 223.
[1167] *R v Firns* (2001) 38 ACSR 223, 223.
[1168] *R v Firns* (2001) 38 ACSR 223, 223.
[1169] *R v Firns* (2001) 38 ACSR 223, 238. Mason P cites the Shorter Oxford Dictionary definition of “public”: ‘open to general observation, existing, done or made in public, manifest, not concealed’.
[1170] *R v Firns* (2001) 38 ACSR 223, 236.
[1171] *R v Firns* (2001) 38 ACSR 223, 231.

process. The drafters who added the phrase "readily observable matter" to the insider trading provisions intended to promote economic efficiency.[1172]

More specifically, the readily observable matter test was added to the "generally available" definition because of concerns that under the draft definition 'information directly observable in the public arena would not be regarded as generally available, as it had not been "made known".'[1173] It was considered that a person could be liable for insider trading when trading in securities on the basis of an observation that the company had excess stocks in a yard.[1174] However, 'it was not intended that the provisions would regard as inside information such things as deductions and conclusions which investors, brokers or other market participants may make based on independent research of generally available information.'[1175] This reflected concerns by the Griffiths Committee and Parliament not to penalise individual initiative and diligence and to encourage cleverness, swiftness and efficiency.[1176]

Mason P indicated that the words "readily observable matter" are opaque, and legislative 'assistance is blurred by the conflicting [equal access and market efficiency] goals embedded in the essentially two-pronged definition of' "information generally available"'[1177] The Parliament therefore 'left the courts with a scheme embodying the ambiguous embrace of the market fairness (equal access) and market efficiency theories,'[1178] resulting in a difficult interpretative task.[1179] Ultimately, Mason P concluded that the market fairness or equal access paradigm could not be the sole basis for interpretation of the criminal insider trading provisions. Instead, a broad interpretation of the "generally available" provision was required to promote economic efficiency.[1180]

Justice Carruthers in dissent suggested that Mason P was interpreting the phrase "readily observable" matter as "readily available" material. His Honour pointed out

[1172] *R v Firns* (2001) 38 ACSR 223, 234.
[1173] *R v Firns* (2001) 38 ACSR 223, 233.
[1174] *R v Firns* (2001) 38 ACSR 223, 233.
[1175] *R v Firns* (2001) 38 ACSR 223, 233.
[1176] *R v Firns* (2001) 38 ACSR 223, 234.
[1177] *R v Firns* (2001) 38 ACSR 223, 234.
[1178] *R v Firns* (2001) 38 ACSR 223, 230.
[1179] *R v Firns* (2001) 38 ACSR 223, 234.
[1180] *R v Firns* (2001) 38 ACSR 223, 232.

that '[m]aterial may be available but not observable.'[1181] Further, the insider trading provisions were undoubtedly designed to protect investors by promoting equal access to information for investors.[1182] There is a 'remarkably high percentage of the Australian public who hold securities … Shareholders in companies listed on the … ASX cannot now be regarded as a small elite section of the Australian community.'[1183] Within this framework, the legislature did not intend members of the public to have to meticulously search for relevant investor information. No evidence was presented at the trial confirming that the Papua New Guinea Supreme Court judgment was posted on the internet.[1184] Justice Carruthers concluded that if the provisions are interpreted to mean that information need not be generally available to the Australian investing public, the protection offered to the public by the provisions is 'nugatory'.[1185]

Neither the ASX nor ASIC pursued Carpenter for a possible breach of its continuous disclosure obligations relating to the delay in notifying the ASX about the court judgment.

Since the *R v Firns* decision, there has been considerable uncertainty on the issues of when information is readily observable and how, where and by whom information must be observable.[1186]

(c) R v Rivkin[1187]

On 30 July 2003, a jury found Rivkin guilty of a charge of insider trading under s 1002G(2). The information which was the subject of the charge was conveyed in a telephone conversation on the morning of 24 April 2001 between Rivkin and McGowan. McGowan, the Executive Chairman of Impulse Airlines, gave evidence that he informed Rivkin during the telephone call about a proposed merger of the Impulse business with Qantas because his purchase of a property from Rivkin was subject to approval of the merger by the Australian Competition and Consumer Commission.

[1181] *R v Firns* (2001) 38 ACSR 223, 243.
[1182] *R v Firns* (2001) 38 ACSR 223, 240.
[1183] *R v Firns* (2001) 38 ACSR 223, 240.
[1184] *R v Firns* (2001) 38 ACSR 223, 243.
[1185] *R v Firns* (2001) 38 ACSR 223, 242.
[1186] CAMAC, above n 71, 12.
[1187] *R v Rivkin* (2003) 45 ACSR 366; *R v Rivkin* [2004] NSWCCA 7; *R v Rivkin* (2004) 59 NSWLR 284.

However, he indicated that he advised Rivkin that he could not trade in Qantas shares until the deal was publicly announced.[1188]

Following the telephone call, Rivkin directed a Stock Exchange Automated Trading System operator, Mr Kerstens, to purchase 50 000 Qantas shares on behalf of Rivkin Investments.[1189] On 30 April, prior to the public announcement of the merger through the ASX, Mr Rivkin instructed Mr Kerstens to sell the Qantas shares at $2.85, resulting in a trading profit of $2 664.94.[1190]

Rivkin appealed against his conviction and sentence to the Court of Criminal Appeal, but the appeal was dismissed. In its judgment, the court stated that the 'Crown had to establish that the information was not generally available, and, in the course of doing so, it had to exclude the existence of deductions, conclusions or inferences …'[1191] This required circumstantial proof. The Crown was able to provide this by pointing to the 'absence of any information in relation to "the deal" in press reports, media releases and analysts' reports of the kind that might have been expected, had the information been generally available … and to the price movements on 1 May'[1192] following the public announcement of the merger. The Crown was also entitled to rely on evidence concerning the confidentiality of the negotiations.[1193]

(d) ASIC v Citigroup[1194]

The Australian arm of Citigroup Inc (Citigroup) included investment banking and equities trading operations, with a Chinese wall established between these two divisions.[1195] The investment banking division was an advisor to Toll Holdings Ltd (Toll) on a takeover bid of Patrick Corporation Ltd (Patrick). Manchee, an employee of the equities trading division, purchased shares in Patrick for Citigroup's own account a day before the planned announcement of the bid through the ASX. When employees of the investment banking division became aware of these purchases, Manchee was

[1188] *R v Rivkin* [2004] NSWCCA 7, [4, 17].
[1189] *R v Rivkin* [2004] NSWCCA 7, [35].
[1190] *R v Rivkin* [2004] NSWCCA 7, [40].
[1191] *R v Rivkin* [2004] NSWCCA 7 [178].
[1192] *R v Rivkin* [2004] NSWCCA 7 [179].
[1193] *R v Rivkin* [2004] NSWCCA 7 [179].
[1194] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427.
[1195] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 427.

instructed to stop further buying of Patrick shares. Manchee responded by selling the Patrick shares purchased earlier that day.[1196]

The ASIC initiated a number of claims against Citigroup, including two alleged insider-trading contraventions under s 1043A of the Act. The first of these claims alleged that the instruction given to Manchee to discontinue buying Patrick shares constituted information under s 1042A and the subsequent sales of the Patrick shares constituted insider trading by Citigroup. The second alleged that because senior officers of Citigroup knew about the likely takeover bid by Toll of Patrick, knowledge of Manchee's trading in the Patrick shares was attributable to Citigroup so as to make the company liable for insider trading.[1197]

Justice Jacobsen dismissed both of the insider-trading claims in the Federal Court of Australia. The first claim failed because Manchee was not an officer of Citigroup, and in any event, the claim had not established that Manchee traded with knowledge that Citigroup was acting for Toll in relation to the Patrick takeover. The second claim failed because at the time of the Manchee sales, Citigroup had Chinese walls in place that satisfied the requirements of s 1043F, a defence provision.[1198]

ASIC v Citigroup: Key Facts

Date	Facts	Patrick Share Price
8 August 2005	Engagement of Citigroup as joint adviser on takeover.[1199]	
18 August 2005	The *Sydney Morning Herald* and *The Age* newspapers reported rumours of a possible takeover of Patrick by Toll. Mr Little, the CEO of Toll, declined to comment on the speculation.[1200] Virgin (a subsidiary of Patrick) announced a profit downgrade to ASX. Patrick also announced a downgrade.[1201]	Intraday high $6.13, $5.70 at close Traded volume 9 million
19 August 2005 (Fri)	The *Australian Financial Review* indicated the Toll/ Patrick bid rumours would not go away, and Little had not denied the rumours. Bloomberg, Dow Jones & IRESS also highlighted the	$5.75 at open/ 6.45 at close Traded volume 20.5 million

[1196] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 427.
[1197] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 428.
[1198] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 428.
[1199] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 435.
[1200] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 451.
[1201] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 451.

	continued rumours.[1202]	
22 August 2005 (Mon)	Toll announced its offer for Patrick, stating the value equated to $6.70 based on the closing prices on 19 Aug for Toll and Virgin, and emphasising the premium of 17.5 percent to the closing price on 18 August prior to the bid rumours.[1203]	Bid value $6.70

Justice Jacobson confirmed that the 'test of whether material is readily observable is not whether the particular matter was widely observed but whether it could have been'.[1204] According to Justice Jacobsen

> [t]he question of whether a matter is "readily observable" is one of fact. Observability does not depend on proof that persons actually perceived the information; the test is objective and hypothetical … [Futher, where] the information is a "matter of supposition", the question of whether it is generally available depends on whether the supposition is capable of being made or drawn by other investors based on readily observable matter or information that has been made known …[1205]

In addition, s 1042C(1)(c) does not require that 'the market has had a reasonable time to absorb the information.'[1206]

To determine what a reasonable and diligent investor would have been able to observe or deduce from readily observable material prior to the alleged insider trading, Justice Jacobsen considered contemporaneous reports, speculation and rumours, and the levels and prices of trading in the stock. His Honour concluded that while the supposition 'that Citigroup was acting for Toll was not generally available, … if it had been available, … it would not have had the requisite material effect'.[1207] Justice Jacobsen indicated that such investors could be expected to have known there was a substantial likelihood of a takeover of Patrick, based on the bid rumours in the newspapers and in other professional outlets, a rally in the share price, and increased trading volumes in Patrick's stock on the day before the bid was announced through the ASX.[1208]

[1202] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 451-452.
[1203] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 454.
[1204] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 495-496.
[1205] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 495.
[1206] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 496.
[1207] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 498.
[1208] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 496-498.

The ASX did not pursue Toll for any breach of its continuous disclosure obligations by not notifying the market earlier of its proposed bid for Patrick.[1209] An ASIC file of a conversation with officers of the ASX indicated they were concerned on 19 August 2005 that confidentiality may have been lost under ASX Listing Rule 3.1A.2.[1210] However, any breach of the continuous disclosure obligations was considered by the ASX and ASIC to have been "inadvertent".[1211]

(e) ASIC v Macdonald (No 11)[1212]

The facts in *ASIC v Macdonald (No 11)* are complex and the case involved a range of charges. The continuous disclosure outcomes were outlined earlier in the enforcement section. Justice Gzell concluded that the "generally available" element relating to the DOCI Information was not significantly contested. His Honour stated that there

> seems little doubt that on 15 February 2001 the DOCI Information was not generally available. There is no reference to it in the communication strategy … There was no reference to it in either the Draft …. or the Final ASX Announcement. There was no reference to it in any of the materials … for the press conference…. It was not mentioned during the press conference [and] [n]one of the media articles and analysts' reports … made any mention …[1213]

More notably, His Honour stated that

> information on an ASIC register that might, on payment of a fee, be searched and might reveal relevant information if the searcher was sufficiently astute to consider name changes and conducted a search for the ABN of JHIL, was not readily observable matter. The legislation aimed at preventing selective disclosure of market sensitive information should not be understood as treating as readily observable a complex series of filings by a private company that had changed its name on a number of occasions … a complex series of filings with ASIC is not presented in a manner likely to be brought to the attention of the investing public, entitled to assume that information will be made available in accordance with the listing rules.[1214]

[1209] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 454.
[1210] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 454-455.
[1211] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 454.
[1212] [2009] NSWSC 287.
[1213] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 [485].
[1214] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 [1133-1134].

As previously noted, the courts have indicated that the "generally available" and materiality tests overlap.[1215]

B Materiality Requirement

Section 1042A of the insider trading provisions and s 674(2) of the continuous disclosure provisions apply to information that a reasonable person would expect to have a material effect on the price or value of the securities. Under s 1042D, information is "material" if the information 'would, or would be likely to, influence persons who commonly acquire … financial products in deciding whether or not to acquire or dispose of the … products.'[1216] Similarly, under s 677, the materiality test is satisfied when

> a reasonable person would… expect [the] information to have a material effect on the [security] price … [and] the information would, or would be likely to, influence persons who commonly invest in the securities in deciding whether to acquire or dispose of the … securities.[1217]

The statutory tests in ss 677 and 1042D are objective. However, the materiality tests involve questions of fact and law. In *Flavel v Roget*,[1218] Justice O'Loughlin indicated that the type of information that is material depends on the characteristics of a particular company, stating that

> much will depend upon the identity of the particular company; what one company should advise the Stock Exchange might not have to be advised by a second company; what should be advised by a company at one stage in its career might not have to be advised at another stage of its career because of changed circumstances.[1219]

[1215] *R v Hannes* (2000) 36 ACSR 72, 136; *R v Rivkin* [2004] NSWCCA 7 (5 February 2004) [196]; *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 498.

[1216] *Corporations Act 2001* (Cth) s 1042D.

[1217] *Corporations Act 2001* (Cth) s 677.

[1218] *Flavel v Roget* (1990) 1 ACSR 595. Justice O'Loughlin reviewed the conditions under which companies were required to inform the ASX of material information under ASX Listing Rule 3A(1). A company director, Roget, was charged with failing to act honestly in his duties as a director because he had failed to supply the Stock Exchange with details of a variation to a firearms contract. However, a copy of the amended contract was supplied to the Corporate Affairs Commission. Justice O'Loughlin agreed that companies are generally required to disclose material items in a document to the stock exchange. However, the appeal was dismissed because the prosecution had not proven a dishonest or intentional concealment of the facts.

[1219] *Flavel v Roget* (1990) 1 ACSR 595, 602-603.

The materiality tests include the likely effects of disclosure of the information on investors and on the security price. The information must be important enough to affect the security price, as well as sufficiently unexpected that it has not already been incorporated into the security price.[1220]

1 *Potentially Material to Investors and Share Price*

Justice Cooke stated in *Coleman v Myers*[1221] that determining whether matters are sufficiently material to require disclosure involves an evaluation of both the likelihood of the event occurring and the magnitude of the effect of the event on the company's performance. Information is not material if the likely occurrence and magnitude are low. However, information may be found likely to materially affect the investment decisions of those commonly investing in the securities even if the effect of the disclosed information on the share price eventually turns out to be immaterial.[1222]

In *ICAL v County Natwest Securities and Transfield (Shipbuilding) Pty Ltd*,[1223] Justice Bryson found the information was not important or valuable and would therefore have little material effect on the relevant share price. Similarly, in *Riley v Jubilee Mines NL*,[1224] the information did not satisfy the materiality requirement. In contrast, knowledge of an intended application to convert notes at a ratio significantly different from market expectations,[1225] a proposed takeover,[1226] a future earnings announcement,[1227] a pending liquidation,[1228] and a Court decision in relation to an exploration license,[1229] have been held to be material by the courts. In *R v Rivkin*,[1230]

[1220] Expert evidence is generally required to determine materiality.
[1221] *Coleman v Myers* [1977] NZLR 225.
[1222] *Coleman v Myers* [1977] NZLR 225.
[1223] *ICAL v County Natwest Securities and Transfield (Shipbuilding) Pty Ltd* (1988) 6 ACLC 467. See also *Westgold Resources NL v St George Bank Ltd* (`998) 29 ACSR 396. In the *Westgold* case, Justice Anderson concluded that the alleged inside information, namely put options at a price well above the existing share price, could not materially influence the share price. His Honour indicated that the connection between information which might adversely affect the market price of shares trading at 10 cents and a decision to exercise a put option at 40 cents was remote.
[1224] (2006) 59 ACSR 252.
[1225] *Ampolex Ltd V Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* (1996) 14 ACLC 1514.
[1226] *Australian Securities and Investments Commission v Petsas* (2005) 23 ACLC 269; *R v Frawley* [2005] NSWSC 585; *R v Rivkin* (2003) 45 ACSR 366; *R v Hannes* (2002) 43 ACSR 508; *R v Doff* (2005) 54 ACSR 200.
[1227] ASIC, 'Former Harts Executive Director Jailed For Insider Trading' (Press Release, 17 December 2004) 04-415; *R v McKay* (2007) 61 ACSR 470; ASIC, 'Brisbane Research Analyst Pleads Guilty to Insider Trading Charge' (Press Release, 6 June 2007) 07-154.
[1228] *R v Hall* (No 2)[2005] NSWSC 890; ASIC, 'Perth Man Sentenced On Insider Trading' (Press Release, 1 August 2003) 03-240.
[1229] *R v Firns* (2001) 38 ACSR 223.
[1230] [2004] NSWCCA 7 (5 February 2004) [132, 134].

the Court indicated that information is more likely to be material when the information source is considered by investors to be reliable or credible.[1231]

Finally, while a new piece of available information may be immaterial or not price sensitive in itself, the additional information may complete a mosaic of information, which as a whole constitutes material information.[1232] ASIC indicates that 'there is not always a clear line between what is price sensitive and what is not … A particular piece of information may, when fitted together with other information … affect the company's share price'.[1233] In the US, information is generally considered to be material under securities law if there is 'a substantial likelihood' that a reasonable investor would view the information as 'having significantly altered the "total mix" of information … available.'[1234]

In *ASIC v Macdonald (No 11)*,[1235] Mr Humphris, an expert witness for the prosecution argued that the aggregate net effect of a range of items was such that a reasonable person would expect them to have a positive material effect on the value and price of JHINV's shares.[1236] Justice Gzell held that criticism of these factors individually did not address the accumulation.[1237] His Honour also stated that 'the question is not an *ex post facto*, whether the market did react to the disclosure of the information. The question is whether a reasonable person would expect the information to have a material effect on the market price.'[1238]

2 *Incorporated within Share Price*

Chief Justice Spigelman confirmed in *R v Hannes* that while the prospect of something may have a lesser effect on a security price than the actuality, what actually happened is still relevant to an assessment of the materiality of the prospect.[1239] If a significant level of probability of a take-over had already been factored into the share price, then

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[1231] *R v Rivkin* (2004) 59 NSWLR 284 [132, 134].
720-722, 730.
[1232] Golding et al, above n 616, 392.
[1233] ASIC, above n 177, 13.
[1234] *Basic Inc v Levinson*, 485 US 224, 232 (1988). See also *TSC Industries Inc v Northway*, 426 US 438 (1976); Notably, under Regulation Fair Disclosure, an issuer is not implicated when they disclose immaterial information whose significance is discerned only by the analyst.
[1235] [2009] NSWSC 287.
[1236] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 [1109].
[1237] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 [1117].
[1238] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 [1123].
[1239] *R v Hannes* (2000) 36 ACSR 72, 121.

that may have made a difference to the materiality issue.[1240] In *R v Rivkin,* the information was material because 'the fact of the price rise, after the announcement, meant the market had not factored in the disappearance of one of the players.[1241] In contrast, in *ASIC v Citigroup,* Justice Jacobsen found that an action for insider trading would have failed under the materiality test, because at the time of the alleged insider trading, the share price reflected knowledge of the takeover. The 'share price had already moved to a price which reflected a substantial likelihood of a takeover [from Toll], although "not necessarily with Citigroup acting for the bidder."'[1242]

C Regulatory Uncertainties Critique and Conclusion

'The secret of business is to know something nobody else knows'[1243]

As discussed in Chapters Two and Three, the primary rationales supporting the Australian company disclosure and insider trading regimes are market fairness and market efficiency. However, the debates on the content of the rationales, and how they are intended to operate independently or in tandem, have become confused. I illustrate the confusion by reviewing commentary on the rationales in policy documents, published scholarly material, and case law. The case law analysis encompasses discussion on the "generally available" and materiality provisions.

1 *Policy Commentary on the Efficiency and Fairness Rationales*

The Griffiths Committee that reviewed insider-trading policy in 1989 rejected Manne's arguments that insider trading promotes efficiency and that it is a legitimate reward for enterprise. Moreover, it indicated that even if insider trading enhances market efficiency by faster dissemination of information, the negative effects of insider trading on investor confidence outweigh these efficiency benefits.[1244] The report identified the promotion of economic efficiency through improved investor confidence in the integrity of the market as one of the benefits of insider trading regulation.[1245]

[1240] *R v Hannes* (2000) 36 ACSR 72, 136.
[1241] *R v Rivkin* [2004] NSWCCA 7 [196].
[1242] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 497-498.
[1243] Aristotle Onassis (1906-1975).
[1244] Griffiths Report, above n 56.
[1245] Griffiths Report, above n 56, [3.3.4].

The 2001 CASAC insider trading report described the market fairness rationale in terms of an unerodable information advantage approach.[1246] The report suggested that the insider trading prohibition does not seek to eliminate the risks or trading advantages of participants due to superior skill, time, or commitment - the prohibition only applies to trading on price sensitive information that all market participants cannot gain access to by 'ordinary research, skill or analysis.'[1247]

The Explanatory Memorandum to the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* stated that

> [i]nadequate disclosure has the potential to discourage investor participation in securities markets. This in turn could reduce the liquidity of these markets and hence the efficiency of the price discovery process.[1248]

As outlined in Chapter Two, subsequent Australian policy material affirms that the primary rationales supporting the insider trading and company disclosure regulation are market fairness and market efficiency.[1249] The policy commentary consistently emphasises equal access and acknowledges the links from equal access and investor confidence in the integrity of the market to efficiency outcomes. Apart from the Griffiths Report that identified the promotion of economic efficiency as a benefit of insider trading regulation, policy makers refer to price or market efficiency concepts.

2 *Published Scholarly Commentary on the Efficiency and Fairness Rationales*

As outlined in Chapter 3, most published Australian scholarly commentary argues that the equal access and market efficiency rationales are in conflict and that equal access needs to be restricted or traded off to some extent to ensure efficiency. These parties don't explain what the conflict is or how the two rationales should be balanced. Their arguments appear to be founded on the Manne price signalling theory. As explained in Chapter Three, Manne argued in the 1960s that insider trading should be permitted

[1246] CASAC, above n 61, 15.
[1247] CASAC, above n 61, 15. This market fairness rationale may derive from, or be based on, the unerodable information advantage approach developed by Brudney in the US. The Brudney model was outlined in Chapter Three.
[1248] Explanatory Memorandum, above n 53, [4.219].
[1249] Commonwealth, above n 177, 103; Commonwealth, above n 5, 2.

because it provides price signals to the market that enhance price efficiency. The Manne arguments are discussed further within the next section.

3 *Case law on the Efficiency and Fairness Rationales*

In *R v Firns,*[1250] Mason P suggested the clear initial policy approach of the insider-trading regime to promote equal access to information became badly blurred in the legislative process.[1251] His Honour cited the Manne theory in defence of insider trading and suggested the drafters who inserted the "readily observable matter" carve-out intended to include the Manne theory or principles into the provision in order to promote economic efficiency.[1252] The market fairness or equal access rationale could not be the sole basis for interpretation of the criminal insider trading provisions. Instead, a broad interpretation of the term "generally available" was required to promote economic efficiency.[1253] His Honour indicated that the equal access and market efficiency goals embedded in the essentially two-pronged definition of "generally available" information are incompatible.[1254] The parliament therefore left the courts with a scheme embodying the ambiguous embrace of the market fairness (equality of access) and market efficiency theories, resulting in a difficult interpretative task.[1255]

Mason P doesn't outline or explain the Manne theory in *R v Firns.* As outlined in Chapter Three, Manne argues that permitting insider trading promotes efficiency because trades based on inside information provide timely signals that enhance the accuracy of security prices. However, when systemic trading on inside information is permitted, the price signals are noisier and the factoring of news into share prices is slower than when the information is widely disseminated.[1256] It takes a period of time for share prices to incorporate new information, and during this period, uninformed

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[1250] (2001) 38 ACSR 223.
[1251] *R v Firns* (2001) 38 ACSR 223, 231.
[1252] *R v Firns* (2001) 38 ACSR 223, 234.
[1253] *R v Firns* (2001) 38 ACSR 223, 234.
[1254] *R v Firns* (2001) 38 ACSR 223, 231. See also *Ampolex Ltd V Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* (1996) 14 ACLC 1514, 1522 (Justice Rolfe); *Exicom Ltd v Futuris Corporation Ltd* (1995) 18 ACSR 404, 407-409 (Justice Young).
[1255] *R v Firns* (2001) 38 ACSR 223, 234.
[1256] Schotland, above n 586, 1440-1442, 1448-1449**;** Mendelson, above n 586, 489**;** Brudney, above n 67, 334; Barry, above n 583, 1329; Levmore, above n 586, 149; Cox, above n 536, 643, 648, Levmore, above n 583, 103-104; Black, above n 583, 219; Krawiec, above n 527, 496-498; Ayres et al, above n 473, 15, 23.

investors are not able to distinguish between trading and price movement based on credible private information and speculative trading activity. As a result, the unexplained trading tends to encourage further speculative trading, leading to an overall reduction in share price accuracy and increased price volatility, especially when the speculation is incorrect.

In any event, information that is revealed (or that might be readily observable) through trading on inside or selectively disclosed information often becomes public soon after the insider trading occurs. When this arises, any price or market efficiency gains are limited.[1257] Furthermore, even if one accepts the Manne argument that insider trading allows earlier incorporation of the relevant information into the share price, and that insider trading is the best way to optimise market efficiency, the effects on real capital allocations (and not merely secondary trades) are likely to be minimal.[1258]

No scholarly empirical research could be found which suggests that the long-term efficiency of markets or economies is enhanced by permitting systemic trading on private (inside or selectively disclosed) information. Instead, the insider trading research outlined in Chapter Three suggests that any short-term price efficiency gains arising from insider trading are outweighed over the long run by increases in market volatility and reductions in other efficiency measures such as bid ask spreads, liquidity, price accuracy and capital costs.[1259] Moreover, the global empirical research suggests that markets with enforced insider trading laws benefit from enhanced liquidity, more informative stock prices, lower costs of capital and higher economic returns.[1260] The combined study findings, which suggest that insider trading regulation enhances long-term market and economic efficiency, formed the basis of the Griffiths Committee recommendations in 1989.

[1257] David Pompillo, 'On the Reach of Insider Trading Law' (2007) 25 *Company and Securities Law Journal* 467, 472.
[1258] Klock, above n 584, 304.
[1259] See, eg, Cornell et al, above n 641, 1055; Fishe et al, above n 643, 461-462, 481; Du et al, above n 646, 916, 940.
[1260] See, eg, Bhattacharya et al, above n 645; Beny, above n 647.

4 *Case law on the Readily Observable Matter Carve-out*

Mason P and Justice Jacobsen acknowledged in *R v Firns* and *ASIC v Citigroup* respectively that the "readily observable matter" carve-out was included in s 1042C(1) so as not to penalise individual initiative and diligence.[1261] In *R v Firns,* Mason P held that the judgment was readily observable because the court was open to the public, albeit the court was in Papua New Guinea. Justice Jacobsen held that information about the takeover bid in *ASIC v Citigroup* was readily observable (prior to an announcement on the bid through the ASX) on the basis of independent research of the speculation in news sources and the unusual price movement and trading volumes in the Patrick securities. However, the extent of initiative and diligence or independent research done by investors who make profits based on private advance knowledge of takeover bids is limited. Further, it is not clear how investors who have not been publicly informed about a bid or a potential bid are supposed to distinguish between speculation and fact. An almost endless number of examples can be cited when there are significant spikes or volatility in share prices or trading volumes based on groundless rumours or speculation. In practice, institutional investors are often able to find out who is behind heavy trading prior to a public announcement. However, intermediaries who have private knowledge about a bid are unlikely to share this knowledge with retail clients given the confidential nature of the information involved.

Justice Gzell explicitly noted in *ASIC v Macdonald (No 11)*[1262] that the public are entitled to assume that information will be made in accordance with the ASX listing rules.[1263] This may reflect a differing judicial interpretation of the "generally available" carve-outs in the continuous disclosure regime from the insider trading rules.

5 *Materiality Test*

In *R v Hannes,*[1264] Chief Justice Spigelman stated that if a significant probability of a take-over had already been factored into the share price, that may have made a

[1261] *R v Firns* (2001) 38 ACSR 223; *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 496.
[1262] (2009) 71 ACSR 368.
[1263] *ASIC v Macdonald (No 11*) (2009) 71 ACSR 368 [1134]
[1264] *R v Hannes* (2000) 36 ACSR 72.

difference to the materiality issue.[1265] In *R v Rivkin,*[1266] the court held that the relevant information was immaterial 'if prior to its communication, the market had factored in a good chance that due to the price war, one of the players would disappear.'[1267] In *ASIC v Citigroup,*[1268] Justice Jacobsen found that an action for insider trading would have failed under the materiality test because the 'share price had already moved to a price which reflected a substantial likelihood of a takeover [from Toll], although "not necessarily with Citigroup acting for the bidder".'[1269] Thus, case law indicates that it is difficult to establish the materiality requirement once a *significant* level of probability,[1270] a *good chance,*[1271] or a *substantial* likelihood of a takeover[1272] is factored into the target company share price. In other words, the bid information may be deemed immaterial prior to a public announcement of the bid through the ASX and the *full* takeover premium being reflected in the target share price.

The takeover bids in all of these cases were announced shortly after the alleged insider trading occurred. In such instances, the trades in the short period prior to the public announcement result in a transfer of wealth among market participants, without any impact on capital allocations. The judicial interpretations of materiality in *R v Hannes, R v Rivkin* and *ASIC v Citigroup* may have been influenced by judicial developments in the US[1273] and the Australian scholarly commentary arguing for a greater emphasis on the efficiency goal.[1274] However, while potential outcomes arising from these materiality principles *may* enhance short-term price efficiency, empirical research suggests this approach is likely to reduce economic efficiency over the long run.

1265 *R v Hannes* (2000) 36 ACSR 72, 136.
1266 *R v Rivkin* (2003) 45 ACSR 366; *R v Rivkin* [2004] NSWCCA 7 (5 February 2004); *R v Rivkin* (2004) 59 NSWLR 284.
1267 *R v Rivkin* [2004] NSWCCA 7 [196].
1268 *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427.
1269 *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 497-498.
1270 *R v Hannes* (2000) 36 ACSR 72, 136.
1271 *R v Rivkin* [2004] NSWCCA 7 [196].
1272 *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 497-498.
1273 *In SEC v Ingoldsby,* (1990) Fed Sec L Rep (CCH) 95,351 (D Mass 1990), the relevant information was held to have not been published following articles in the *Wall Street Journal* and in the Dow Jones Broad Tape because the security price did not change significantly following the release of these articles. However, the information was held as publicly disseminated when the article appeared in a trade journal and the security price rose 20% on large volumes. Similarly, in *United States v O'Hagan*, 39 F.3d 641 (6th Cir 1999), the Eighth Circuit rejected O'Hagan's claim that the takeover information he possessed was already public because of media reports. The reports contained only speculation about a takeover whereas O'Hagan had first-hand concrete knowledge of the takeover. The Court noted that the market had not paid heed to the media reports as evidenced by the lack of any significant effect on the stock price.
1274 Semaan et al, above n 612, 220; Jacobs, above n 617, 235, 240; Loke, above n 628, 158, 171.

Consider a hypothetical insider trading case against institutional traders who were privately informed of the pending bid by Toll for Patrick. The bid was announced through the ASX on 22 August. The Patrick share price increased 13 percent from the close on 18 August to the close on 19 August and 5 percent from 18 August intra-day high to the close on 19 August. The price jumped a further 4 percent on 22 August when the bid was announced through the ASX.[1275] Under the materiality approach adopted by Justice Jacobsen, were the insiders who had actual knowledge of the Toll bid by lunchtime on 18 August free to trade without risk of insider trading liability because of the newspaper reports, rumours and increased trading volumes in the Patrick securities? Such traders could make very significant profits at the expense of uninformed traders. Alternatively, was the materiality of the bid information extinguished by lunchtime on 19 August? If so, there were still significant profits to be made.

The profits made on 18 and 19 August by informed traders may have amounted to many millions of dollars.[1276] It is likely that there was a transfer of at least some profits on a riskless basis to investors who knew of the Toll bid, from investors who traded on the basis that the companies were in compliance with their continuous disclosure obligations or who made their investment decisions based on a revised fundamental valuation taking into account the Patrick profit downgrade announced on 18 August.

A materiality determination based on a link between the relevant information and short-term security price movements is at best a simplistic view of market reality.[1277] Few experienced market practitioners would confidently assert that markets and individual security prices are typically efficient on a short-term basis. The relationship between price-sensitive information and share prices is complex. Share prices are impacted by many factors and information that is impounded into prices is constantly changing. It is often not possible to determine the impact of specific information on a security price.[1278]

[1275] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 451-452.
[1276] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 451-452.
[1277] Gething, above n 622, 619; Pompillo, above n 1257, 473.
[1278] Notably, in *Gambotto v WCP Ltd* (1995) 16 ACSR 1, the joint judgment by the High Court at pg 10 emphasised that a shareholder's interest cannot be valued solely by the current market value. A fair price for shares may depend on factors such as assets, market value, dividends, the nature of the corporation

However, under the established materiality principles, ASIC is only likely to initiate enforcement actions against individuals or persons very early in the leakage or tippee chains when the information can still provoke spikes in the security price or trading volume. The materiality test adopted in the insider trading case law may make it difficult for ASIC to successfully prosecute:

- market participants who trade in the securities of a company after partial movement in the prices or trading volumes;
- those who are able to manipulate their trading to achieve only gradual rather than sharp movements in the security price or trading volume; and
- where the relevant information is considered immaterial in itself but material when combined with other available information.

Justice Gzell confirmed in *ASIC v Macdonald (No 11)*[1279] that materiality may be shown through an accumulation of factors.[1280] His Honour also indicated that the question is whether a reasonable person would expect the information to have a material effect on the market price rather than whether the market reacted to disclosure of the information. However, the timing of the information was not "at issue" in this case.

In *R v Hannes, R v Rivkin* and *ASIC v Citigroup*, a reasonable person would prima facie have expected the takeover bid information to have a material effect on the target security price. However, the courts indicated that the materiality element depended on the extent to which the market already reflected the bid news. This leaves open the important issue of when private (inside or selectively disclosed) information about a pending bid becomes immaterial or readily observable due to unusual movements in the price or trading volume of the relevant security or speculation in news sources.

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and its likely future. Justice McHugh indicated at 18 that '[s]hare markets are driven by many factors, not all of them fair or rational … [there is] [n]o doubt in the long term the share price of a company will reflect its fundamental earnings capacity or value.' However, the intrinsic value of a company can remain unnoticed by the market for long periods of time. Justice McHugh suggested that share prices are far more volatile than the underlying assets that they represent because '[t]he "herd mentality" exists in the stock market as in other areas of life'. These judgments adopt a view that although markets are generally fundamentally efficient over the longer term, inefficiencies can arise during shorter periods. I agree with this view.

[1279] [2009] NSWSC 287.

[1280] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 [1117].

In practice, the amount of potential money to be made from advance private knowledge of takeovers bids is significant because a bid is nearly always made at a premium to the pre-bid target share price.[1281] However, as previously highlighted, the extent of initiative and diligence used, or independent research done, by investors who make profits based on private advance knowledge of bids is minimal, if any. Moreover, any trading on private knowledge of a takeover involves the infringement of property or confidentiality rights and depends upon a lawful privilege to which an outsider cannot acquire access. That is, the original source of the profits arises from the misappropriation of confidential information.[1282]

ASX Listing Rules 3.1 and 3.1A require disclosure of materially price-sensitive information once confidentiality is breached, when speculation is accurate, or when share price movements or trading volumes indicate a breach of confidentiality. Under any of these scenarios, a company must disclose that it is in discussion with a party about a bid or merger, and must provide appropriate details.[1283] Very similar rules exist in the US and Europe.[1284] However, these rules have not been tested in the Australian courts to date. Notably, ASIC opted to initiate insider-trading actions against Firns and Citigroup, rather than continuous disclosure actions against C and Citigroup for a possible breach of their obligations to immediately notify the ASX of the court judgment (in the case of C) and the takeover bid once confidentiality has allegedly been lost (in the case of Citigroup). As outlined earlier in this Chapter, continuous disclosure infringement notices have been issued against companies for delays in making an announcement through the ASX once confidentiality about a pending bid had allegedly been lost. However, none of these notices were challenged.

[1281] Barry Rider, *Insider Trading* (1983) 28; Anisman, above n 54, 1; Cole, above n 1126.
[1282] See *United States v O'Hagan* 521 US 642, 658-659 (1997). Trading on private knowledge about pending bids is a global problem. For instance, nearly two thirds of the 47 insider trading cases initiated by the SEC in the year ended 30 September 2007 involved merger and acquisition activity, with ten of these cases involving multiple deals or insider trading rings: ASIC, above n 177, 89.
[1283] The ASX Listing Rule 3.1A exception only applies when all three of the specified limbs have been satisfied. Disclosure or a trading halt is required: when confidentiality is breached; when speculation is accurate; or when share price movements indicate a breach of confidentiality: ASX Listing Rule 17.2; ASX Guidance Note 16*: Trading Halts* No 7; ASX, above n 177, Nos 53, 54; ASX Guidance Note 16*: Trading Halts* No 14.
[1284] New York Stock Exchange, *NYSE Listed Company Manual*, r 202.03 (Dealing With Rumors Or Unusual Market Activity); r 202. 05 (Timely Disclosure Of Material News Developments); NASDAQ, *Regulatory Requirements* July 2007, 8; New York Stock Exchange, *NYSE Listed Company Manual, Rule* 202.03 Dealing with Rumors or Unusual Market Activity Timely Disclosure of Material News Developments; NASDAQ, *Regulatory Requirements* (March 2009), 8-11; Financial Services Authority Handbook, *Disclosure and Transparency Rules*, DTR 2.2.9 (When To Disclose Inside Information); DTR 2.5.6 (Selective Disclosure); DTR 2.7 (Dealing With Rumours).

6 *Summary*

Mason P indicated in *R v Firns* that the equal access and efficiency goals within the "readily observable matter" test are incompatible and they point in opposite directions. This reasoning is insightful, and the conclusion that the efficiency and equal access rationales are incompatible (based on the Manne theory) underpins many of the issues raised in this Chapter. The Mason P reasoning **c**an be encompassed within, or extended to, an argument that the requirement in the insider trading and continuous disclosure provisions that the information must not be "generally available" is circular in nature. ASIC made a similar point in a recent parliamentary submission.[1285] That is, the release of information to influential institutional participants may by its very nature constitute "publishing" of the information or making it "readily observable" on the basis that this enhances short-term price efficiency. If so, information disclosed at general analyst briefings or to a selected group of institutional investors may be "generally available". These issues around the scope of the "generally available" carve-outs are explored more fully in the CAMAC review discussion in Part III.

The case law and highlighted interpretative issues or uncertainties around the "generally available" and materiality provisions make it important for Australian policy makers to consider whether, and the degree to which, traders or tippees in the following scenarios can be caught and successfully prosecuted under the continuous disclosure or insider trading regimes:

- Trading on the release of price-sensitive information to institutional investors at private briefings.[1286]
- Trading on the release of price-sensitive information to analysts and institutional investors at general analyst briefings or during conference calls without open access.
- Trading on the release of price-sensitive information to investors at general analyst briefings or during conference calls with open access.
- Trading on price-sensitive information in an analyst report.
- Trading on private knowledge of a pending takeover bid or capital raising.

[1285] ASIC, above n 326, 22.
[1286] Lyon et al, above n 488, 54.

To the extent that these scenarios constitute a breach of the statutory continuous disclosure provisions or fall within the insider trading prohibitions, the next issue to consider is at what point does the trading become legitimate on the basis that the information is no longer material (or readily observable) because of unusual movement in the security price or trading volume or speculation in analyst reports or news sources.

The accumulated regulatory uncertainties or factors result in a listed company disclosure framework that potentially provides minimal protection to investors:

1. To the extent that information is published under the "generally available" carve-out upon release to some institutional investors, the pool of likely enforcement actions is significantly diminished.
2. To the extent that information is "readily observable" when it is referred to in analyst reports, news services and or closed briefings but not disclosed through the ASX CAP, the pool of likely enforceable actions is further reduced.
3. To the extent that the materiality requirement within the insider trading and continuous disclosure regimes requires evidence of sharp short-term price movements linked to the relevant information, the potential pool of enforceable actions is further limited.
4. To the extent that information becomes immaterial due to unusual movements in the price or trading volume of the relevant securities, the pool of potential actions is further significantly reduced.

The practical effects of these uncertainties and the potential limits on equal access, investor protection and likely enforcement actions are most acute in relation to professional systemic trading on inside or selectively disclosed information.

A majority of the members of the CAMAC review of the insider trading provisions in 2003 acknowledged the ambiguities around the "generally available" carve-outs and the negative effects on equal access and investor protection.

III INSIDER TRADING REGIME: POLICY REVIEWS

In 2003 CAMAC reviewed and reported on the insider trading provisions, with a particular focus on the generally available carve-outs.

A Corporations and Markets Advisory Committee Review

The Committee grappled with two main issues: the extension of the regime in 2002 to cover all financial products as part of the financial services reforms;[1287] and the published information and readily observable matter carve-outs within the insider trading provisions. CAMAC ultimately considered three possible approaches to the application of the insider trading provisions in Australian financial markets:

1. return the legislation to the pre-March 2002 position;[1288]
2. retain the existing law with specific defences or carve-outs where appropriate (*the carve-outs approach*); or
3. 'tighten the ambit of the legislation by focusing the prohibition on information that the market expects should be disclosed to all participants on an equal basis [and by introducing] … a new simplified test of when information is generally available'[1289] (*the proposal*).

Some of CAMAC's recommendations provide majority and minority options, including Recommendations 10 and 38 on the "generally available" tests.[1290] The majority supported the proposal, while the minority opted for the carve-outs approach.[1291]

[1287] CAMAC, above n 71, i, iii. Until March 2002, the insider trading prohibition was confined to transactions in securities (whether of public or private entities), interests in managed investment schemes and futures contracts that related to the securities of a body corporate or the price of these securities. However, the prohibition was extended as part of the *Financial Services Reform Act 2001* (Cth). The financial products now covered by the prohibition include: securities, including options over unissued shares; derivatives; interests in a managed investment scheme; debentures, stocks or bonds issued or proposed to be issued by a government; superannuation products (other than prescribed products); or any other financial products that are able to be traded on a financial market.

[1288] CAMAC, above n 71, 47.

[1289] CAMAC, above n 71, 47.

[1290] CAMAC, above n 71, iv. The minority included David Knott, the Chairman of ASIC, and in some instances another Committee member. The majority recommendations were supported by the remaining 12 or 13 members of the Committee, as outlined on pages vi and vii of the Report.

1 *The Majority Proposal*

(a) Published Information Test[1292]

The CAMAC majority argued that the 'published information test can create considerable uncertainty about when persons may lawfully trade.'[1293] It can be difficult to determine '[w]hen, or how, information can be "made known" … [or] how many investors are contemplated in the expression "persons who commonly invest".'[1294] They even rhetorically asked whether it would suffice 'if the information was known to a particular group of investors, such as a group of brokers, working on a confidential planned takeover bid or subscribers to a research newsletter?'[1295] The issue of what constitutes a reasonable period for dissemination of information is also open to interpretation.

The majority proposed a new publishable information test to replace the existing published information and readily observable matter tests within the definition of "generally available".

(b) Readily Observable Matter Test[1296]

The CAMAC majority suggested that the ambit of the readily observable matter test is even more uncertain than the published information test.[1297] They argued that the

> focus of the insider trading prohibition should be on information that the market expects should be disclosed to all participants on an equal basis. To permit trading in these circumstances could give the informed person an unfair advantage over other market participants and undermine confidence in the fairness and integrity of financial markets.[1298]

The majority concluded that the 'insider trading prohibition should apply only to confidential price-sensitive information that should be generally disclosed [disclosable information] or will be the subject of a public announcement [announceable

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1291 CAMAC, above n 71, 12-13, 61-62 (Recommendations 10 & 38).
1292 *Corporations Act* 2001 (Cth) s 1042C(1)(b).
1293 CAMAC, above n 71, 12.
1294 CAMAC, above n 71, 12.
1295 CAMAC, above n 71, 12.
1296 *Corporations Act 2001* (Cth) s 1042A(1)(a).
1297 CAMAC, above n 71, 13.
1298 CAMAC, above n 71, 48.

information].'[1299] To achieve this goal, they recommended that the phrase "the inside information is disclosable information or announceable information;" be added to s 1043A;[1300] and the following definitions of disclosable and announceable information be included under s 1042A;

"**disclosable information"** means information that:

(a) has to be disclosed either now or in the future pursuant to any legal or regulatory requirement (other than a requirement for disclosure only to a counterparty), whether or not that obligation is complied with, or

(b) would come within paragraph (a) were any person subject to the legal or regulatory requirement to be aware of the information, or

(c) would come within paragraph (a) or paragraph (b) if the subject matter of the information came to fruition (whether or not it does so);

"announceable information" means information, other than disclosable information, that

(a) will become the subject of a public announcement, or

(b) would come within paragraph (a) if the subject matter of the information came to fruition (whether or not it does so).[1301]

The proposal also recommended that the current s 1042C(1) be replaced with the following provisions:

1042C(1) For the purposes of this Division, information is "generally available" only if it

(a) is accessible to most persons who commonly invest[1302] in Division 3 financial products of a kind whose price or value might be affected by the information, or

[1299] CAMAC, above n 71, 48.
[1300] CAMAC, above n 71, 61.
[1301] CAMAC, above n 71, 61-62.
[1302] The majority of the CAMAC Committee suggested at page 52 that a note in the Explanatory Memorandum or in legislation could:

- state that information satisfies paragraph (1)(a) only if it either can at that time be obtained by most investors without resort to technical assistance beyond that likely to be used by those investors or comes within subsection (1A).
- list examples of information that satisfies paragraph (1)(a), including, for instance, any information that has been published in widely circulated print or broadcast media.
- indicate that posting information on the Internet will not make the information accessible under paragraph (1)(a) unless the information has been disclosed through a prescribed Internet disclosure procedure under subsection (1A).

(b) consists of deductions, conclusions or inferences made or drawn from any information referred to in paragraph (a).

1042C(1A) Information is deemed to satisfy paragraph (1)(a) if it is disclosed pursuant to any prescribed disclosure procedure.[1303]

The proposal directly linked the insider trading provisions with the continuous disclosure regime.[1304] In addition, the majority suggested that the 'list of prescribed disclosure procedures could be … augmented over time, as communication technology develops or as different markets provide new methods of disseminating information to their participants.'[1305] The majority concluded that the new test of generally available would 'overcome complexities and ambiguities in the current test (including the indeterminate breadth of the "readily observable matter" concept).'[1306] In addition, the proposal would avoid an overreach of the prohibition to over-the-counter market trading and trading in the financial products of unlisted entities.[1307]

2 *The Minority Carve-outs Approach*

The minority recommended that the current published information test should remain as it is.[1308] Further, the readily observable matter test should remain subject to modifications that the relevant matter must be observable:

- by a cross-section of Australian investors
- without resort to technical assistance beyond that likely to be used by a cross-section of those investors and
- for a reasonable period of time.[1309]

The minority argued that the 'current approach to insider trading – a broadly expressed offence subject to particular carve-outs – is neither untenable nor unworkable.'[1310] They suggested that any problems facing the over-the-counter or other markets can be

[1303] CAMAC, above n 71, 62.
[1304] CAMAC, above n 71, 49-52.
[1305] CAMAC, above n 71, 52.
[1306] CAMAC, above n 71, 48.
[1307] CAMAC, above n 71, 50.
[1308] CAMAC, above n 71, 12-14, 62.
[1309] CAMAC, above n 71, 13.
[1310] CAMAC, above n 71, 47.

dealt with on a case-by-case basis where the justification for a defence or carve-out is apparent.[1311]

B Position and Consultation Paper

The governmental belatedly responded to the CAMAC recommendations with a PCP in 2007.[1312] The PCP indicated that the government accepted 31 of the 38 recommendations made by CAMAC.[1313] Public submissions were sought on the remaining recommendations, including those on the statutory definitions of inside information and generally available.

The PCP rejected the CAMAC majority proposal on the following grounds:

- the proposed definitions of disclosable and announceable information risked applying the insider trading provisions retrospectively;[1314]
- the proposed definitions were not sufficiently clear or certain to justify being an element of a criminal offence;[1315]
- '[a]dding a further physical element for the prosecution to prove would make the [insider trading] prohibition more difficult to establish and enforce';[1316] and
- the proposed amendments did not pay sufficient regard 'to the importance of financial market transparency and to the expectations of the wider financial industry and community's expectations as to what constitutes inside information.'[1317]

It concluded that the majority proposal would 'increase the complexity of the insider trading provisions, resulting in greater uncertainty for market participants.'[1318]

1311 CAMAC, above n 71, 48.
1312 Commonwealth, above n 72.
1313 Commonwealth, above n 72, ix; App A. The government indicated in the Position and Consultation Paper that it agreed with the CAMAC Recommendations 1, 4-9, 12-13, 15-32 and 34-37 but did not accept recommendation 33 to extend the continuous disclosure infringement notice scheme to insider trading. Public comments were sought on the remaining recommendations: 2, 3, 10-11, 14-15 & 38.
1314 Commonwealth, above n 72, 18-19.
1315 Commonwealth, above n 72, 19. The Attorney General's Department advised that the proposed definitions of 'disclosable information' and 'announceable information' were not sufficiently clear or certain to justify being an element of a criminal offence.
1316 Commonwealth, above n 72, 20.
1317 Commonwealth, above n 72, 20. The Position and Consultation Paper didn't explain what these expectations are or might be.
1318 Commonwealth, above n 72, 19.

The PCP sought public comment on the following options to address the readily observable matter test uncertainties:[1319]

1. Amend the readily observable matter test in accordance with the recommendation made by the minority of CAMAC; namely, the definition of generally available information continues to include the published information and readily observable matter tests. However, under the readily observable matter test, matters must be observable by a cross-section of Australian investors; in a manner that is likely to be observable within the resources of these investors; and for a reasonable period of time.
2. Retain the existing provisions, but include notes within s 1042C and leave the interpretation of "readily observable" to the courts.
3. Amend the readily observable matter test within the definition of generally available so that: a matter is readily observable when it is publicly disclosed or when it can be observed in public without infringing rights of privacy, property or confidentiality; even if other market users cannot obtain it because of limitations on their resources, expertise or competence or only on payment of a fee; and even if it is only available overseas.

It is unclear which, if any, of the CAMAC or PCP proposals will be implemented by legislators.

C Policy Reviews Critique and Conclusion

1 *Published Information Test*

The amendments proposed by the majority to the published information test are discussed within the readily observable matter section below. The PCP rejected the majority proposal and indicated that the existing published information test is working. If the PCP view is adopted as the final policy stance, the ambiguities and uncertainties around this limb of the "generally available" provisions will remain.

[1319] Commonwealth, above n 72, 22-23.

2 *Readily Observable Matter Test*

The proposal by the CAMAC majority is compelling and deserves serious consideration. The underlying rationales are sound. A person who possesses potentially publicly disclosable or announceable information is prohibited from trading, regardless of whether this information subsequently crystallises and is in fact disclosed or announced to the market. The definitions of announceable and disclosable information link the insider trading provisions with the continuous disclosure obligations by inclusion of the ASX notification test. In turn, the ASX notification requirement provides an unambiguously reliable and credible platform for all investors to reference in order to make informed investment decisions. Unfortunately, no published responses to the criticisms made of the proposal in the PCP could be found. It is not clear whether the government has definitively rejected this option as suggested by the PCP, or whether discussion is still ongoing. The majority proposal could be reconsidered as a civil regime provision to satisfy critics whose primary argument appears to be the inappropriateness of a potentially retrospective criminal offence.

The first option proposed in the PCP raises possible red flags. Although the rationales underlying the inclusion of the phrases "cross-section of investors", "in a manner that is likely to be observable within the resources of these investors" and "for a reasonable period of time" are commendable, their inclusion within the readily observable matter carve-out may create more uncertainties than they resolve. Some parties may argue this proposal would catch a person who trades after viewing a factory fire or excess stocks in a yard, or following the discovery of minerals while flying over land.[1320] However, Justice Jacobson confirmed in *ASIC v Citigroup* that the 'test of whether material is readily observable is not whether the particular matter was widely observed but whether it could have been'.[1321] The 'question of whether a matter is readily observable is one of fact. Observability does not depend on proof that persons actually perceived the information; the test is objective and hypothetical.'[1322] On this basis, a cross section of investors could potentially have observed the factory fire or excess stocks or have flown over the land, within their resources. Moreover, one might argue that real-world examples where observation of a factory fire or excess stocks in a yard by a person prior

[1320] *R v Firns* (2001) 38 ACSR 223, 233; Gething, above n 622.
[1321] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 495-496.
[1322] *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 495.

to notification of the information to the ASX might be material to a listed company share price seem limited.[1323] Nevertheless, this option leaves unresolved issues. For instance, the inclusion of the phrase "for a reasonable period of time" means that persons who trade immediately on information observable in the public arena or on information garnered from independent research may be liable for insider trading.

The second option leaves it to the courts to resolve the uncertainties. However, Justice Rolfe indicated in *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* that the provisions require policy reconsideration.[1324]

> I should say that much of the argument has arisen from the drafting of this part of the Law. The problems of construction and interpretation, which it presents, were readily acknowledged by all counsel and it is a matter of concern that legislative provisions, which create serious criminal offences, inter alia, should provide not only difficulties of interpretation because of the language used, but because of apparent internal inconsistencies. I would respectfully suggest that re-consideration be given to these provisions. They are intended to have a beneficial commercial effect. It is unfortunate that they should be couched in language, which is difficult of understanding and application. This may well have the consequence that the intended beneficial effect will not be forthcoming.[1325]

In addition, Mason P indicated in *R v Firns* that the courts have been left with a difficult interpretative task.[1326] This option is therefore unlikely to result in a sufficiently clear or certain outcome, particularly in the short term.

The third option is similar to the unerodable information advantage model proposed by Brudney in the US.[1327] A person can trade on information in the public arena, within or

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[1323] See *R v AB Evans; R v GJ Doyle* [1999] VSC 488. Evans was a director of a private company that discovered valuable resources under its mining lease. Prior to public notification of this discovery, Evans sought to purchase shares through a broker in a listed company, Mt Kersey Mining NL with leases or application for mining leases close by. Doyle worked as an institutional dealer for the relevant broker. Justice McDonald indicated that the information possessed by Doyle at the relevant time did not consist of deductions, conclusions or inferences drawn from readily observable matter. The prosecutions failed because it was held that a person instructing a broker to buy shares on his or her behalf did not enter into an agreement to purchase securities. An agreement to purchase securities was only entered into when the broker as agent has achieved a trade or agreement to purchase the securities. The circumstances of the case were such that Justice McDonald was not required to consider whether the relevant information was readily observable or not.

[1324] *Ampolex Ltd V Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* (1996) 14 ACLC 1514, 1522.

[1325] *Ampolex Ltd V Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* (1996) 14 ACLC 1514, 1522.

[1326] (2001) 38 ACSR 223, 234.

[1327] Brudney, above n 67, 346.

outside Australia, but not if it infringes rights of privacy, property or confidentiality. The main issues with this proposal are determining what is in the public arena and what infringes rights of privacy, property or confidentiality. The exclusion of expertise and competence from consideration is sound. However, the potential breadth of what is in the public arena is concerning. It is not clear whether this proposal would capture trading on advance private knowledge of takeover bids, capital raisings or earnings announcements, including traders positioned down the tippee or communication chains, and after price and trading volume movements. If not, many uninformed investors would suffer significant detriment.

To date, no legislative changes have been made to the "generally available" or materiality provisions within the insider-trading regime, so the highlighted regulatory uncertainties remain. These provisions are also included within the continuous disclosure provisions, suggesting the two regimes are linked to some extent. In the next part, I explore the relationships between the periodic disclosure, continuous disclosure and insider trading regimes and the extent to which the disclosure framework operates on an integrated basis.

IV THE COMPANY DISCLOSURE FRAMEWORK: PIECEMEAL OR INTEGRATED?

Legislators, regulators and litigators are required respectively to draft, enforce and initiate specific legislation and legal actions. The wording and interpretation of the relevant provisions are all important. To succeed, legal actions have to be clearly focused, outlined, argued and supported with evidence. Potential actions generally concern a specific company disclosure, a failure to disclose, or trading on private information at a particular point in time.

Most, if not all, Australian investors and other stakeholders are concerned about being kept well informed. However, investors or other users of disclosures in Australia are required to take a holistic approach to company information. Individual pieces of information or disclosures are typically only of value when viewed and processed within a mosaic of available information on a company or security. Few investors pause to consider the discrete disclosure regime under which information is provided or any provisions that may have been breached when required company disclosures have not been made. When listed companies fail to provide prescribed information to the market, this may constitute a breach of periodic disclosure or continuous disclosure regulation. In addition, trading on materially price-sensitive information that has not been disclosed to the market, or that has been selectively disclosed to some investors, may result in liability under insider trading regulation.

This makes it important to understand the nature and scope of the broader disclosure framework. From an investor's perspective, the efficacy of the regulation ultimately succeeds or fails on an integrated basis. Regulation designed to ensure timely and transparent disclosure in the public arena and sustained investor confidence must simultaneously encourage effective disclosure on both a periodic and continuous basis, and penalise disclosure failures, selective disclosure and insider trading. However, there is little agreement among policy makers, the judiciary and academics on the links across the company disclosure and insider trading regimes.

A The Links between the Periodic Disclosure and Continuous Disclosure Regimes

As outlined in Chapter Two, mandatory corporate disclosure in Australia is governed by periodic and continuous disclosure regulation. The periodic disclosure regulation as it applies to listed companies includes the reporting requirements under the ASX listing rules and the statutory obligations under the Act. Listed Australian companies must currently provide an online half year report,[1328] an online preliminary final report,[1329] and an annual report that is available online or in hard copy by request.[1330] Chapter 2M of the Act and Chapter 4 of the ASX listing rules mandate the content of listed company half-year and full year reports including the preliminary final and annual reports. The periodic reports, which include financial accounts and management commentary, are intended to provide investors with the essential foundational information on a company.

[1328] Some listed Australian companies require investors to source their half-year reports online.
[1329] ASX Listing Rule 4.3B; ASX Guidance Note 14 *Company Announcement Platform,* 2.
[1330] As outlined in Chapter Two, some listed Australian companies are required to provide quarterly reports.

Continuous disclosure regulation requires companies to keep the market informed of events and developments between reporting periods. Under ASX Listing Rule 3.1, companies that become aware of materially price-sensitive information must immediately disclose that information through the ASX CAP.[1331] A statutory continuous disclosure regime was introduced in September 1994 to support or reinforce the listing rule obligations.[1332]

The relationship between the periodic and continuous disclosure regimes is somewhat blurred. Some parties suggest that the continuous disclosure requirements reduce or replace the need for periodic disclosure regulation. These commentators argue that 'continuous disclosure means that the market is informed at all times and that no investor is disadvantaged by lack of access to material information'.[1333] However, as discussed in Chapter Two, the purposes and content of the periodic and continuous disclosures are different. It is important to understand the practical limitations of the continuous disclosure regime, as explained more fully in Chapter Five.

Informed judgments on investment decisions require access to the solid base of information on a regular and timely basis. Individual pieces of company information between reporting periods are only useful to investors when they are understandable, complete, accurate, and in an appropriate form, allowing them to be readily connected and compared with the information provided in the periodic reports.

B The Links between the Continuous Disclosure and Insider Trading Regimes

It is interesting that prior to 2001, the statutory continuous disclosure provisions and the insider trading prohibitions were included within Division 2 of Part 7.11 of the Act. At that time, Division 2 included misleading and deceptive conduct (s 995), insider trading (s 1002G) and continuous disclosure (s 1001C).[1334] However, the structure of the Act was changed by the passing of the *Financial Services Reform Act 2001* (Cth).[1335] Under the current structure, Chapters 6-6D provide disclosure obligations relating to company

[1331] ASX Listing Rule 3.1.
[1332] *Corporations Act 2001* (Cth) Ch 6CA ss 674-678.
[1333] ASX, *Continuous Disclosure The Australian Experience* (20 February 2002).
[1334] Section 1001C was similar to the current s 676 except that s 1001C included definitions and headings for 'primary information' and 'derived information'.

securities, and Chapter 7 governs financial services and markets including prohibited conduct. More specifically, Chapter 6 provides the rules in relation to takeovers; Chapter 6A deals with compulsory acquisitions and buy-outs; Chapter 6B outlines the rights and liabilities in relation to Chapters 6 and 6A matters; Chapter 6C deals with disclosure of information about ownership of listed companies and managed investment schemes, including information on substantial holdings and beneficial ownership; Chapter 6CA outlines the continuous disclosure obligations; and Chapter 6D prescribes the required disclosures in relation to fund raising and managed investment schemes. Division 2 of Part 7.10 prohibits a range of types of market misconduct, including: market manipulation (s 1041A); false trading and market rigging (ss 1041B and 1041C); dissemination of information about illegal transactions (s 1041D); and provisions in relation to misleading, false, dishonest or deceptive conduct and false or misleading statements (ss 1041E-1041H). The insider trading prohibitions are outlined in Division 3 of Part 7.10. To summarise, the continuous disclosure provisions are now located within Chapter 6CA, the insider trading prohibitions are within Division 3 of Part 7.10 and other market misconduct is included in Division 2 of Part 7.10. Nevertheless, links may still exist between the continuous disclosure regime, the insider trading provisions, and other prohibited conduct under Division 2 of Part 7.10.

Published scholarly material suggests the insider trading and continuous disclosure regimes are linked.[1336] As previously outlined, the statutory insider trading and continuous disclosure provisions require that the relevant information has a 'material effect on price'[1337] and is not 'generally available'.[1338] Furthermore, one of the stated rationales for the introduction of continuous disclosure regulation is to 'minimise the opportunities for perpetrating insider trading or similar market abuses.'[1339] On the other hand, there are differences in the insider trading and continuous disclosure provisions. Sections 674(1) and 674(2)(b) of the continuous disclosure regime require notification of materially price-sensitive information to the relevant market operator. In addition, Mason P indicated in *R v Firns* that although the possible alignment between the

[1335] The changes to the *Corporations Act 2001* (Cth) were effected by the *Financial Services Reform Amendment* Act 2001 (Cth).
[1336] Gething, above n 622, 620-627; Semaan et al, above n 612, 236-239; Golding et al, above n 616, 408-421.
[1337] *Corporations Act 2001* (Cth) ss 674(2), 677, 1042A, 1042D.
[1338] *Corporations Act 2001* (Cth) ss 674(2)(c)(i), 1042C; 1043A; *R v Hannes* (2000) 158 FLR 359, 402-406; *R v Firns* (2001) 38 ACSR 223, 235-238.
[1339] CASAC, above n 43, 7.

criminal regulation of insider trading activities and the continuous disclosure obligations might be a worthy suggestion or goal, this needs to be considered by legislators and not the judiciary. His Honour indicated that, as it stands currently, 'Division 2A and its criminal sanctions do not link themselves with the scheme of statutory reinforcement of ASX's continuous disclosure rules.'[1340]

C The Links between Insider Trading and Selective Disclosure

There is no specific regulation in Australia governing selective disclosure. However, company disclosures to selected investors such as analysts and other professionals may be prohibited under insider trading regulation. For instance, insider-trading convictions have been achieved against a financial advisor from a large institution,[1341] a media relations consultant,[1342] and a research analyst employed by a stock broking firm.[1343] Nevertheless, the extent to which selective disclosure is prohibited under the insider-trading provisions has not been substantively tested in the courts, as all of these defendants pleaded guilty.

As discussed in Chapter Three, Reg FD in the US mandates that when a company chooses to disclose material information, the information must be disclosed broadly to the investing public, and not selectively to a favoured few.[1344] Companies, or those acting on the company's behalf, are prohibited from selectively disclosing material non-public information to securities industry professionals, institutional investors, and specified other persons. Reg FD applies to closed-door meetings, conference calls with analysts, and any situations where material information is communicated, verbally or in writing.[1345] The SEC argues that the 'economic effects of …[selective disclosure and insider trading] are essentially the same'.[1346] Some investors 'gain an informational edge — and use that edge to profit at the expense of the uninformed.'[1347]

[1340] *R v Firns* (2001) 38 ACSR 223, 235.
[1341] *Australian Securities and Investments Commission v Petsas* (2005) 23 ACLC 269.
[1342] *R v McKay* (2007) 61 ACSR 470; ASIC, 'Former Aristocrat Media Relations Consultant Pleads Guilty to Insider Trading' (Press Release, 28 November 2006) 06-413.
[1343] ASIC, 'Brisbane Research Analyst Pleads Guilty to Insider Trading Charge' (Press Release, 6 June 2007) 07-154.
[1344] SEC, above n 721.
[1345] SEC, above n 721.
[1346] SEC, above n 720.
[1347] SEC, above n 720.

D The Links between Continuous Disclosure and Selective Disclosure

Selective disclosure in Australia is also prohibited when it breaches continuous disclosure regulation. A company may fail to continuously disclose materially price-sensitive information that it is aware of, when it fails to disclose the information to any market participants, or when it selectively discloses the information to only some investors without notifying the ASX or making the information generally available.

For example, in *Australian Securities and Investments Commission v Southcorp Limited (No 2)*,[1348] Southcorp was found guilty of breaching s 674(2) because it selectively disclosed price-sensitive information to analysts without any notification of this information to the ASX. Justice Lindgren confirmed that 'the continuous disclosure provisions are intended … to prevent selective disclosure of market sensitive information'.[1349]

Similarly, Justice Gzell stated in *Australian Securities and Investments Commission v Macdonald (No 11)*[1350] that the continuous disclosure legislation is aimed at preventing selective disclosure of market sensitive information.[1351] As previously outlined, His Honour found that a 'complex series of filings with ASIC [was] not presented in a manner likely to be brought to the attention of the investing public, entitled to assume that information will be made in accordance with the listing rules.'[1352] This finding potentially limits the scope of what constitutes a "readily observable matter" but the facts of the case do not fall within any of the scenarios outlined in Part II.

E An Integrated Framework Critique and Conclusion

Users of company disclosures undoubtedly want to be kept informed of developments on a timely basis. However, most investors and other stakeholders are not aware of or interested in the discrete disclosure regime that an individual announcement falls within.

[1348] *Australian Securities and Investments Commission v Southcorp Limited (No 2)* (2003) 130 FCR 406.
[1349] *Australian Securities and Investments Commission v Southcorp Limited (No 2)* (2003) 130 FCR 406, 408.
[1350] (2009) 71 ACSR 368.
[1351] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368, 541.
[1352] *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 [1134].

Indeed, the information contained in an individual announcement is often not significant in itself. Company information is generally only meaningful when viewed or processed within context or as part of the mosaic of available information. As such, the efficacy of company disclosure regulation in a market ultimately succeeds or fails on an integrated basis, and debate on the efficacy of the regulation needs to be considered in the context of the comprehensive company disclosure framework.

Policy commentary on the periodic disclosure, continuous disclosure, and insider trading regimes suggests intended theoretical and empirical links across the disclosure and insider trading regulation.[1353] However, the precise nature of the relationships is unclear. Some parties suggest the continuous disclosure requirements reduce or replace the need for periodic disclosure regulation. However, the purposes of, and the information provided under, the periodic and continuous disclosure regimes are different. It is important to understand the practical limitations of the continuous disclosure regime. The regular and relatively standardised periodic reports provide the necessary investor framework from which investors can understand and assess one-off continuous disclosures.

The nature and scope of the insider trading prohibitions in Australia are largely determined by the "generally available" and materiality carve-outs. It is unclear whether the insider trading case law on these elements applies to the continuous disclosure regime. Inclusion of the "generally available" and materiality elements within the continuous disclosure and insider trading statutory provisions suggests that legislators sought some degree of integration between the two regimes.[1354] Scholars also suggest there are links between the two regimes. However, Mason P indicated in *R v Firns* that the two regimes are not currently aligned.[1355]

[1353] CASAC, above n 43, 1.
[1354] *Corporations Act 2001* (Cth) ss 674(2), 677, 1042A, 1042C, 1042D, 1043A.
[1355] *R v Firns* (2001) 38 ACSR 223, 235.

V CHAPTER FOUR: CRITIQUE AND CONCLUSION

'Laws are like spiders webs: if some poor weak creature comes up against them, it is caught; but a bigger one can break through and get away.'[1356]

Laws are generally only effective, when they are enforced on a consistent and fair basis, and when the nature and level of enforcement action is appropriate to the misconduct involved or the expected deterrent effect. Ultimately, the efficacy of the company disclosure and insider trading regimes depend on:

A Whether the regimes provide sufficient certainty on the prohibited activity and disclosure required?

B Whether the enforcement regimes are effective?

C Whether the regimes are enhancing market fairness and long-term economic efficiency?

A Do the Regimes Provide Sufficient Certainty on the Prohibited Activity and Disclosure Required?

There are significant uncertainties on what market activity *is prohibited* under the Australian insider-trading regime. Justice Kirby indicated that

> there needs to be a more wholehearted endeavour to understand what the insider trading prohibition is concerned with … so that … we [can] identify the ambit of the prohibition and the people and activities who are to fall within it … while there are no easy answers, "the beginning of wisdom is to ask the right questions".[1357]

Justice Rolfe suggested in *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)*[1358] that the provisions are difficult to interpret because of apparent internal inconsistencies and they require policy reconsideration. Mason P confirmed in *R v Firns* that the provisions are badly blurred leaving the courts with a difficult interpretative task.[1359] In addition, the majority and minority of CAMAC who reviewed the insider-trading provisions in 2003 highlighted uncertainties and recommended varying changes to the provisions. The majority confirmed that the published information test within the "generally available" provisions in the insider trading regime can create considerable uncertainty about when persons may lawfully trade. They also described the readily

[1356] Diogenes Laertius, *Lives of the Eminent Philosophers*, 1.58.
[1357] See, eg, Kirby, above n 41, 154, 168.
[1358] (1996) 14 ACLC 114, 1522.

observable matter test as indeterminate. However, no legislative amendments have been made to date.

Arguably, there is even greater uncertainty on what disclosure *is required* under the periodic and continuous disclosure obligations. Within the periodic disclosure regime, the preliminary final report provides the most substantive disclosures to investors on a timely basis. However, the mandatory notes and relevant accounting standards in the preliminary final report are ambiguous. In addition, the scope of required management discussion and analysis within all of the periodic reports is uncertain. These ambiguities result in a weak and loosely defined periodic disclosure regime.

There are also significant uncertainties around the continuous disclosure obligations. The "generally available" and materiality elements within the insider trading provisions are replicated within the statutory continuous disclosure regime. However, the extent to which the insider trading case law and the CAMAC commentary applies to the continuous disclosure regime is unclear. In addition, the "generally available" provisions are potentially circular in nature.[1360] The release of information to large institutional participants may constitute publishing of the information or making it readily observable on the basis that this enhances short-term price efficiency. On this interpretation, information released at general analyst briefings or to a range of institutional investors may be "generally available" or in the public arena.[1361]

Under ASX Listing Rule 3.1, the relevant information need not be "generally available". However, there has been no case law on ASX Listing Rule 3.1 as standalone regulation, so it is not clear whether the listing rule provides broader investor protection than the statutory continuous disclosure provisions. Uncertainties around the "generally available" and materiality provisions within the statutory regime, differences between the listing rule and statutory continuous disclosure provisions, and ambiguities around the Listing Rule 3.1 obligations (these are discussed in more detail in Chapter Five), make it difficult to define the nature and scope of the continuous disclosure regime.

[1359] (2001) 38 ACSR 223, 234.
[1360] ASIC, above n 326.
[1361] See, eg, Earp et al, above n 1143, 309-310; Walker et al, above n 441, 572.

B Are the Enforcement Regimes Effective?

ASIC has initiated court actions under the statutory periodic disclosure provisions relating to financial issues within the annual reports. It has also used the full range of continuous disclosure enforcement options, including the civil penalty, infringement notice and enforceable undertaking processes. All of the successful actions under the continuous disclosure statutory regime have been achieved since 2000. Similarly, the number of insider trading convictions in Australia has increased over the last eight years in comparison with previous decades.[1362]

However, the status and enforceability of the ASX disclosure listing rules are unclear. Possible beaches of the continuous disclosure listing rules are referred to ASIC for action. However, there is no evidence of any formal enforcement of the periodic or continuous disclosure listing rules by the ASX or ASIC as standalone regulation, other than a suspension in the listing of some smaller companies for failures to provide accounts on a timely basis. Consequently, the disclosure listing rules appear to be in limbo or largely superfluous as standalone regulation.

Most of the ASIC initiated court actions have alleged insider trading rather than a breach of the periodic or continuous disclosure provisions. However, these enforcement actions are likely to represent only the tip of the iceberg in terms of insider trading occurrences.[1363] Detection and enforcement of insider trading is difficult and requires considerable resources. The SEC, FSA, a prior head of enforcement at the London Stock Exchange, and commentators suggest that the most significant insider trading problems and losses arise from systemic professional insider trading on either a transactional or longer-term basis.[1364] The SEC highlights that individuals engaged in misconduct are increasingly securities professionals, gatekeepers or high ranking corporate officials and that recidivist insider trading cases and serial illegal trading have become more common.[1365] In such cases, insider trading can be carried out by a number of defendants,

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[1362] As outlined in Chapter Two, the statutory continuous disclosure regime was introduced in September 1994. It is not clear why there were no successful cases prosecuted under the statutory regime prior to 2000. Further, the reasons for an increase in the number of insider trading convictions over the last eight years in comparison with previous decades are not known. The cut off date of 2002 for detailed analysis of the insider trading cases from primary sources was a practical one.

[1363] Rider, above n 217, 73.

[1364] ASIC, above n 6, 90; Cole, above n 1126; Rider, above n 217, 73; Thomsen, above n 1126; Thomsen, above n 32.

[1365] Thomsen, above n 1126.

involving multiple trades over a number of months, using sophisticated approaches.[1366] Professional insiders are smart and always look 'for new ways to gain an edge',[1367] particularly when there are 'huge chuncks of precious valuable information.'[1368]

None of the successful insider trading actions in Australia have involved systemic professional trading on inside or selectively disclosed information. The ambiguities around the "generally available" provisions make such actions difficult. In addition, an interpretation of materiality based on unusual movement in the price and trading volumes of the relevant security or speculation in news sources limits potential enforcement actions, particularly in relation to trading on selectively disclosed information. In practice, ASIC are likely to restrict potential enforcement actions to activity very early in the leakage or tippee chains when information is clearly not generally available and the information is still able to provoke sharp movements in the security price or trading volumes.

An individual's response to the enforcement records depends on their interpretation of what constitutes a breach of the periodic disclosure, continuous disclosure and insider trading regimes. As outlined more fully in Chapter Five, leading market participants and a majority of the respondents in an ASIC sponsored survey suggest that those involved in market abuse are unlikely to be deterred under the current regimes and to face any regulatory action. Hunt, the Chairman of Caliburn, argues that 'people within the marketplace know, as much as you can possibly know, that insider trading is taking place.'[1369] While the actual levels of disclosure failures, selective disclosure, insider trading and other market abuses in Australia are unknowable, a perception by a large proportion of market participants that there is rampant un-enforced insider trading or other market abuses is likely to have a significant impact on investor confidence, regardless of the accuracy of the perception.

The investor and ASIC stakeholder feedback suggests that Australian regulators need to take a more vigorous approach to corporate disclosure matters. In an article that extends beyond the scope of the thesis, I call for a bold and effective regulatory approach that is

[1366] Cole, above n 1126; Thomsen, above n 1126.
[1367] ASIC, above n 6, 95. See also Thomsen, above n 1126.
[1368] ASIC, above n 6, 95.
[1369] ASIC, above n 6, 82.

risk based; with clearly identified long-term goals and priorities; with a primary emphasis on prevention; and evidentiary based decision-making.[1370] I conclude that such a framework would result in greater regulatory focus on compliance with, and enforcement of, the periodic and continuous disclosure obligations. It is not suggested that enforcement of other areas such as insider trading litigation should be wound down. Instead, a recalibration of the regulatory priorities and emphases is sought.

C Are the Regimes Enhancing Market Fairness and Economic Efficiency?

The integrated listed company disclosure framework in Australia is weakened by significant regulatory ambiguities and gaps and conservative enforcement. Uncertainties around the generally available provisions and the narrowness of the materiality test make the extent to which selective disclosure in Australia is prohibited and enforceable largely indeterminate. No legislative amendments have been made to the insider trading provisions following the CAMAC or PCP reviews, and the periodic and continuous disclosure regimes have not been comprehensively reviewed for several years. Consequently, the highlighted ambiguities around the nature and scope of the company disclosure and insider trading provisions remain.

Many of these ambiguities arise because of a lack of definition or clarity around the efficiency rationale or goal. Mason P stated in *R v Firns* that the equal access and market efficiency goals within the “readily observable matter” test are incompatible. Mason P arrives at this conclusion on the assumption that the drafters of the readily observable matter provision intended to promote efficiency based on the Manne price signalling theory. It appears that this price signalling theory underpins the Mason P finding that the court judgment was readily observable, the materiality principles applied in the *Hannes, Rivkin* and *Citigroup* cases, and the scholarly commentary on the insider trading rationales. However, the Manne arguments are not supported by empirical evidence.[1371] All of the empirical research reviewed suggests that adoption of a short-term price efficiency goal (rather than long term economic efficiency) is counterproductive. The combined insider trading studies suggest that allowing systemic trading on private information reduces long-term market and economic efficiency. In

[1370] Gill North, ‘A Call for A Bold & Effective Corporate Disclosure Regulatory Framework’ (2010) 28 *Company and Securities Law Journal* 331.

addition, the disclosure studies suggest that transparent public disclosure is needed to promote belief in fairness and to sustain investor confidence. The global studies suggest or infer links between the strength and enforceability of a country's disclosure system, the efficiency of markets, the breadth and depth of stock market investor participation, investor confidence, effective legal protections for minority shareholders, and economic growth.

Adoption of a short term price efficiency goal allows a transfer of profits from uninformed investors, who may trade on the basis that companies are in compliance with their continuous disclosure obligations, to institutional investors who may trade on advance knowledge of takeover bids, capital raisings and earnings news. As outlined in Chapter Five, experienced market participants suggest that informed trading in advance of ASX announcements on takeover bids, capital raisings and earnings related matters is commonplace in Australia. These views are supported by independent research from ASIC, which found that processes around the management and handling of confidential company information are suboptimal and below international standards.[1372] Trading by investors on private specific knowledge of a pending bid, capital raising or earnings information is virtually riskless, while trading based solely on observations of unusual movement in security prices or trading volumes is speculative and risky. Furthermore, trading on private knowledge about pending takeover bids, capital raisings or earnings information that has not been disclosed through the ASX involves trading on misappropriated confidential information. Many investors cannot get access to this information and there is an unerodable information advantage.

Equality of access, investor confidence, and public transparency are severely undermined when some investors are able to regularly trade on information that has not been released through the ASX. The policy principle of wanting to encourage independent initiative and diligence is sound. However, this principle should not, and need not, be applied to allow profitable trading on leaked confidential information. To promote equal access and long-term economic efficiency, enforcement actions involving

[1371] See Gill North, 'Disclosure Policy Decision Making in Australia: The Elusive Efficiency Goal' (Working Paper, UNSW, 2010).

the leakage of confidential company information should, where possible, be initiated under the continuous disclosure provisions. The regulators need to encourage early disclosure of the company information through the ASX or better protection of confidential information at its source.

Chapter Five provides further evidence and analysis on listed company disclosures through the ASX.

[1372] ASIC, Consultation Paper 128, *Handling Confidential Information* (December 2009). The Commission proposes to issue best practice guidelines in relation to the handling of confidential company information.

CHAPTER FIVE: CONTINUOUS DISCLOSURE: EMPIRICAL RESEARCH AND ANALYSIS

'Too large a proportion of recent 'mathematical' economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols'[1373]

Chapter Five outlines an empirical study, which examines the extent to which listed Australian companies comply with Guidance Note 8 on disclosure of earnings expectations. As explained in Chapter Two, listed Australian companies have been subject to continuous disclosure requirements for many years. Under ASX Listing Rule 3.1, companies that become aware of materially price-sensitive information must immediately disclose that information through the ASX.[1374] This listing rule obligation is supported or reinforced by the statutory regime.[1375]

The empirical study is important because timely disclosure on prospective company earnings is necessary to enable well-informed investment decisions and to ensure genuinely equal access to material company information. When disclosures on expected earnings are provided on a private or selective basis rather than through the ASX, significant information asymmetry arises across the market. Empirical studies by other scholars on the continuous disclosure regime in Australia suggest that listed companies often fail to provide timely updates through the ASX on changes in expected earnings. However, theories and recent evidence to explain or predict which companies are likely to provide forecasts, and the attributes of the earnings disclosures provided, are limited. While there is some published material on the continuous disclosure regime,[1376] issues around the nature, scope and usefulness of the ASX disclosures are not discussed.

The empirical work involved a review of company disclosures through the ASX during the 2007 and 2008 financial years. The market environment in 2008 was very different from 2007 as a result of the global financial crisis. This cycle change provided a valuable

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[1373] Keynes, above n 808, 298.
[1374] ASX Listing Rule 3.1.
[1375] *Corporations Act 2001* (Cth) Ch 6CA ss 674-678.
[1376] Brown et al, above n 443; Golding et al, above n 616, 393-394; Raykovski, above n 376, 270; Welsh, above n 1117; Josephine Cofffey, 'Enforcement of Continuous Disclosure in the Australian Stock Market' (2007) 20 *Australian Journal of Corporate Law* 301; Angie Zadstra, Jason Harris and Anil

opportunity to examine possible changes in disclosure patterns. All ASX announcements with potential earnings related information were reviewed, including half year reports, preliminary final reports, annual reports, AGM statements, presentations, and other earnings related announcements. Company results and earnings forecasts were obtained from these original data sources.

My succinct summary of the observed disclosure practices is “ad hoc and messy – could do better”. There were large variations in the manner and extent to which listed Australian companies provided earnings disclosures through the ASX. On a positive note, the level of earnings disclosures may have increased over the last ten years.[1377] In addition, the transparency and accuracy of forecasting by some companies were excellent. However, general compliance with the Note 8 guidance on disclosure of prospective earnings was poor.

The study provides compelling evidence to support hypothesis one that it is difficult for investors relying on public disclosures to make rational investment decisions. Evidence consistent with hypothesis two is also outlined. The number of companies that experienced a material change in earnings compared to a prior forecast or the previous corresponding period, and that provided an earnings forecast or update (“forecast”) prior to the end of the financial year, was low. In addition, a significant proportion of the forecasts that were provided were not useful for well-informed investment decisions because:

- They were difficult to find;
- They were not appropriately labeled;
- They were in a management selected format (rather than a statutory format);[1378]
- They were incomplete and only calculable by reference to other documents;
- They were not understandable using information released through the ASX;
- They were provided as multiple forecasts over a year using differing specificities; or

Hargovan, ‘Widening the Net: Acessorial Liability for Continuous Disclosure Contraventions’ (2008) 22 *Australian Journal of Corporate Law* 51.

[1377] Comparisons with prior studies need to be interpreted with caution because of the different databases and proxies used.

[1378] A statutory format is defined as a format or line entry in the profit and loss account in the annual report. The numbers in the profit and loss account must comply with mandatory accounting standards and are subject to audit.

- They were retrospectively adjusted to achieve the forecast benchmark.[1379]

Overall, the evidence suggests a high level of non-compliance with the Note 8 guidance and a concomitant likelihood of selective disclosure.

Descriptive analysis is provided on the characteristics of companies that provided quantitative earnings forecasts, as well as those that provided forecasts in a statutory format. The key findings are summarised at the end of the section under the headings of general trends, changes in disclosure patterns from 2007 to 2008, and sectoral factors. Binary logistic regression analysis is used to examine the earnings disclosure trends further. This analysis examines the variation in company characteristics associated with the provision of a forecast. The evidence from the series of regression tests confirmed the general findings in the descriptive analysis. Guidance Note 8 requires disclosure when an expected change in earnings becomes material. However, there were no consistent statistically significant associations between the absolute changes in annualised earnings levels and the provision of earnings forecasts. Smaller companies, those reporting a statutory loss, and resource entities were less likely than other companies to provide an earnings update or forecast. Conversely, a larger market capitalisation, an industrial classification, and expecting to report a statutory profit, were important predictors to the disclosure decision.

It is important to view these findings in context. As highlighted in Chapters Two and Four, there are many uncertainties around the continuous disclosure obligations in Australia. The status, content and enforceability of Listing Rule 3.1 and Guidance Note 8 are not clear. Guidance Note 8 provides the only policy material on the nature and scope of the continuous disclosure obligations but it leaves many questions unanswered. The composition of the Australian listed securities market also makes it difficult for companies and investors to determine the timing and content of required continuous disclosures.

The ASX does not have the equivalent breadth or depth of industry representation and is smaller than its counterparts in the UK and US.[1380] In Australia, there is currently only

[1379] In other words, the guidance forecast made during the year and the comparative forecast used at the time of result reporting were not the same.

[1380] The market capitalisations at the end of Dec 2008 of the New York Stock Exchange & the main market of London Stock Exchange were US$10.2 trillion & 1,288,092 million pounds respectively.

one major exchange,[1381] with approximately 1800-2000 actively traded companies listed.[1382] This includes large companies with an established track record and many small, immature or loss making entities.[1383] By contrast, there are several exchanges in the US with varying listing requirements,[1384] and in the UK there is a main market for established companies and a secondary market for developing or growth companies.[1385] The Australian market also includes a high concentration of companies or entities from the financial, resource, real estate, utility and infrastructure industries. Many of these companies develop or manage long dated assets, and their short-term earnings levels typically reflect a lower proportion of the relevant security valuation than for other companies. This provides significant challenges for companies, investors and regulators relating to continuous disclosure obligations and security valuations.

Regulator, listed company, investor and stakeholder views on company disclosure practices are outlined in Part II to provide context for the study. The investor commentary and stakeholder responses present a generally negative picture on the listed company disclosure culture and enforcement regimes.

Chapter Five concludes that policy makers should review the company disclosure framework with careful consideration given to the relationship between the continuous

[1381] The Newcastle and Bendigo Stock Exchange are not linked to the ASX and represent a relatively insignificant proportion of listings and capital raisings in Australia.

[1382] The number of listed companies provided by the ASX includes finance vehicles, foreign companies with only minimal trades, other companies with no trading during the prior six moths, and companies in administration.

[1383] A company may list on the Australian market under one of the following three tests;

1. $ 1 million net profit over the past three years + $400,000 net profit over the last 12 months; or
2. $2 million in net tangible assets; or
3. $10 million market capitalisation:

ASX, *IPO: The Road to Growth and Opportunity* (2008) 14.

[1384] Major markets include the New York Stock Exchange and NASADQ. The minimum NYSE listing financial criteria are based on Earnings, Valuation with Cash Flow or Pure Valuation: New York Stock Exchange, *NYSE Listing Standards.* <*http://www.nyse.com/regulation/nyse/1147474807344.html*> at 24 February 2009.

1. The earnings criteria requires pretax earnings of $10 million over the last three years + a minimum of $2 million in each of the most recent 2 years.
2. The valuation with cash flow criteria requires positive operating cashflow over the last three years of $25 million.
3. The pure valuation criteria require revenues of $75 million for the most recent fiscal year and a global market capitalisation of $750 million.

[1385] London Stock Exchange, *Main Market Listing Criteria* <http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/mainmarket/aboutmainmarket/Listing+criteria/admissioncriteria.htm> at 7 December 2008. The main market listing criteria includes three years of audited historical financial information, including 75% of the entity's business supported by a revenue earnings track record for the three years. The secondary market is called AIM.

and periodic disclosure regimes. Listing Rule 3.1 is a vital part of the overall disclosure framework, but the continuous disclosure regime has inherent limitations.

The Chapter is in Five Parts:

1. Part I outlines the rules on continuous disclosure of earnings expectations.
2. Part II summarises regulator, company and investor views on listed company disclosure practices and outlines prior scholarly research on management forecasts and the continuous disclosure regime.
3. Part III explains the empirical study design.
4. Part IV reviews the empirical study findings.
5. Part V provides critique and concludes.

I CONTINUOUS DISCLOSURE: EARNINGS UPDATES AND FORECASTS

A ASX Guidance Note 8

ASX Guidance Note 8 to Listing Rule 3.1 and the ASIC document entitled 'Better Disclosure for Investors - Guidance Rules'[1386] indicate that the 'way to manage earnings expectations is … to establish a range within which earnings are likely to fall', with a public announcement of any change in expectations.[1387] Imprecise statements are discouraged, including references to analysts' consensus forecasts.[1388] Page 19 of Guidance Note 8 states the following:

> Listing Rule 3.1 provides examples of information that, if material, would require disclosure. One of those examples is a change in the entity's previously released financial forecast or expectations.[1389] As a general policy, *a variation in excess of 10% to 15% may be considered material, and should be announced by the entity as soon as the entity becomes aware of the variation*.[1390] If the entity has not made a forecast, a similar variation from the previous corresponding period will need to be disclosed. In certain circumstances a smaller variation will be disclosable.

[1386] ASIC, above n 244.
[1387] ASIC, above n 244, 3; ASX, above n 177, 19.
[1388] ASX, above n 177, 23.
[1389] The terms "financial forecast" and "expectations" are not defined in Guidance Note 8.
[1390] I added the italics for emphasis.

> Similarly, a larger variation may not necessarily be disclosable provided it is not material. In making such disclosure, the entity must provide some details… of the extent of the variation. … [This may be formatted as] expected net profit or EBIT… a stated range… [or an] approximate percentage movement. ASX discourages entities from using terms such as "single digit" and "double digit" … as they are considered to be insufficiently precise …
>
> In some cases, it may be appropriate for a listed entity to disclose material variations from analysts' consensus forecasts and expectations … [However], listed entities should refrain from publicly commenting they are "happy" or "comfortable" with analysts' consensus forecasts' or a range of analysts' forecasts… [Such comments are likely to result in a request for immediate disclosure of] an expected profit or an approximate amount or an amount within a stated range.

Page 23 of Guidance Note 8 provides working examples of when disclosure is required under ASX Listing Rule 3.1. These examples indicate that disclosure is required when a company becomes aware part way through a financial period that actual revenues and profits for the period will vary to a material extent, in comparison to the previous corresponding period or to projections and indications previously provided to the market for the period. Immediate disclosure is also required two weeks prior to the lodgement of a preliminary final report when year-end adjustments and write-downs result in a significant reduction in the results in comparison to the previous corresponding period.

B Management Forecasts and Updates

The Guidance Note 8 benchmarks against which expected earnings are to be compared are:

- A prior management earnings forecast or
- The previous corresponding period.

There are significant differences between these two benchmarks. The results for the previous corresponding period are readily available from the statutory or other accounts. However, it is more difficult to determine whether a forecast has been provided, and if so, what the relevant benchmark number is.

When prospective financial information is included within a disclosure document in Australia, there must be reasonable grounds for any estimates provided or assumptions made.[1391] The provision of management earnings forecasts is often assumed to be voluntary.[1392] However, an earnings update genrally becomes mandatory under Guidance Note 8 when company management become aware that expected earnings are likely to exceed a prior forecast or previous corresponding period by more than 10-15 percent and this constitutes materially price-sensitive information.

II CONTINUOUS DISCLOSURE FRAMEWORK

A Listed Company Disclosure Practices: The Varying Perspectives

Regulators, listed companies, company advisors, investors and other stakeholders have divergent views on the purposes and efficacy of the listed company disclosure and insider trading regimes.

1 *ASX Commentary*

In 2002, Humphrey, a prior managing director and CEO of ASX, indicated in a speech entitled 'Incentives to Integrity – ASX as a "For Profit" Supervisor' to the Group of 100 that

> [t]he Listing rules cover a lot of detail but their central theme is disclosure. A fair, orderly and transparent market is one that is fully informed. So we are in the business of information – and in particular, we are in the continuous disclosure business: ensuring that listed companies are keeping the market informed by providing material information under Listing Rule 3.1.[1393]

[1391] ASIC, Regulatory Guide 170: *Prospective Financial Information* (September 2002). In 1978, the SEC in the United States released a policy statement and guidance encouraging company management forecasts. A safe harbour rule was introduced to shelter companies from litigation in relation to any forecasts made in good faith on a reasonable basis. Management are only liable if a plaintiff can establish that a forecast was made with knowledge that it was false or misleading. Nevertheless, companies are advised to disclose assumptions and limitations associated with any voluntary forecasts: *Private Securities Litigations Reform Act* (1995); Securities Act Release No 6084.

[1392] ASX, above n 177, 23. The distinction between voluntary management earnings forecasts and mandatory earnings updates is important within the theoretical and legal debates. There are large theoretical and empirical bodies of work that examine why managers voluntarily provide forecasts.

In 2003, Newman, a prior Chairman of ASX, stated in an address on ‘The Markets and Investors: Is There Too Much Disclosure?’ to the CEDA Copland Program that the ‘integrity, efficiency and international standing of Australia’s capital markets is to a large extent dependent on a sound system of disclosure.’[1394] He went on to say that

> [e]nsuring that our continuous disclosure regime remains at the forefront of world’s best practice is something that ASX is strongly committed to.
>
> There is no doubt, that today’s market has much greater transparency. There is also a greater demand indeed a thirst for information. The advent of discount brokers, advances in internet technology, the introduction of open interface trading technology have all created an information flow which is constantly challenging whether the market is fully informed.[1395]

In 2006, Newman addressed the AIRA Conference on ‘The Perfect Storm: Managing Investor Relations in a Volatile Market’. He indicated that

> [a]s a market operator licensed by the Australian Government, ASX is obliged to provide a market of integrity – one that is fair, orderly and transparent. A market of integrity ensures a level-playing field, inspiring confidence among all users and, by doing so, reducing risk and driving down the cost of capital … In Australia, we are about sunlight and transparency.[1396]

In 2009, Mayne spoke to AIRA on ‘Governance & Supervision’. He concluded that

> [d]isclosure and the “informed shareholder” go hand in hand. Shareholders would only be able to exercise their rights in a responsible, informed and considered way only if companies uphold the highest standards of disclosure and transparency. It is not about boiler plate reporting nor is it about tick-a-box compliance – the key is quality reporting.[1397]

[1393] Richard Humphry, Managing Director and Chief Executive Officer ASX, ‘Incentives to Integrity – ASX as a “For Profit” Supervisor’ (Speech delivered at the Group of 100, 27 November 2002) 5.

[1394] Maurice Newman, Chairman ASX, ‘The Markets and Investors: Is There Too Much Disclosure?’ (Speech delivered at the CEDA Copland Program, 8 August 2003) 2.

[1395] Newman, above n 1394, 5-6.

[1396] Maurice Newman, Chairman ASX, ‘The Perfect Storm: Managing Investor Relations in a Volatile Market’ (Speech delivered at the AIRA Conference, 23 November 2006) 2, 4.

[1397] Eric Mayne, Chief Supervision Officer ASX, ‘Governance & Supervision’ (Speech delivered at the AIRA Conference, 2 December 2009) 26-27.

2. *ASIC Commentary*

In 2008, Gibson, an ASIC Commissioner, made a speech on 'Disclosure and the role of ASX and ASIC' at the Listed Companies Conference.[1398] Gibson indicated that the key elements of the disclosure regimes are:

1. Disclosure of price sensitive information to the market in a timely fashion;
2. Announcements that are not false, misleading or deceptive; and
3. Announcements that are clear, accurate and complete.[1399]

She defined "clear announcements" as information contained in a market release that is factual and expressed in an objective and clear manner; "complete announcements" as documents that can be read as a whole without reference to other documents to locate price-sensitive information; and "accurate announcements" as disclosure of information that is factually correct, easily understandable, with due prominence to positive and negative information.[1400]

In a presentation to the Company Directors Conference in June 2009 on 'Regulators At the Forefront of Change', Gibson stated that the big focus is on restoring confidence in the capital markets. She indicated that this requires the promotion of market integrity – 'the attributes of transparency and fairness that set our market above many.'[1401]

In October 2009, in a presentation at a University of Sydney Faculty of Economics and Business Conference on "Aspects of Market Integrity – Where Next?", Gibson acknowledged that an ASIC research project on the control and management of company information found that listed company processes around confidential information are suboptimal and below the standards adopted in overseas markets.[1402] Gibson described the environment for obtaining company information as "pushy" and

[1398] Belinda Gibson, ASIC Commissioner, 'Disclosure And The Role of ASX and ASIC' (Speech delivered at the Listed Companies Conference, 26 March 2008).
[1399] Gibson, above n 1398, 6.
[1400] Gibson, above n 1398, 11-12.
[1401] Belinda Gibson, ASIC Commissioner, 'Regulators At the Forefront of Change' (Speech delivered at the Company Directors Conference, 11 June 2009) 6.
[1402] Gibson, above n 1112.

indicated that some investors even frequent bars that company executives are known to use.[1403]

In a speech to the AIRA in December 2009, Gibson highlighted that

> good disclosure is an essential attribute of a market "with integrity"… [including] disclosure of information about an investment in the initial offering material and also ongoing disclosure of current information to the market. It is both the quality of information as well as the quantity of information which is crucial in determining whether disclosure advances the transparency and fairness of a market.[1404]

In 2010, Gibson spoke on the topic 'Working in a Regulated Environment' to the Law Society of Western Australia Summer School. Gibson described the continuous disclosure regime as sitting over the formal documents and as a regime that rather than being prescriptive, 'requires inclusion of "everything investors and their advisers reasonably require to make an informed assessment of the investment".'[1405] She defined "clear, concise and effective" documentation to mean that

> [d]ocuments must be readable – if they are lengthy, there must be a clear road map to enable the readers to select the information they need to make a sensible investment decision. They must be understandable. The content must be clear and relevant to the investment decision at hand. The risk must be put up front and in one place.[1406]

3 *Listed Company Commentary*

The ASIC Summer School in 2008 included panel discussion specifically on disclosure of earnings expectations. Cole, General Counsel at Woodside Energy, confirmed that Woodside provides the market with forecast oil and gas production levels but does not make profit forecasts, and doesn't update the market when expected earnings move beyond a 10-15 percent variation to the prior year results. Cole suggested that this is 'something that the market just doesn't expect us to do and it's not meaningful … because the profit can swing quite dramatically in and out of the 10-15 percent range'.[1407] Story, Chairman of the Australian Institute of Company Directors, indicated

[1403] Gibson, above n 1112. See also ASIC, above n 1372. The Commission proposes to issue best practice guidelines in relation to the handling of confidential company information.
[1404] Gibson, above n 327, 5.
[1405] Gibson, above n 24, 5.
[1406] Gibson, above n 24, 5.
[1407] ASIC, above n 6, 70-71.

that companies should give guidance when they are ‘coming to the end of a financial period and … have a pretty good idea of [the] results … [and] market expectations are … contrary to variance.’[1408] Krasnostein, the Chief General Counsel at National Australia Bank, indicated that ‘for companies that are closely scrutinised … in the very efficient transparent market that we live in now, [the] issue of what ... the law say[s] is almost an afterthought.’ [1409]

Cole suggested that the Note 8 guidance on disclosure of earnings expectations doesn’t apply to Woodside because the “market” doesn’t expect such disclosure. Story suggested that it is acceptable for companies to wait until near the end of a financial year to disclose management expectations, and even then, only if contrary to “market expectations”. It is not clear what Cole and Story mean by the phrases “market” and “market expectations”, but it is probably analyst and analyst consensus figures. The use of these phrases may suggest that some Australian company managers have not fully accepted the rationales underlying Listing Rule 3.1 and Guidance Note 8 – namely, the need for timely and equal disclosure to *all* investors.

4 *Investor Commentary*

Investor views on company disclosure and disclosure failures reflect a different perspective. Even some of the largest Australian institutional investors have complained about significant levels of insider trading and information asymmetry. Morgan, the investment director of 452 Capital and a well-respected fund manager in Australia, suggested there ‘is a lot of questionable trading going on and it is in some ways, out of hand … 80 percent of announcements from large companies [are] associated with some sort of unusual trading beforehand.’[1410] Sisson, the Managing Director of Balanced Equity Management Pty Ltd, agreed, indicating that ‘[a]gain and again you see price movements that are unexplained’.[1411] Several commentators have suggested there are clear trading patterns of very high share trading volumes and profits made prior to announcements of ‘takeover bids, capital raisings and other price sensitive news’ in

[1408] ASIC, above n 6, 71.
[1409] ASIC, above n 6, 71.
[1410] Geoffrrey Newman, ‘Praise for ASIC Surveillance Boost’, *The Australian* (Sydney), 12 December 2006, 17.
[1411] ASIC, above n 6, 83.

Australia.[1412] Hunt, the Chairman of Caliburn, indicated that '[u]nusual price movements ahead of takeover announcements and capital raisings in this market are frustratingly commonplace'.[1413] He suggested that the incidence of insider trading is "unacceptably high" and that a change in regulatory approach is required.[1414] Seabrook, an Executive Director of Gresham Investment Partners, suggested there 'are some outrageous practices at the larger end of the market where leaks occur.'[1415] While some of these comments were made in the context of insider trading**,** most, if not all, of the described circumstances represent failures to continuously disclose.

In addition, only 39 percent of the business respondents and seven percent of the consumer respondents to the 2008 ASIC Stakeholder Survey were confident that Australian capital markets are free from insider trading and other market abuses, and only 30 percent agreed that fraud, dishonesty and misconduct are likely to be found and punished. Yet around 80 percent of the respondents agreed that prosecuting market abuses should be a high priority.[1416]

The investor and ASIC stakeholder comments present a generally negative stance on the level of disclosure integrity and the extent to which company disclosure failures or insider trading are enforced in Australia.

B Continuous Disclosure and Management Forecast Empirical Research

1 *International Studies*

There have been many studies in the US on earnings disclosure, some of which were highlighted in Chapters Two to Four. This includes a distinct body of research on voluntary management forecasts. The accounting and finance literature suggests that company management provide voluntary management earnings forecasts to ensure a

[1412] David Elias, 'Insiders Profit in Murky Business', *The Age* (Melbourne), 6 August 2005; Malcolm Maiden, 'Marriage Of Exchanges a License to Print Monopoly Money', *The Age* (Melbourne), 25 May 2006, 10.
[1413] Michael West, 'Insider Trading Still On the Rise', *Sydney Morning Herald* (Sydney), 20 February 2008, 19.
[1414] West, above n 1413.
[1415] ASIC, above n 6, 82.
[1416] The Allen Consulting Group, *ASIC Stakeholder Survey* (April 2008) 13, 14, 18, 30, 35.

successful capital raising,[1417] enhance market valuations or reputation by releasing good news,[1418] reduce selective or unequal access to private information,[1419] correct or confirm analyst forecasts, move market expectations on prospective earnings,[1420] or avoid litigation.[1421] Conversely, company management may choose not to voluntarily provide public earnings guidance because of an inability to predict future earnings, litigation risks, or concerns about potential increased pricing volatility.[1422]

International empirical studies suggest that management forecasts reduce analyst forecast dispersion and price volatility,[1423] and result in lower discounting of future earnings.[1424] In addition, they are informative for company valuations[1425] and reduce information asymmetry.[1426] Management forecasts have generally been found to be more accurate than forecasts provided by analysts in the absence of management guidance,[1427] and there is some evidence suggesting an association between earnings

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1417 Ajinkya et al, above n 1005, 428; William Ruland, Samuel Tung and Nashwa George, 'Factors Associated with the Disclosure of Managers' Forecasts' (1990) 65 *Accounting Review* 710; Mark Lang and Russell Lundholm, 'Cross-Sectional Determinants of Analysts Ratings of Corporate Disclosures' (1993) 31 *Journal of Accounting* 246; Clarkson et al, above n 155.

1418 Stephen Penman, 'An Empirical Investigation of the Voluntary Disclosure of Corporate Earnings Forecasts' (1980) 18 *Journal of Accounting Research* 132; Ajinkya et al, above n 1005; Brett Trueman, 'Why do Managers Voluntarily Release Earnings Forecasts?' (1986) 8 *Journal of Accounting and Economics* 53; Ruland et al, above n 1417; Baruch Lev and Stephen Penman, 'Voluntary Forecast Disclosures, Non-Disclosure, and Stock Prices' (1990) 28 *Journal of Accounting Research* 49; Skinner, above n 61 (1994), 58.

1419 Ajinkya et al, above n 1005, 428.

1420 Ajinkya et al, above n 1005; Trueman, above n 1418; Ruland et al, above n 1417.

1421 Ron Kasznik and Baruch Lev, 'To Warn or Not to Warn: Management Disclosures in the Face of an Earnings Surprise' (1995) 70 *Accounting Review* 113; Skinner, above n 458.

1422 Ajinkya et al, above 1005, 427-428; Skinner, above n 458; Leonard Soffer, S Ramu Thiagarajan and Beverly Walther, 'Earnings Preannoucement Strategies' (2000) 5 *Review of Accounting Studies* 5.

1423 Gregory Waymire, 'Earnings Volatility and Voluntary Management Forecast Disclosure' (1985) 23 *Journal of Accounting Research* 268.

1424 Michael Clement, Richard Frankel and Jeffrey Miller, 'Confirming Management Earnings, Forecasts, Earnings Uncertainty and Stock Returns' (2003) 41 *Journal of Accounting Research* 653.

1425 Penman, above n 1418, 167; Gregory Waymire, 'Additional Evidence on the Information Content of Management Earnings Forecasts' (1984) 22 *Journal of Accounting Research* 703; Trueman, above n 1418; Grace Pownall, Charles Wasley and Gregory Waymire, 'The Stock Price Effects of Alternative Types of Management Earnings Forecasts' (1993) 68 *Accounting Review* 896.

1426 Coller et al, above n 455, 190.

1427 George Foster, 'Stock Market Reaction to Estimates of Earnings Per Share By Company Officials' (1973) 11 *Journal of Accounting Research* 25, 35**;** Nicholas Gonedes, Nicholas Dopuch and Stephen Penman, 'Disclosure Rules, Information Production and Capital Market Equilibrium: The Case of Forecast Disclosure Rules' (1976) 14 *Journal of Accounting Research* 89**;** James Patell, 'Corporate Forecasts of Earnings Per Share and Stock Price Behavior: Empirical Test' (1976) 14 *Journal of Accounting Research* 246, 246; Bikki Jaggi, 'A Note on the Information Content of Corporate Annual Earnings Forecasts' (1978) 53 *Accounting Review* 961, 966. See also John Poole, 'Improving the Reliability of Management Forecasts' (1989) 14 *Journal of Corporations Law* 547, 635.

guidance and aggregate returns.[1428] Long-term earnings forecasts appear to be more important predicators of share price movement than short-term forecasts.[1429] The extent of outside[1430] ownership of a company and new capital raisings have been found to be important factors driving the provision of voluntary management forecasts, with analyst forecast error playing a less significant role.[1431]

The empirical studies as a whole suggest that market efficiency is enhanced by the provision of management earnings forecasts.

2 *Australian Studies*

Scholarly studies on the Australian continuous disclosure regime have used various designs and measures.[1432] Gallery, Gallery and Gilchrist reviewed earnings changes between 1994 and 1996 from a sample of 209 of the largest ASX listed industrial firms.[1433] They found only 14 percent of earnings changes were preceded by an ASX announcement, there was greater disclosure of bad news than good news, and the frequency of disclosure did not increase with the magnitude of the earnings change. Moreover, even when announcements of changes to earnings forecasts were made between reporting periods, share price reaction was weak, suggesting private trading on the information prior to disclosure. The study authors suggested the evidence provided 'little support for a culture of "continuous disclosure".'[1434]

Gallery, Gallery and Hsu examined annualised management earnings forecasts made through the ASX by the top 500 listed companies from September 1994 to June

[1428] Waymire, above n 1423, 717; Carol Anilowski, Mei Feng and Douglas Skinner, 'Does Earning Guidance Affect Market Returns? The Nature and Information Content of Aggregate Earnings Guidance' (2007) 44 *Journal of Accounting & Economics* 36.
[1429] Uren, above n 121, 196 citing Philip Brown.
[1430] Outside ownership is defined in the study as shareholdings by parties that are not company directors or officers.
[1431] Ruland et al, above n 1417, 720.
[1432] Proxies adopted to assess the efficacy of the regime have included: the level of ASX announcements; the level of management earnings forecasts provided; the levels of earnings disclosures made through routine, non-routine or stand-alone ASX announcements; the timeliness, specificity and reliability of negative and positive earnings disclosures; the effects of the magnitude of earnings changes on ASX disclosures; and price efficiency effects following regulatory changes.
[1433] Gallery et al, above n 97.
[1434] Gallery et al, above n 97, 24.

1998.[1435] Companies that experienced large earnings disappointments or materially inaccurate analyst forecasts were more likely than other companies to provide earnings updates.[1436] However, managers rarely pre-emptively disclosed large positive earnings increases through the ASX.[1437] Chan, Faff, Ho and Ramsay examined management forecast disclosures for listed companies with analyst coverage for the period 1994-2001.[1438] The number of total forecasts, non-routine forecasts and bad news forecasts increased significantly over the study period.[1439] The authors suggested the findings were consistent with the hypothesis that the increased disclosure resulted from legislative change to the continuous disclosure regime and increased enforcement action.[1440]

CASAC conducted a review of the statutory regime in 1996 and suggested the regime was operating effectively and companies were able to apply the rules.[1441] In a survey of listed company managers, one third of the respondents indicated they had increased their levels of disclosure and companies generally reported that the new regime had assisted in keeping the market more informed.[1442] However, a commissioned study by Brown, Taylor and Walter found mixed results. Although total disclosures increased after the introduction of the statutory regime, disclosures classified as price-sensitive by the ASX only became more frequent for firms without large analyst following and companies releasing bad news.[1443] Secondly, while share prices for smaller companies were found to be more efficient with prices reflecting information earlier, there were no price efficiency gains in relation to larger companies. Thirdly, while there was an increase in forward-looking statements and voluntary disclosures, and a significant decrease in market and share price volatility, it was difficult to determine whether this

[1435] Gerry Gallery, Natalie Gallery and G Hsu, 'The Association Between Management And Analyst's' Earnings Forecasts In The Australian Continuous Disclosure Environment' (Working Paper, University of New South Wales, University of Sydney, 2002) 21.
[1436] Gallery et al, above n 1435, 7.
[1437] Gallery et al, above n 1435, 21.
[1438] Howard Chan, Robert Faff, Yew Kee Ho and Alan Ramsay, 'Management Earnings Forecasts in a Continuous Disclosure Environment' (2007) 19 *Pacific Accounting Review* 1. Announcements made at annual general meetings (AGM), half yearly and annual earnings announcements were reviewed and announcements between the AGM and three months prior to the annual earnings announcement.
[1439] The routine announcements were defined as those made at the AGM or the half yearly result, with others defined as non-routine. The forecasts were classified as good, neutral or bad news based on net profit after tax and compared against analysts' forecasts or prior year earnings.
[1440] Chan et al, above n 1438, 25.
[1441] CASAC, above n 95, 2-5.
[1442] CASAC, above n 95, 4-5.
[1443] Brown et al, above n 443, 161.

resulted from continuous disclosure regulation or other factors.[1444] Brown et al concluded that overall 'there was no strong evidence that the implementation of continuous disclosure had any significant impacts on the efficiency of the Australian share market or on the disclosure policies of listed' companies.[1445]

In a survey of Australian company directors in 2000, 93 percent of respondents indicated that the continuous disclosure regime 'had increased their propensity to disclose bad news about their business'.[1446] Sixty eight percent believed the regime had increased their incentive to release good news, and 42 percent that it made them more willing to 'disclose forward-looking information.' In addition, half of the respondents believed there had been a reduction in the inequality of information flows since the introduction of the regime.[1447]

However, a Gallagher et al study of daily trades of institutional Australian equity managers for the period 1995-2001 found evidence consistent with active Australian equity managers being able to generate abnormal returns from earnings announcements in a number of ways. The study authors indicated that fund managers have advantageous portfolio holdings prior to earnings announcements. They earn abnormal profits from trades immediately prior to the announcements being made, and they profit from trading after the announcements are made.[1448] They suggested that fund 'managers … have private information regarding positive earnings announcements.'[1449]

Neagle and Tyskin suggested in a study that examined stock price queries during 1999 and 2000 that many companies seemed to respond to the continuous disclosures obligations on a reactive rather than a proactive fashion.[1450] The company responses to ASX queries seemed poor and the authors suggested the number of queries issued indicated a 'potential lack in candour in disclosure activity'.[1451] Similarly, McNamara,

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[1444] Brown et al, above n 443.
[1445] CASAC, above n 95, 7.
[1446] H Corlett, Raymond da Silva Rosa and Terry Walter, 'Corporate Executive Experience of Continuous Disclosure' (Working Paper, University of Sydney, 2002).
[1447] Corlett et al, above n 1446.
[1448] David Gallagher, Adran Looi and Matt Pinnuck, 'Institutional Trading Around Earnings Announcements' (Working Paper, University of New South Wales, University of Melbourne, March 2007) 1, 23.
[1449] Gallagher et al, above n 1448, 16. See also Craswell et al, above n 550, 301, 320.
[1450] Neagle et al, above n 428.
[1451] Neagle et al, above n 428, xi. See also ASX, *Exposure Draft Proposed ASX Listing Rule Amendments Enhanced Disclosure* (July 2002) 16, 39; ASX, *ASX Report to Shareholders 2004/05* (2005) 16. The ASX

Gallery and Fargher examined ASX price queries for the period 1 March 2000 to 30 June 2002 and found evidence consistent with management reluctance to disclose earnings related information prior to the mandatory reporting periods.[1452] The study found positive associations between the level of abnormal returns leading up to the issue of an ASX query and the magnitude of the subsequent earnings surprise and related disclosures, but no association was found between the magnitude of the abnormal returns leading up to the issue of the ASX query and the management responses to the queries. The authors' conjectured explanation was selective disclosure.[1453]

A more recent study by Gallery, Guo and Nelson examined management earnings forecasts made through the ASX during the period from 1994 to 2008. This research found the timeliness of the management forecasts provided deteriorated over the study period. Moreover, unfavourable earnings news was routinely released later than favourable news.[1454]

The prior studies suggest some listed Australian companies fail to disclose material changes in earnings expectations through the ASX on a timely basis. I examine earnings disclosures further using Guidance Note 8 to ASX Listing Rule 3.1 as a benchmark.

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responded that the Neagle et al study provided no concrete evidence of reluctance by companies to disclose. It argued that corporate disclosure improved following the HIH and One-Tel collapses, continuous disclosure regulation was effective, retail shareholders had no reason to question the integrity of the market, and company disclosure was the best it had ever been.

[1452] Christopher McNamara, Gerry Gallery and Neil Fargher, 'Management Reluctance to Disclose Earnings Information in a Continuous Disclosure Environment: Evidence From the Association Between Unexplained Stock Returns and Subsequent Disclosure' (Working Paper, University of NSW, February 2004).

[1453] McNamara et al, above n 1452.

[1454] Gerry Gallery, Chan Guo and Jodie Nelson, 'The Impact of Litigation Risk on Disclosure Timeliness' (Working Paper, Queensland University of Technology, April 2010) Gallery et al, above n 97, 14, 22. The 2010 Working Paper indicates that the asymmetric timeliness gap between favourable and unfavourable news declined later in the reporting period but no details are provided.

III EMPRICAL STUDY DESIGN

A Background

To examine the efficacy of the continuous disclosure regime, appropriate measures or proxies must be adopted as benchmarks against which compliance can be assessed. The empirical study uses the Note 8 guidance on disclosure of changes in earnings expectations as a benchmark because:

(i) Company disclosures on expected earnings[1455] are necessary for rational investment decisions on a fundamental basis;

(ii) Timely disclosures on earnings matters are essential for investors to have genuinely equal access to material company information;

(iii) Guidance Note 8 is the only policy commentary on the nature and scope of the continuous disclosure obligations; and

(iv) Management disclosure on changes in financial forecasts or expectations is the first example provided in Guidance Note 8, indicating its importance within the continuous disclosure regime.

The legal status of Guidance Note 8 is unclear.[1456] However, given the uncertainties around the continuous disclosure obligations and the minimal case law and policy guidance on the content of the obligations, the Note 8 guidance provides a credible framework to test compliance with Listing Rule 3.1.

Guidance Note 8 states that variations in earnings expectations of more than 10-15 percent compared to a prior forecast or the previous corresponding period are prima facie material, although the final materiality determination remains with the company. The ASX, company management and company advisors regularly refer to the Note 8 guidance of a 10-15 percent change in prospective earnings within price queries, ASX

[1455] The earnings amount the company management expect to report for the current year or period.

[1456] Guidance Note 8 outlines guidance from the ASX on the operation of Listing Rule 3.1. There is no case law on Listing Rule 3.1 as stand alone regulation, and no case law that references Guidance Note 8. Thus, it is not clear whether, and how, the judiciary would take Guidance Note 8 into account when determining an action under Listing Rule 3.1 or pursuant to the statutory continuous disclosure regime.

announcements and media reports.[1457] Most of the compliance analysis is based on a "best case"[1458] 15 percent materiality threshold.

Guidance Note 8 to ASX Listing Rule 3.1 is ambiguous on what the term "earnings" refers to. Consequently, the study captured earnings changes on four bases; net profit, diluted EPS, earnings before interest and tax (EBIT) and any management format adopted by company management. Consistent exchange rates over a year were applied to companies that reported in currencies other than in Australian dollars.

Most of the analysis is based on the diluted EPS figure because this measure of a company's financial performance incorporates all forms of dilution.[1459] Other earnings measures such as operational earnings, earnings before interest, tax, depreciation and amortisation (EBITDA), earnings before interest, tax and amortisation (EBITA), EBIT, and net profit are not complete measures and may not provide an accurate indication of performance.[1460] Nevertheless, some analysis is provided on the net profit and EBIT measures, and the accuracy measures are based on the management forecast benchmark.

B Study Sample

The full study sample included two groups of companies. All companies within the S&P/ASX 300 index as at 17 November 2008 were included, plus another three

[1457] Australian analysts were scathing in 2009 when the Commonwealth Bank argued that information had not been disclosed because the impact on earnings was below the 15 percent threshold: Eric Johnston, 'CBA Faces Debt Disclosure Probe', *Sydney Morning Herald* (Sydney), 20 December 2008; Eric Johnston, 'Commbank Defends Disclosures', *Sydney Morning Herald* (Sydney), 22 December 2008.

[1458] Many companies provided updates to the market of changes in earnings expectations below 15 percent during 2007 and 2008. Assuming a close link between company performance (eg the cumulative growth rate in the annualised diluted eps) and equity returns, the equity return data suggests that "material" changes in earnings for many listed companies are often well below 15%. Historical real Australian equity returns have been around 7-10 percent: Tim Brailsford, John Handley and Krishnan Maheswaran, 'Re-examination of the Historical Equity Risk Premium In Australia' (2008) 48 *Accounting and Finance* 73, 87.

[1459] See, eg, Financial Services Institute of Australasia, *Company Reporting- The Equity Analysts' Perspective* (May-Oct 2005). In a 2005 survey by the Financial Services Institute of Australasia, 63 percent of analyst participants supported the provision of management earnings forecasts or guidance. The preferred format of earnings guidance was ranked in the following order: earnings per share (EPS), net profit after tax (NPAT), earnings before interest and taxes (EBIT), revenue, and finally cashflow. I concur with the survey rankings.

[1460] This is particularly important where a company has increased the number of shares on issue significantly, the financing has been changed, the company is highly leveraged, or there are significant events or items during the period.

hundred listed companies selected on a random basis.[1461] The 300 companies were selected from all listed companies on 17 November 2008 after removing ASX/ S&P 300 companies and companies that had not traded in the prior six months. From the initial two groups, the following companies were excluded: those admitted to listing during the 2007 or 2008 financial years; those that didn't provide disclosures for the full 2007 and 2008 financial years; those who changed their balance date within the 2007 or 2008 financial years; and companies suspended from trading or in administration, receivership or liquidation. The final sample comprised 466 listed companies, of which 262 were included within the ASX/ S&P 300 index and 204 were smaller companies.

Table 1: Sample Selection Procedure

Selection Steps	**No of Companies**
1. Companies within the ASX/S&P 300 on 17 November 2008	295[1462]
Less companies admitted to listing within the 2007 or 2008 financial years	20
Less: companies with a change in balance date within the 2007 or 2008 financial years	4
Less: companies in administration or liquidation or suspended from trading	4
Less: companies that did not provide financial accounts for the 2007 & 2008 financial years	5
ASX/ S&P 300 companies within study	**262**
2. Random sample of companies outside of the ASX/ S&P 300	
Total number of companies listed on the Australian market on 17 November 2008	2012
Less: companies with no trading activity for the prior 6 months	299
Less: companies within ASX/S&P 300	295
Companies used for random sample selection	1418
Random sample size	300
Less companies admitted to listing within the 2007 or 2008 financial years	74
Less: companies with a change in balance date within the 2007 or 2008 financial years	1
Less: companies in administration or liquidation or suspended from trading	16
Less: companies that did not provide financial accounts for the 2007 & 2008 financial years	5
No of companies outside of ASX/ S&P 300 within study	**204**
Total study sample	**466**

[1461] A random sample of 300 from the remaining 1418 companies (21%) was sufficiently large statistically that the sample results could be expected to accurately reflect the properties across the rest of the market.
[1462] The index constituents were sourced from the ASX website list, which included only 295 companies on 17 November 2008.

C. Study Period

Company disclosures made through the ASX during the 2007 and 2008 financial years were examined. The Australian business and capital market environments in 2008 were very different from 2007 as a result of the global financial crisis. The crisis events provided a valuable opportunity to examine possible changes in disclosure patterns.

D Study Data Sources

Most of the data was sourced from the ASX company announcement website. All ASX announcements with potential earnings news were reviewed, including half year reports, preliminary final reports, annual reports, AGM statements, presentations, and other announcements. Company results and the forecasts provided were obtained from these original data sources.

E Study Variables and Definitions

The relevance, comparability and limitations of an empirical study depend on the proxies and variables selected. The variables I adopted reflect the focus of the thesis; namely the extent to which the forecasts were accessible from the ASX website, and the transparency, consistency, accuracy and timeliness of the forecasts provided. The study variables and definitions are outlined in Table 2.

(Table 2) Study Definitions

	Proxies	Explanation
Disclosure	0. Non-disclosing company 1. Disclosing company	A **disclosing company** provided a quantitative earnings forecast or update (forecast) prior to the relevant financial year-end.
Earnings Announcements	1. Earnings forecast 2. Preannouncement 3. Quantitative forecast 4. Qualitative forecast.	**Earnings forecast:** an ASX announcement prior to the financial year-end containing a forecast for the full year. The first such forecast is included and any subsequent revised forecasts. **Pre-announcement:** an ASX announcement after the relevant financial year-end containing a forecast for the full year. **Quantitative forecast:** a forecast in a quantitative format **Qualitative forecast**: a forecast with specific earnings news on a qualitative basis only.
Forecast Specificity	1. EPS point or range 2. Net profit point 3. Net profit range 4. Other financial indicator 5. Qualitative	The most precise statutory forecast specificities are EPS or net profit. Quantitative forecasts using other specificities are included as a '**other financial indicator**". Further categorisation of these forecasts is provided in Table 6**.**
Forecast Format	1. Statutory forecast 2. Management forecast 3. Unexplained forecast	**Statutory forecast:** a forecast in a format shown in the profit and loss in the annual report. **Management forecast**: a forecast in a format not used in the statutory profit and loss but which is explained. **Unexplained forecast**: the forecast format or type is not explained or is ambiguous
Forecast Location	1. Prelim report 2. Annual report 3. AGM 4. Interim report 5. ASX query 6. Other	The **location** where the final forecast was provided.
Forecast Label	1. Result label 2. Earnings label 3. AGM label 4. Presentation only 5. Other	**Result label:** a forecast with an ASX announcement label clearly identifying a result disclosure. That is, a forecast labelled as an interim or preliminary final result announcement or as the annual report. **Earnings label:** a forecast with an ASX announcement label clearly identifying an earnings update. This includes announcements during a result period clearly identified as earnings disclosures. **AGM label:** a forecast with an ASX announcement label referencing an AGM presentation or statement. **Presentation only:** a forecast provided only within company presentation slides. **Other label:** a forecast provided in an announcement with a label that is not result, earnings, AGM or presentation related.
Forecast Transparency	1. Complete 2. Incomplete forecast 3. Not calculable	**Complete**: a forecast that is understandable without reference to other documentation. **Incomplete forecast**: a forecast that is only understandable by reference to other documentation released through the ASX. **Not calculable:** a forecast that cannot be calculated numerically based on information released through the ASX.

Forecast Consistency	1. Consistent 2. Inconsistent 3. Not applicable	**Consistent:** when multiple forecasts are provided during a financial year and the specificities are consistent. **Inconsistent:** when multiple forecasts are provided during a financial year and the specificities differ throughout the year. **Not applicable:** where only one forecast is made during the year.
Forecast Benchmark	1. Previous corresponding period 2. Prior forecast 3. Market expectations 4. None/not determinable	The **forecast benchmark** is defined as a comparison against: the previous corresponding period, a prior forecast, or market expectations.
Forecast Accuracy	% Comparison to forecast benchmark	**Framed accuracy**: the percentage variation between the earnings forecast and the actual result based on the forecast benchmark.
BdNews	1. Good news company 2. Bad news company	**Good news company**: a company with the same or improving year-on-year diluted EPS. **Bad news company**: a company with a decreasing year-on-year diluted EPS.
Res	1. Industrial 2. Resource	Listed Australian companies are classed as either industrials or resources.
Size	Market capitalisation	The log of the market capitalisation of a company in Australian dollars (millions)
Loss	1. Statutory profit 2. Statutory loss	**Statutory profit**: a positive diluted EPS in the profit and loss account in the annual report. **Statutory loss**: a negative diluted EPS in the profit and loss.
DilEPS	Statutory diluted EPS	The diluted EPS figure in the profit and loss account.
DilEPSΔ	Year-on-year change in diluted EPS	The annualised change in diluted EPS. The prior year diluted EPS is deducted from the current year diluted EPS and scaled by the absolute value of the prior year diluted EPS. Calculations involving a base of zero are excluded. A change from a negative to positive is a positive year-on-year change and **vice versa**. Eg a change from 5 to 15 or –5 to +5 = +200% and 10 to –5 = -150%.
DilEPSΔAbs	Absolute year-on-year (yoy) change in diluted EPS	The absolute value of the annualised diluted EPS change (i.e. the sign of the change is ignored).
EBITΔAbs	Absolute year-on-year change in EBIT	The absolute value of the annualised EBIT change.
Comply	0. Annualised dilEPS change <= specified level 1. Annualised dilEPS change > specified level	Year-on-year change in diluted EPS above a specified level of 10 / 15 / 25 / 50 / 100/or 200%. (Eg Comply10, Comply15 ... Comply 200)
SDevEPS	% Std Dev	Standard deviation of the diluted EPS over the 2006-2008 financial years.

IV EMPIRICAL STUDY FINDINGS

The study findings are split into two sections. Descriptive tables are provided initially on the observed disclosure patterns. Subsequent logistic regression analysis examined possible factors to explain these patterns.

Most of the study analysis was based on the companies within the study sample of 466 companies that disclosed or provided a quantitative forecast (forecast) prior to the relevant financial year-end.[1463] When companies provided multiple earnings forecasts within a financial year, the analysis used the final forecast on the basis that it was likely to be the most precise and accurate.

A Study Descriptive Analysis

A series of tables is presented throughout the Chapter:

- Table 3 outlines the properties of the final forecasts provided during the 2007 and 2008 financial years.
- Table 4 looks at the specificity and transparency of the forecasts.
- Table 5 reviews the forecasts against the sign[1464] and materiality of the annualised diluted EPS changes, with an emphasis on the 15 percent materiality threshold.
- Tables 6 analyses the specificity of the forecasts used for good and bad news disclosures.

Tables 3-6 present a lot of data, so the key findings are summarised at the end of the section under the headings of general trends, changes in disclosure patterns from 2007 to 2008, and sectoral factors.

[1463] The value of qualitative forecasts to investors is limited due to the ambiguities of such forecasts. Similarly, the materiality or share price impact of pre-announcements is limited because these disclosures are made close to the result announcement. I accept that some of these announcements cannot be made until after the end of a financial year and that disclosure of these events should be made to the market as soon as possible. Nevertheless, these disclosures, which are generally provided less than a month prior to the formal release of a company's results, are not generally price informative.

[1464] A negative change is defined as bad news and a positive change as good news.

1 *(Table 3): Properties of the Earnings Forecasts Provided*

Table 3 presents data on the final forecasts provided during the 2007 and 2008 financial years within various categories. In columns 1-5 and 12-16, the data is presented by company size (proxied by the main ASX indices: the S&P/ASX 100 index (ASX 100), the S&P/ASX 200 index (ASX 200), the S&P/ASX 300 index (ASX 300) and "Other" companies).[1465] In columns 6-7 and 17-18 of Tables 3 and 4, the data is shown according to whether the companies are resource or industrial. Finally, in columns 8-11 and 19-22, the data is reviewed by industries and factors that were expected to reflect disclosure problem areas (as explained below); namely financial companies, real estate entities, utility and infrastructure entities (the proxy used for the latter category is companies within the transportation index) and companies reporting a statutory loss.

In 2007 37 percent, 27 percent, 28 percent and 13 percent of the ASX 100, ASX 200, ASX 300 and "Other" companies respectively provided forecasts, and the comparative figures in 2008 were 50 percent, 36 percent, 29 percent and 18 percent. The disclosure levels were higher for all of the indices categories in 2008 than in 2007. However, the proportion of companies that provided forecasts decreased monotonically with the size of the companies in both years.

Following down the Table 3 categories, the proportion of final forecasts made outside of the periodic disclosure processes (that is, outside of the preliminary final report, annual report, interim report and AGM releases) increased from 32 percent in 2007 to 41 percent in 2008.[1466] The proportion of companies that provided a preannouncement increased from 4 percent in 2007 to 7 percent in 2008. The forecasts and preannnouncements were spread relatively evenly across the study horizon categories.

[1465] The companies are put into the respective indices categories on a marginal basis. In other words, the ASX 100 companies are excluded from the ASX 200 analysis, and the ASX 100 & ASX 200 companies are excluded from the ASX 300 analysis.
[1466] The location and specificity categories in Tables 3 & 4 include all of the financial forecasts. The other categories include the final quantitative forecasts only.

2 *(Table 4): Specificities and Transparency of the Forecasts Provided*

Table 4 uses the same indices, industry and loss columns as in Table 3 to review the specificity and transparency of the final forecasts provided. The specificity and transparency indicators were generally weaker in 2008 than 2007. The proportion of forecasts specified as "other financial indicators" (in a format other than EPS or net profit) rose significantly from 40 percent in 2007 to 59 percent in 2008.[1467] Although the proportion of forecasts that proved to be accurate within 15 percent of the forecast benchmark increased from 74 percent in 2007 to 80 percent in 2008, this may have been due to the use of differing forecast specificities. Of the final forecasts specified as "Other financial indicator" in 2008, 68 percent were based on an underlying figure (Table 6). It is generally easier for company management to achieve a forecast based on a selected benchmark than one based on a statutory format.

Some of the Table 3 and 4 categories are explained more fully to highlight specific disclosure issues.

(a) Resource Companies

Listed Australian companies are split into varying sector categories depending on the particular index. At the most detailed level, the companies are categorised into 22 sectors. More broadly, companies are classed as either resources or industrials. The resource category includes companies within the materials and energy sectors. All remaining companies are classed as industrial.

The resource category in Australia encompasses many types of materials and energy companies. The sector includes the largest resource companies in the world that are well established, profitable and cash flow positive. At the other end of the spectrum, the sector includes companies in the early development phase that are not profitable, require regular capital or cash injections, and that are not expected to make a profit or generate positive cashflow for many years.

[1467] In 2007, 50 percent of the quantitative forecasts were specified as either net profit point or range in 2007, with a further 13 percent specified as underlying net profit (total 63 percent). In contrast, the proportion of forecasts in 2008 specified as either a net profit point or range fell to 30 percent, with a further 20 percent as underlying net profit (total 50 percent).

The proportion of resource companies that provided a forecast was 9 percent in 2007 and 11 percent in 2008, compared to 31 percent and 40 percent respectively for industrial companies (Table 3). Many resource companies with large changes in profits or swings from profits to losses and vice versa failed to provide the market with any information or updates on their earnings expectations prior to the financial year-end. On a more positive note, resource companies that provided earnings disclosures included coal, building materials, chemical, aluminium, steel, timber, fertiliser, iron ore, and gold companies, as well as general resource development entities.

As indicated in Chapter Two, all listed mining producing entities and exploration companies are required to provide quarterly exploration and cashflow reports under the ASX listing rules. These reports provide project summaries and cashflow and reserve statements. However, the level of management discussion and analysis in these reports and other disclosures to assist with security valuations was generally minimal. Only a few provided project feasibility analysis such as expected returns, assumptions and sensitivities.[1468] Moreover, some companies failed to provide updates on their currency or commodity hedging or forward positions even when these positions significantly impacted actual or prospective future earnings, cashflow and available capital.

(b) Financial Companies

Listed financial companies in Australia include banks, insurance companies and diversified financials. The study financial sector category included 9 banks,[1469] 5 insurance companies[1470] and 34 diversified financials.[1471] Most of the banks in Australia are financial conglomerates that incorporate retail and wholesale banking, wealth management and proprietary trading divisions. Similarly, the largest companies within the insurance and diversified financial indexes are conglomerates with a broad spectrum of businesses. However, some of the smaller listed wealth managers operate with a relatively simple business model.

[1468] A handful of resource companies provided details of feasibility studies. See, eg, Strike Resources Limited, Fox Resources Limited and Tap Oil Limited.

[1469] Westpac, National Australia Bank, ANZ, Commonwealth Bank, St George, Bendigo and Adelaide Bank, Mortgage Choice and Rock Building Society. Strictly speaking, the latter two companies are deposit-taking institutions and not banks. Nevertheless, they are included within the banking index.

[1470] AMP, AXA, Insurance Australia Group, QBE and Suncorp Metway.

[1471] Includes the ASX, various forms of fund managers, investment banks, and a litigation funder.

The proportion of companies within the financial category that provided forecasts in 2007 and 2008 was broadly in line with the industrial category (Table 3). However, 36 percent of the forecasts in 2007 and 75 percent in 2008 were either incomplete or not able to be calculated using the information released through the ASX, and 36 percent of the forecasts in 2007 and 69 percent in 2008 provided by the financial companies were in a management or unexplained format (Table 4). There were significant differences across the category. For instance, only one insurance company provided a forecast.

The statutory reporting of most of the listed financial companies is very different from the industrial companies. A significant proportion of the liabilities of banks and insurance companies are long term. Banks and other companies involved with lending are required to estimate and provide for expected credit losses.[1472] Although Australian banks have been doing this on what is commonly referred to as an "economic basis" for many years, the provisioning is adjusted as actual default rates rise and fall and loss expectations change. Similarly, insurance companies are required to provide for expected future claim losses and these provisions are adjusted as claims are made, loss expectations change, and for changes in the levels of reinsurance. In addition, most financial companies are required under existing accounting standards to mark to market some of their assets such as equities and other market securities.[1473] The loss or claim provisioning and the mark to market adjustments reflected through the statutory profit and loss significantly impact on the reported statutory net profit and diluted earnings per share results. Some of the banks that forecast significant growth in cash earnings during the 2008 financial year suffered reduced diluted EPS due to increases in provisioning, significant items or write-offs.

The management of the financial companies tend to emphasise the cash or operational earnings (prior to or excluding provisioning or mark to market adjustments). However, as clearly highlighted in the recent crises, a critical component of financial company operations and valuations is the management of scarce capital. In practice, actual or provisioned capital losses generally have to be replenished.

[1472] Provisioning for losses is done through general and specific provision accounts.
[1473] See AASB 7 Financial Instruments: Disclosures.

(c) Real Estate Entities

The real estate entities operate under a range of business models. Some are predominantly involved in development, some are solely involved in property management on behalf of third parties, and others operate a mixed business model. However, most of this sector in Australia is comprised of real estate investment trusts.

The earnings disclosure levels by this sector were slightly below the industrial category in 2007, but similar in 2008 (Table 3).[1474] However, a significant variation between these two categories was the lower forecast accuracy levels from the real estate entities largely due to write-downs. The proportion of these forecasts that proved to be accurate within 15 percent of the benchmark result was 44 percent in 2007 and 56 percent in 2008, compared to 77 percent and 84 percent for the industrial category (Table 4).

The statutory reporting of some of the real estate investment trusts was opaque. The non-operational or non-recurring components were often poorly explained. Some of the result releases excluded items such as depreciation, amortisation, losses on sales, significant or non-recurring items when this had not been explained in the forecast disclosures. On a more positive note, many of the real estate entities provided regular updates on the estimated net tangible assets value and expected distributions.

(d) Utilities and Infrastructure Entities

Utility and infrastructure entities are typically involved in large-scale infrastructure projects that span long periods. The companies within the utilities sector are predominantly power related, including power generators, distributors and asset managers. A large proportion of the transportation index is comprised of large listed infrastructure management entities that hold assets such as airports and tollroads.

The levels of earnings disclosures from the combined utilities and transportation category were lower in 2007 and 2008 than the broader industrial category. The proportion of these companies that provided quantitative forecasts in 2007 was 18 percent in 2007 and 27 percent in 2008 compared to 31 percent and 40 percent respectively for the industrial category (Table 3). The forecasts provided were from major energy companies, airline companies and an airport company. None of the listed

[1474] Some of these companies provided regular leasing, debt profile and revaluation updates.

managers of power or transport assets provided forecasts during the 2007 and 2008 financial years.[1475] Disclosures from these types of companies were limited to expected distributions.

Some of the infrastructure companies provided regular updates on the estimated net tangible assets value including assumptions made and sensitivity analysis. However, the statutory reporting of some utility and infrastructure companies was so complex[1476] that the reports were likely of minimal value to investors. Most of these entities had split units or securities and reported in a series of complicated formats.

(e) Companies Reporting a Statutory Loss

Of the 466 sample companies, 175 reported a statutory loss in 2007 (38 percent) and 192 in 2008 (41 percent).[1477] Only 5 percent of these companies provided an earnings disclosure in 2007 and 9 percent in 2008 (Table 3). In addition, only one company within the ASX 300 provided explicit advance guidance of a net loss or a change in expected loss levels in either the 2007 or 2008 financial years.[1478] A few entities warned of impending write-downs without detailing the impact on their bottom line result. However, many avoided announcing an expected loss by forecasting on a selected management basis such as “underlying earnings”, “normalised earnings”, or “cash earnings”. Sixty one percent of the quantitative forecasts from companies that reported a loss were in a management or unexplained format in 2008 (Table 4). Moreover, 6 percent were incomplete and 61 percent were not numerically calculable based on information released through the ASX (Table 4). More than 50 percent of the companies who reported a loss in 2007 and 2008 were resource companies.[1479]

[1475] Some these companies provided detailed project valuations, adopted assumptions, estimated expected returns, and sensitivity analysis to assist investors with security valuations.
[1476] In my view, unduly so.
[1477] Company data provided by Aspect for the financial years to December 2007 and February, March, June, July & September 2008 indicates that 1179 (61%) listed Australian companies made a net loss after tax, while 750 (39%) made a net profit. Of the 1179 companies that made a net loss, 702 (60%) were materials or energy companies.
[1478] Several companies outside of the ASX/ S&P 300 index provided guidance on expected loss levels in 2007 and 2008.
[1479] Loss making companies within the consumer services, media and real estate companies provided a higher proportion of earnings disclosures than other sectors.

3 *(Table 5): Materiality of Earnings Changes and Disclosure*

Table 5 links the forecasts with the sign (positive or negative) and level of the year-on-year diluted EPS changes. The level of forecasts from larger companies was higher than from smaller companies. In addition, the proportion of disclosing companies with annualised diluted EPS changes of more than 15 percent increased from 20 percent in 2007 to 27 percent in 2008. In 2007 24 percent of the companies with an annualised increase in diluted EPS of more than 15 percent disclosed, while only 15 percent of the companies with decreases in the year-on-year diluted EPS of more than 15 percent provided forecasts. These levels improved in 2008 to 26 percent and 28 percent, driven predominantly by increased disclosures from companies within the ASX 100 with large negative diluted EPS changes.

However, the proportion of companies that provided forecasts generally decreased with the size of the year-on-year diluted EPS changes. In 2007 the samples with the highest disclosure levels were companies with absolute changes in diluted EPS of below 15 percent, and the lowest disclosure levels were from companies with the most extreme or the largest positive and negative year-on-year diluted EPS changes. In 2008 this pattern still held but was not as striking.[1480]

4 *(Table 6): Forecast Specificities for Good and Bad News*

A large proportion of the negative news during 2007 and 2008 was framed or presented with an optimistic bias, and this was reflected most clearly in the forecast benchmarks adopted by company management (Table 6). In 2007 forecasts that used statutory and quasi-statutory benchmarks such as profit before tax, EBIT, EBITA and EBITDA were weighted to disclosures of good news (defined as an increase in the year-on-year diluted EPS) rather than bad news (defined as a decrease in the year-on-year diluted EPS). In contrast, the forecasts in management formats such as "underlying earnings" were weighted to bad news disclosures. The format with the heaviest weighting to disclosure of bad news was underlying net profit, a number that generally excluded most or all of the negative news. Of the companies that provided forecasts using specified underlying

[1480] Some companies may have adopted net profit rather than diluted EPS as the relevant earnings benchmark. Of the *non-disclosing* companies with annual diluted EPS changes of more than 15%, 8 companies in 2007 and 15 in 2008 had net profit changes of less than 15%.

net profit, 57 percent suffered an annualised decline in their diluted EPS result in 2007 and 74 percent in 2008. In 2008 20 of the 65 forecasts associated with companies with a decline in their year-on-year diluted EPS provided forecasts using underlying net profit.

5 *Other Companies*[1481]

Many companies provided incomplete or ambiguous forecasts. One ASX 100 company repeatedly forecast strong sales and profit growth for 2008. While the reported EPS for "continuing operations" doubled, the reported EPS for the total group nearly halved. A company within the ASX 300 initially provided net profit forecasts for 2008. An update confirmed the results would be in line with prior guidance and the final result release claimed to have met the guidance. However, the statutory net profit more than halved including one-off items. Similarly, another company within the ASX 300 consistently confirmed its expectations for low double-digit "core" EPS growth for the financial years 2006-2008. However, the diluted EPS for the three years did not change due to write-downs and significant or one-off items. In contrast, a company that achieved 62 percent and 37 percent growth in diluted EPS in the 2007 and 2008 financial years restricted its forecast statements to 'strong top and bottom line growth'. It is not clear how investors were supposed to assess these forecasts when they could be interpreted, and did in fact encompass, wide result variations.

6 *Summary*

(a) Significant General Trends

During the 2007 and 2008 financial years, the proportion of companies that provided quantitative forecasts fell in line with the size of the companies, as proxied by the relevant ASX index. In 2007 37 percent of the ASX 100 sample companies provided forecasts compared to 13 percent of the companies outside of the ASX 300 and the comparative figures in 2008 were 50 percent and 18 percent (Table 3).

Industrial companies were significantly more likely to provide earnings disclosures than resource companies. Only 9 percent of the resource companies provided a forecast in 2007 and 11 percent in 2008 (Table 3).

[1481] That is, industrial companies outside of the outlined sectors.

In 2007 only 5 percent of companies that reported a statutory loss provided a forecast. The disclosure level increased slightly to 9 percent in 2008 (Table 3).

The propensity to provide a forecast did not vary systematically with the materiality of the earnings changes (Table 5). Indeed, the proportion of companies disclosing was higher from companies with year-on-year diluted EPS changes within 10-15 percent than from companies with very large diluted EPS changes.

Statutory and quasi-statutory benchmarks such as profit before tax, EBIT, EBITA and EBITDA were weighted to disclosures of good news in both 2007 and 2008. In contrast, the forecasts in management formats such as "underlying earnings" were weighted to bad news disclosures (Table 6).

In 2007 19 percent of the quantitative forecasts provided were on an inconsistent basis (multiple forecasts during a financial year with differing specificities). The comparative level in 2008 was 17 percent (Table 4).

In addition, a significant number of listed Australian companies reported in currencies other than Australian dollars, including many of the largest companies. Some of these companies reported only in one foreign currency and some partially reported in Australian dollars. A few reported in one currency and provided forecasts in another. Inconsistent formatting and use of different currencies made assessment of the forecasts especially difficult.

(b) Significant Changes in Disclosure Patterns from 2007 to 2008

The proportion of disclosing companies in 2008 increased across all index and sector categories. Moreover, the proportion of companies with annualised diluted EPS changes of more than 15 percent that provided a quantitative forecast increased from 20 percent in 2007 to 27 percent in 2008 (Table 3). In 2007 24 percent of the companies with an improved annualised diluted EPS of more than 15 percent disclosed, while only 15 percent of the companies with decreases in the year-on-year diluted EPS of more than 15 percent provided forecasts (Table 5). These levels improved in 2008 to 26 percent and 28 percent, driven predominantly by increased disclosures from companies within the ASX 100 with large negative diluted EPS changes (Table 5).

The specificity and transparency indicators were generally weaker in 2008 than 2007. The proportion of forecasts specified as “Other financial indicators” (a forecast using a specificity other than EPS or net profit point or range) rose significantly from 40 percent in 2007 to 59 percent in 2008 (Table 4). Similarly, the proportion in a statutory format (a format shown in the profit and loss of the annual report) fell from 67 percent in 2007 to 49 percent in 2008, the forecasts that were complete (or understandable without reference to other documents) fell from 62 percent in 2007 to 43 percent in 2008, those not clearly explained increased from 2 percent in 2007 to 19 percent in 2008, and the proportion that were not numerically calculable based on information released through the ASX increased from 19 percent in 2007 to 41 percent in 2008 (Table 4).

Similar trends were observed for preannnouncements. The proportion of preannnouncements using management rather than statutory formats increased from 15 percent in 2007 to 30 percent in 2008, and the number that could not be calculated using information released through the ASX increased from 5 percent in 2007 to 15 percent in 2008.

Notably, 6 percent of the forecasts in 2007 and 8 percent in 2008 were provided in an analyst presentation, with no labelling on the ASX announcement to indicate the provision of a forecast (Table 4). In addition, 3 percent referred to an unexplained market expectations benchmark in 2007 and 5 percent in 2008, with ASX 100 companies providing most of these forecasts (Table 4). Six percent of the quantitative forecasts provided by companies in the ASX 100 referred to unexplained market expectations in 2007 and 9 percent in 2008.

(c) Sectoral Disclosure Factors

Only 5 percent of companies that reported a statutory loss provided a forecast in 2007 and 9 percent in 2008 (Table 3). More than 50 percent of the companies that reported a statutory loss were resource entities. The proportion of resource companies that provided a forecast was 9 percent in 2007 and 11 percent in 2008, slightly higher than for companies reporting a statutory loss (Table 3). Sixty one percent of the quantitative forecasts provided by companies that reported a loss in 2008 were in a management or unexplained format (Table 4).

The proportion of financial companies that provided a forecast was broadly in line with the industrial category in 2007 and 2008 (Table 3). However, 36 percent of these forecasts were in a management or unexplained format in 2007 and 69 percent in 2008 (Table 4). Moreover, 36 percent in 2007 and 75 percent in 2008 were incomplete or not able to be calculated using information released through the ASX (Table 4).

The level of companies within the real estate category that provided a forecast was similar to the industrial category (Table 3). However, the proportion of these forecasts within 15 percent of the benchmark result was 44 percent in 2007 and 56 percent in 2008, compared to 77 percent and 84 percent respectively for industrials (Table 4).

Finally, the proportion of companies within the combined utility/transportation category that provided a forecast in 2007 was 18 percent in 2007 and 27 percent in 2008 compared to 31 percent and 40 percent respectively for the industrial category (Table 3).

(Table 3) Forecast Properties 2007 & 2008

Column	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
Year							**2008**											**2007**				
Company Size/Sector	**Total**	ASX 100	ASX 200#	ASX 300	Other	Resources	Industrials	Financials	Real estate	Utils/ Trans	Loss	**Total**	ASX 100	ASX 200	ASX 300	Other	Resource	Industrials	Financials	Real Estate	Utils/ Tras	Loss
Sample Company No	466	92	92	78	204	169	297	48	40	22	192	466	92	92	78	204	169	297	48	40	22	174
*Location**																						
1. Prelim Report	24	8	7	2	7	1	23	6	4	1	5	24	10	9	2	3	2	22	3	3	0	0
2. Annual Report	2	1	0	0	1	1	1	0	0	0	1	2	1	0	0	1	0	2	4	0	0	0
3. Interim Report	50	15	11	12	12	4	46	5	6	2	3	55	15	12	14	14	7	48	2	4	4	3
4. AGM	24	10	5	3	6	4	20	3	2	1	5	16	3	4	4	5	4	12	5	2	1	4
5. ASX Query	1	0	0	1	0	1	0	0	0	0	1	0	0	0	0	0	0	0	0	0	0	0
6. Other	70	20	19	10	21	14	56	7	8	3	13	45	13	10	7	15	6	39	5	2	0	7
Total	171	54	42	28	47	25	146	21	20	7	28	142	42	35	27	38	19	123	19	11	5	14
Provided quantitative forecast/ update	138 30%	46 50%	33 36%	23 29%	36 18%	19 11%	119 40%	16 33%	16 40%	6 27%	18 9%	108 23%	34 37%	25 27%	22 28%	27 13%	15 9%	93 31%	14 29%	9 23%	4 18%	8 5%
*Horizon**																						
Pre-announcement Forecast/ Update	33	11	7	3	12	7	26	7	3	0	7	20	4	4	2	10	4	16	4	1	0	2
1. Within 90 days of prelim result	34	8	9	7	10	4	30	3	5	2	4	15	5	5	2	3	1	15	5	0	0	2
2. Within 180 days	33	12	11	4	6	9	24	7	2	0	3	26	8	4	5	9	5	21	5	1	2	2
3. Within 270 days	39	12	8	8	11	4	35	1	5	4	4	37	10	10	10	7	5	32	0	3	2	0
4. > 270 days	32	14	5	4	9	2	30	5	4	0	7	29	11	5	5	8	4	25	4	5	0	4

Based on the companies within the ASX indices on a marginal basis. That is, the ASX 200 excludes those in the ASX 100 and the ASX 300 excludes those in the ASX 100 and ASX 200.
* Based on the final forecast provided by a company within the financial year. The location and specificity categories within Tables 3 & 4 include all final forecasts. The other categories include the final quantitative forecasts only.

(Table 4) Forecast Specificity & Transparency 2007 & 2008

Year	2008											2007										
Company Sector	**Total**	ASX 100	ASX 200#	ASX 300	Other	Reso urces	Indus trials	Finan cials	Real estate	Utils/ Trans	Loss	**Total**	ASX 100	ASX 200	ASX 300	Other	Reso urces	Indus trials	Fina ncials	Real estate	Utils/ Trans	Loss
*Specificity**																						
1. EPS	15	9	1	3	2	0	15	3	6	1	3	11	7	1	3	0	1	10	3	4	0	0
2. Net Profit Point	24	4	6	4	10	6	18	2	1	1	3	32	10	6	6	10	5	27	4	3	2	5
3. Net Profit Range	18	6	6	1	5	5	13	1	1	0	1	22	5	6	3	8	4	18	2	1	1	2
4. Other Fin Indic	81	27	20	15	19	8	73	10	8	4	11	43	12	12	10	9	5	38	5	1	1	1
5. Qualitative	33	8	9	5	11	6	27	5	4	1	10	34	8	10	5	11	4	30	5	2	1	6
*Label**																						
1. Result Label	51	21	10	9	11	4	47	5	7	3	6	55	19	12	12	12	8	47	7	4	2	1
2. Earnings Label	57	18	16	7	16	10	47	6	4	1	6	37	10	11	5	11	4	33	4	3	2	4
3. AGM Label	12	5	2	2	3	1	11	1	3	0	3	8	2	1	3	2	3	5	0	2	0	2
4. Pres Only	11	2	2	3	4	2	9	4	1	1	1	6	2	1	2	1	0	6	2	0	0	0
5. Other	7	0	3	2	2	2	5	0	1	1	2	2	1	0	0	1	0	2	1	0	0	1
*Format**																						
1. Statutory	68	21	15	9	23	11	57	5	9	3	7	72	23	16	13	20	11	61	9	8	2	7
2. Management	44	14	8	10	12	8	36	7	5	3	8	34	10	8	9	7	4	30	5	1	1	1
3. Unexplained	26	11	10	4	1	0	26	4	2	0	3	2	1	1	0	0	0	2	0	0	1	0
*Benchmark**																						
1. Prior Period	61	26	12	7	16	5	56	10	6	3	6	54	19	8	10	17	2	52	11	4	2	2
2. Prior Forecast	5	1	0	2	2	2	3	0	0	0	0	5	1	4	0	0	1	4	0	0	1	0
3. Market Expects	7	4	2	0	1	3	4	1	0	0	3	3	2	0	0	1	0	3	0	2	0	0
4. None/ Not Deter	65	15	19	14	17	9	56	5	10	3	9	46	12	13	12	9	12	34	3	3	1	6
*Transparency**																						
1.Complete	60	17	14	9	20	10	50	4	8	3	6	67	17	17	14	19	11	56	9	6	1	7
2.Incomplete	21	8	2	4	7	2	19	3	2	1	1	21	9	1	4	7	3	17	1	2	2	1
3.Not Calculable	57	21	17	10	9	7	50	9	6	2	11	20	8	7	4	1	1	20	4	1	1	0
*Consistency**																						
1. Consistent	52	16	12	8	16	8	44	4	4	2	7	26	9	8	2	7	3	23	2	1	1	0
2. Inconsistent	23	5	8	5	5	1	22	2	3	2	3	20	6	6	6	2	4	16	3	0	3	1
3. Not Applicable	63	25	13	10	15	10	53	10	9	2	8	62	19	11	14	18	8	54	9	8	0	7
*Accuracy**																						
1. W/n 15% B/mk	111	38	31	18	24	11	100	15	9	6	10	80	26	20	15	19	8	72	12	4	4	2
2. Quant forecasts	80%	83%	94%	78%	67%	58%	84%	94%	56%	100%	56%	74%	76%	80%	68%	70%	53%	77%	86%	44%	100%	25%

(Table 5) Materiality of Earnings Changes & Disclosure 2007 & 2008

		Full sample			ASX 100			ASX 300(All)			"Other"		
2008 FY	**DilEPS Chg**	**n**	**Disclosed**	**%**	**n**	**Disclosed**	**%**	**n**	**Disclosed**	**%**	**n**	**Disclosed**	**%**
TOTAL SAMPLE	=<15%	86	36	42%	20	11	55%	54	29	54%	32	7	22%
	>15%	380	102	27%	72	35	49%	208	73	35%	172	29	17%
Total Sample		466	138	30%	92	46	50%	262	102	39%	204	36	18%
% Total >15% chg		82%	74%		78%	76%		79%	72%		84%	81%	
GOOD NEWS	=<15%	57	26	46%	13	8	62%	35	22	63%	22	4	18%
	>15%	184	47	26%	26	11	42%	89	29	33%	95	18	19%
Total Good News		241	73	30%	39	19	49%	124	51	41%	117	22	19%
% of Total Sample		52%	53%		42%	41%		47%	50%		57%	61%	
% of Total >15%		48%	46%		36%	31%		43%	40%		55%	62%	
BAD NEWS	=<15%	29	10	34%	7	3	43%	19	7	37%	10	3	30%
	>15%	196	55	28%	46	24	52%	119	44	37%	77	11	14%
Total Bad News		225	65	29%	53	27	51%	138	51	37%	87	14	16%
% of Total Sample		48%	47%		58%	59%		53%	50%		43%	39%	
% of Total >15%		52%	54%		64%	69%		57%	60%		45%	38%	
2007 FY													
TOTAL SAMPLE	=<15%	99	34	34%	27	11	41%	56	23	41%	43	11	26%
	>15%	367	74	20%	65	23	35%	206	58	28%	161	16	10%
Total Sample		466	108	23%	92	34		262	81		204	27	
% Total >15%		79%	69%		71%	68%		79%	72%		79%	59%	
GOOD NEWS	=<15%	69	28	41%	21	11	52%	41	20	49%	28	8	29%
	>15%	210	50	24%	39	18	46%	124	42	34%	86	8	9%
Total Good News		279	78	28%	60	29	48%	165	62	38%	114	16	14%
% of Total Sample		60%	72%		65%	85%		63%	77%		56%	59%	
% of Total >15%		57%	68%		60%	78%		60%	72%		53%	50%	
BAD NEWS	=<15%	30	6	20%	6	0	0%	15	3	20%	15	3	20%
	>15%	157	24	15%	26	5	19%	82	16	20%	75	8	11%
Total Bad News		187	30	16%	32	5	16%	97	19	20%	90	11	12%
% of Total Sample		40%	28%		35%	15%		37%	23%		44%	41%	
% of Total >15%		43%	32%		40%	22%		40%	28%		47%	50%	

(Table 6) Forecast Specificities for Good & Bad News 2007 & 2008

Year	2008						2007					
Forecast Specificity	Total F/c n	Total F/c %	Good News n	Good News %	Bad News n	Bad News %	Total F/c n	Total F/c %	Good News n	Good News %	Bad News n	Bad News %
EPS	15	11%	7	47%	8	53%	11	10%	9	82%	2	18%
Net Profit Point	24	17%	18	75%	6	25%	32	30%	23	72%	9	28%
Net Profit Range	18	13%	10	56%	8	44%	22	20%	17	77%	5	23%
Subtotal 1	57	41%	35	61%	22	39%	65	60%	49	75%	16	25%
Profit before tax	8	6%	7	88%	1	13%	5	5%	5	100%	0	0%
EBIT	7	5%	4	57%	3	43%	6	6%	5	83%	1	17%
EBITA	3	2%	2	67%	1	33%	0	0%	0	0%	0	0%
EBITDA	8	6%	5	63%	3	38%	7	6%	6	86%	1	14%
Subtotal 2	26	19%	18	69%	8	31%	18	17%	16	89%	2	11%
Underlying EPS	10	7%	4	40%	6	60%	5	5%	5	100%	0	0%
Und NP	27	20%	7	26%	20	74%	14	13%	6	43%	8	57%
Und PBT	3	2%	1	33%	2	67%	1	1%	1	100%	0	0%
Und EBIT	5	4%	3	60%	2	40%	3	3%	2	67%	1	33%
Und EBITA	2	1%	2	50%	0	0%	0	0%	0	0%	0	0%
Und EBITDA	4	3%	2	50%	2	50%	1	1%	0	0%	1	100%
Cash Earnings	4	3%	1	25%	3	75%	1	1%	1	100%	0	0%
Subtotal 3	55	40%	20	36%	35	64%	25	23%	15	60%	10	40%
Total	138	100%	73	53%	65	47%	108	100%	80	74%	28	26%

Good News: a company with the same or positive diluted EPS year-on-year. **Bad News**: a company with negative diluted EPS year-on-year. **EPS**: Earnings Per Share/ **EBIT**: earnings before interest & tax/ **EBITA:** earnings before interest, tax & amortisation**/ EBITDA**: earnings before interest, tax, depreciation & amortisation/ **NP:** net profit

B Study Regression Analysis

1 *Introduction*

The study analysis examines the variation in company characteristics associated with the provision of a forecast or otherwise. The analysis is performed separately for the 2007 and 2008 financial years and for the samples including all companies and industrial companies.

Binary logistic regression analysis is used to examine the earnings disclosure trends further. Regression analysis is a statistical tool for the investigation of relationships between factors or variables. The effect of factors expected to influence or determine a decision are analysed, with the decision or outcome treated as the dependent variable and the expected causal factors treated as independent variables. Binary logistic regression analysis, a specific type of regression analysis, is used when the dependent decision is dichotomous, the two outcomes are categorical and the independent variables are categorical or continuous.

The regression analysis summary statistics are presented in Table 7.

(Table 7) Regression Analysis Summary Statistics

Variable	n	Minimum	Maximum	Mean	Std Deviation
Size	466	-1[1482]	5.39	2.36	1.06
Res	466	1	2	1.35	.47
SDevEPS	466	0	396.24	16.57	37.51
DilEPSΔAbs07	465[1483]	0	299.0	3.19	18.45
EBITΔAbs07	465	0	133.25	2.11	8.35
Loss 07	466	0	1	.37	.48
BdNews07	466	1	2	1.40	.49
Comply1507	465	0	1	.79	.41
DilEPSΔAbs08	466	0	274.0	2.96	15.92
EBITΔAbs08	466	0	42.0	1.50	4.20
Loss 08	466	0	1	.41	.49
BdNews08	466	1	2	1.48	.50
Comply1508	465	0	1	.82	.38

[1482] The base for the log calculation was a million Australian dollars. The market capitalisations of two sample companies were below this level, hence the negative figure.
[1483] Any calculations involving a zero base were excluded.

To produce credible results, logistic regression data must satisfy assumptions of linearity, no multicollinearity and independence of errors. In addition, the fitting of data to statistical models and the calculation of the probability of outcomes generally assume that the data is normally distributed. The shape of normally distributed data is that of a bell curve, with the majority of the observation values close to the centre or mean and a decreasing number of observations as values deviate further from the mean.[1484] Small standard deviations indicate that the data is close to the mean while large standard deviations are distant from the mean. The final study variable for company size used the log of a company's market capitalisation rather than the market capitalisation figure to reduce the variable standard deviation.

The relationships between regression analysis variables vary. Two variables may not be related to each other or they may be positively or negatively related. The strength of the relationship between two variables is reflected in the correlation coefficient. A correlation coefficient of +1 indicates a perfect positive relationship, a coefficient of –1 indicates a perfect negative relationship, while a coefficient of 0 indicates no linear relationship at all. When the correlation between two or more predictors in a regression model is strong, the problem of multicollinearity arises. When collinearity between variables is very high (by convention above .8 or .9), the reliability and usefulness of the statistical results is threatened and it becomes difficult to separate the effects of the related variables. Matrices analysis of the correlations between study variables or predictors indicated that the highest correlation between the predictors was .473 between the Loss08 and Size variables.

2 *The Analysis Predictors*

Regression analysis requires initial hypotheses about the relationships between likely predictors and the outcome. The descriptive analysis suggested that the size of a company (Size), whether the company was a resource or industrial (Resource), whether the company expected to report a statutory loss or not (Loss), and whether the company was disclosing good or bad news (BdNews), were linked to the decision by a listed Australian company to make an earnings disclosure or forecast (forecast). Prior research also suggested these factors were significant determinants to disclosure

[1484] The distribution of data may not be normal when the distributions are clustered at one end of the scale (known as skewed distribution) or at the tails or ends (known as pointyness or kurtosis).

decisions.[1485] As already highlighted, Guidance Note 8 generally requires an earnings disclosure when the level of expected change in earnings exceeds 10-15 percent compared to a prior forecast or the previous corresponding period. Note 8 does not define earnings and it refers to absolute changes in earnings with no differentiation between falls or gains in the year-on-year earnings. Variables reflecting absolute year-on-year changes in diluted EPS (DilEPSΔAbs) and absolute year-on-year changes in EBIT (EBITΔAbs) were included in the model. A series of compliance dummy variables (which took the value of one when the annualised change in diluted EPS was greater than a specified level of 10, 15, 25, 50, 100 or 200 percent, and the value of zero otherwise) were included to examine the relationship between disclosure and the materiality of the earnings change in more detail.

3 *Understanding the Findings*

The main purpose of regression analysis is to predict the strength of relationship between the predictors (the independent variables) and the outcome (the dependent variable). The top figure in the Table 8-13 boxes is the value of *B*. The standardised regression coefficient *B* indicates the strength of relationship between a predictor and the outcome. When a predictor is positively related to the dependent variable, the odds of the outcome occurring increase as the predictor increases. Conversely, when a predictor is negatively related to another, the odds of the outcome occurring decrease as the predictor increases. The bottom figure in the Table 8-13 boxes is the value of *Exp(B)*. The *Exp(B)* figures represent the expected size effect of the predictor or the odds resulting from a unit change in the predictor. When greater than one, the odds of the outcome occurring increase as the predictor increases. Conversely, when less than one, the odds of the outcome occurring decrease as the predictor increases.

The middle figure in brackets in the Table 8-13 boxes indicates the level of statistical significance. The threshold levels of 1, 5 and 10 percent are highlighted using asterisks. The significance of a relationship in statistical terms is the degree of confidence that the actual relationship is as estimated. In accordance with convention, the significance levels adopted in the study are 1, 5 and 10 percent. Statistical significance is based on probability testing. A result that is statistically significant

[1485] See, eg, Clifford Cox, 'Earnings Variability, Firm Size, and the Information Content in Management Forecasts of Annual Earnings' (1987) 6 *Journal of Accounting and Public Policy* 139;

accepts the hypothesis as true on the basis that the probability of obtaining the value of the test statistic "by chance" is less than the 1, 5 or 10 percent threshold. A result that is not statistically significant indicates that the effect is not big enough to be anything other than a chance finding.

When multiple variables are used in regression analysis, the effects of each of the individual variables or predictors are estimated separately by controlling the other variables or holding them constant. For example, the effect of a unit change in the Size variable can be estimated while controlling or holding the Loss and BdNews variables constant.

4 *The Findings*

Tables 8-13 present the most important findings from the regression analysis in summary format.

(a) Table 8

In Table 8 the coefficient variables explaining the decision by companies to provide a forecast in 2007 that were statistically significant were

1. Company size (Size)
2. Whether the company was a resource (Res) and
3. Whether the company reported a statutory loss (Loss).

The results for 2008 were similar except the statistical significance of the Size variables were stronger at 1 percent across all of the 2008 models compared to 5 percent for models 1 and 2 in 2007.

The negative coefficients on the Resource and Loss variables indicate that resource companies and companies reporting a statutory loss were less likely than industrial companies and companies reporting a statutory profit to provide a forecast. Conversely, the positive coefficients on the Size variables indicate that the larger companies were more likely than smaller companies to provide a forecast. The expected magnitude of effect on the disclosure outcome from a unit change in the Resource variables ranged from .340 to .232 (the inverse of 2.9 to 4.3), the *Exp(B)* on the Size variables ranged from 1.335 to 1.451 and the *Exp(B)* on the Loss variables

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Gallery et al, above n 97.

ranged from .252 to .181 (the inverse of 4.0 to 5.5). This means that holding other variables constant, resource companies and companies reporting a loss were around 3-6 times less likely to provide a forecast than industrials and companies reporting a statutory profit, and larger companies were approximately one and a half times more likely than smaller companies to provide a forecast.

Notably the coefficients of the variables reflecting the absolute year-on-year changes in diluted EPS (DilEPSΔAbs) and the absolute year-on-year changes in EBIT (EBITΔAbs) were close to zero and not statistically significant in either year, indicating no association between the level of earnings change and the provision of a forecast. The variables indicating whether the year-on-year changes in the diluted EPS were positive or negative (BdNews) were not statistically significant either, indicating that the sign of the earnings change was not associated with the decision to provide a forecast.

(b) Table 9

The results were similar when the analysis in Table 8 was repeated for the sample of industrial companies. The Size variable coefficients were positive and statistically significant and the Loss variable coefficients were negative and statistically significant across all models. However, in 2007 the statistical significance of the coefficients on the Size variables fell to 10 percent in models 1 and 2, and 5 percent in model 3.

Once again the coefficients of the BdNews, DilEPSΔAbs and EBITΔAbs variables were not statistically significant in any of the models. That is, controlling for the Size and Loss factors, the absolute changes in the annualised diluted EPS and EBIT were not associated with the decision to provide a forecast. The *Exp(B)* figures relating to the Size and Loss variables were similar to those in Table 8.

(c) Table 10

When the analysis in Tables 8 and 9 was repeated for disclosure of a forecast in a statutory format, the results did change markedly. The dependent variables in these models took the value of one when the companies provided an earnings forecast in a statutory format (a format or line entry included in the profit and loss in the annual report), and were zero otherwise. As in Tables 8 and 9, the Loss variable coefficients were negative and statistically significant across all models. The *Exp(B)* figures on the Loss variables ranged from .374 to .158 (the inverse of 2.7 to 6.3). In addition, the DilEPSΔAbs variable coefficients were again close to zero and not statistically significant.[1486] However, the Size variable coefficients were close to zero and not statistically significant in any of the models. Conversely, the BdNews variable coefficients became negative and statistically significant across all models. The confidence levels for the full sample in 2007 and 2008 and for industrial companies in 2007 were only 10 percent, but in 2008 the BdNews variable was a strong negative predictor for industrials at the 1 percent confidence level. The *Exp(B)* figures on the BdNews Variables ranged from .589 to .441 (the inverse of 1.7 to 2.3).

The negative and statistically significant associations between companies providing forecasts in a statutory format and those expecting to report a statutory loss or a declining diluted EPS result are consistent with the argument in the descriptive analysis that some companies tried to avoid disclosing a prospective loss or bad news by providing forecasts in a management format.

(d) Table 11

In Table 11 the disclosure decision for the full sample was examined with varying levels of absolute year-on-year changes in diluted EPS. In both years the Size coefficients were positive and statistically significant and the Resource and Loss coefficients were negative and statistically significant at all levels. The standardised regression coefficients *B*, the significance levels and the *Exp(B)* values for the Res, Size and Loss variables barely changed across the various earnings change levels.

The Comply variable coefficients were not statistically significant, except in 2007 for the greater than 25 percent model. This evidence affirmed the prior findings that the magnitude of the absolute annualised earnings change was not a significant factor associated with the decision to provide a forecast.

(e) Table 12

Results were similar when the analysis in Table 11 was repeated for the sample of industrial companies. The Loss variable coefficients were negative and statistically

[1486] The absolute EBIT change model is not shown, as these variables were close to zero and not statistically significant.

significant at the 1 percent threshold across all models. The Size variable coefficients were also positive and statistically significant in both years, although the significance levels in 2007 were lower at 5 and 10 percent. More importantly, the coefficients of the Comply variables coefficients were not statistically significant in any model in 2007 or 2008.

(f) Table 13

In Table 13 the independent variables were the same as in Tables 11 and 12 but the dependent variable was changed to disclosure in a statutory format. Under these scenarios, the Loss variable coefficients were negative and statistically significant at 1 percent for all models in 2008 and at 5 percent in 2007. However, the Size variable coefficients were all close to zero and not statistically significant.

In 2007 the Comply variable coefficients were not statistically significant except the greater than 25 percent model at a 10 percent confidence level. However, in 2008 these coefficients were positive and statistically significant in the greater than 100 percent and 200 percent models at 5 and 1 percent confidence levels respectively, indicating a positive association in 2008 between companies with very high absolute year-on-year changes in dilEPS and the provision of forecasts in a statutory format.

5 *Summary*

The evidence from the series of regression tests confirmed the general findings in the descriptive analysis. Across the full market, the size of a company (Size), whether a company was classified as a resource (Res), and whether a company reported a statutory loss (Loss), were the most important predictors to the disclosure decision. Larger companies, industrial companies, and those expecting to report a statutory profit were the most likely to provide a forecast. Conversely, smaller companies, those expecting to report a statutory loss, and resource companies were less likely to provide a forecast. Similarly, across the sample restricted to industrials, company size and reporting a loss were statistically significant predictors of whether a company provided a forecast. Companies with smaller market capitalisations and those expecting to report a statutory loss were less likely than other companies to provide a forecast.

The significant predictors to the decision to provide a forecast in a statutory format were markedly different. In Tables 10 and 12 Loss was a significant factor again but Size was not. In addition, in Table 10 the BdNews variable was a negative predictor for all models for the full sample and industrial companies. This association was particularly strong (at the 1 percent confidence level) in 2008 for industrial companies (Table 10). There were statistically significant negative associations between disclosure in a statutory format and a prospective statutory loss or a declining year-on-year diluted EPS result. There were positive and statistically significant associations between industrial company disclosures in a statutory format in 2008 and very high DilEPSΔAbs (above 100 percent)(Table 13). A likely explanation for this latter finding is not easy to pinpoint - it may relate to litigation concerns.

In Tables 8-10, the DilEPSΔAbs and EBITΔAbs variable coefficients were close to zero and not statistically significant, indicating no associations between changes in earnings levels and the provision of forecasts. In Table 12, deeper examination incorporating the level of the DilEPSΔAbs confirmed there were no statistically significant associations with industrial company disclosures regardless of the magnitude of the earnings change. This was also the case for the full sample in Table 11, except for a negative association in the greater than 25 percent model in 2007.

(Table 8) Logit regression analysis on disclosure determinants of earnings forecasts by all companies during 2007 and 2008

	2007			2008		
	Model 1	**Model 2**	**Model 3**	**Model 1**	**Model 2**	**Model 3**
DilEPSΔAbs[4]	-.053[1] (.206)[2] .949[3]			-.046 (.243) .955		
EBITΔAbs		-0.46 (.186) .955			-.028 (.429) .973	
BdNews			-.300 (.243) .741			.168 (.475) 1.183
Res	-1.088 (.001)*** .337	-1.080 (.001)*** .340	-1.105 (.000)*** .331	-1.401 (.000)*** .246	-1.437 (.000)*** .238	-1.461 (.000)*** .232
Size	.297 (.022)** 1.346	.289 (.027)** 1.335	.313 (.016)*** 1.368	.364 (.003)*** 1.440	.372 (.003)*** 1.451	.369 (.003)*** 1.447
Loss	-1.685 (.000)*** .186	-1.708 (.000)*** .181	-1.620 (.000)*** .198	-1.378 (.000)*** .252	-1.395 (.000)*** .248	-1.460 (.000)*** .232
% Fit[5]	75.1	75.3	76.0	72.5	73.2	71.9
R^2 [6]	.254	.252	.245	.292	.286	.285
n[7]	465	466	465	465	466	465

1. *B*: the standardised regression coefficient indicating the strength of relationship between a given predictor and an outcome.
2. Significance level. */**/*** indicate the 10/5/1% levels respectively.
3. *Exp(B)*: an indicator of the odds resulting from a unit change in the predictor. When greater than one the odds of the outcome occurring increase as the predictor increases. Conversely, when less than one the odds of the outcome occurring decrease as the predictor increases.
4. The analysis variables are defined in Table 2.
5. % fit is how well a model fits the data from which it was generated.
6. R^2 measures the extent to which the total variation of the dependent variable is explained by the regression. The higher the value, the better the regression model explains the variation in the dependent variable and the better the model is for predictive purposes.
7. n is the number of observations.

(Table 9) Logit regression analysis on disclosure determinants of earnings forecasts by industrial companies during 2007 and 2008

	2007 Model 1	2007 Model 2	2007 Model 3	2008 Model 1	2008 Model 2	2008 Model 3
DilEPSΔAbs	-.036 (.333) .965			-.025 (.416) .976		
EBITΔAbs		-.032 (.294) .969			-.022 (.630) .978	
BdNews			-.287 (.315) .750			.145 (.575) 1.156
Size	.268 (.060)* 1.307	.255 (.074)* 1.290	.277 (.051)** 1.319	.336 (.012)*** 1.400	.341 (.011)*** 1.407	.337 (.012)*** 1.401
Loss	-1.705 (.000)*** .182	-1.737 (.000)*** .176	-1.637 (.001)*** .195	-1.221 (.000)*** .295	-1.225 (.000)*** .294	-1.283 (.000)*** .277
% Fit	67.1	67.1	67.9	64.2	63.6	64.6
R^2	.170	.166	.162	.171	.167	.167
n	301	302	302	302	302	302

(Table 10) Logit regression analysis on disclosure determinants of earnings forecasts by all companies in a statutory format during 2007 and 2008

	Full sample				Industrial companies			
	2007 Model 1	2007 Model 2	2008 Model 1	2008 Model 2	2007 Model 1	2007 Model 2	2008 Model 1	2008 Model 2
DilEPSΔAbs	.154 (.278) 1.167		-.037 (.397) .963		-.038 (.422) .962		-.012 (.638) .988	
BdNews		-.535 (.076)* .586		-.529 (.067)* .589		-.566 (.091)* .568		-.820 (.012)*** .441
Size	.154 (.278) 1.167	.171 (.231) 1.187	.010 (.944) 1.010	.051 (.729) 1.052	.177 (.259) 1.194	.176 (.267) 1.193	-.008 (.958) .992	.061 (.708) 1.063
Loss	-1.737 (.000)*** .176	-1.648 (.000)*** .192	-1.842 (.000)*** .158	-1.721 (.000)*** .179	-1.098 (.026)** .334	-.983 (.050)** .374	-1.468 (.001)*** .230	-1.292 (.005)*** .275
% Fit	84.3	84.3	85.2	85.2	79.4	79.5	81.1	81.1
R^2	.139	.137	.131	.135	.077	.082	.084	.115
n	465	466	465	466	302	302	302	302

(Table 11) Logit regression analysis on disclosure determinants of earnings forecasts by all companies during 2007 and 2008 with changes in the annualised diluted EPS

	2007						2008					
DilEPSΔAbs	**>10%**	**15%**	**25%**	**50%**	**100%**	**200%**	**>10%**	**15%**	**25%**	**50%**	**100%**	**200%**
Comply	-.349	-.300	-.507	-.257	-.199	-.309	-.405	-.146	-.288	-.036	.199	.094
	(.255)	(.273)	(.038)**	(.299)	(.507)	(.409)	(.198)	(.602)	(.233)	(.879)	(.467)	(.787)
	.706	.741	.602	.774	.819	.734	.667	.865	.750	.965	1.220	1.098
Res	-1.062	-1.064	-1.039	-1.063	-1.088	-1.086	-1.463	-1.460	-1.424	-1.468	-1.527	-1.492
	(.001)***	(.011)***	(.001)***	(.001)***	(.001)***	(.001)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***
	.346	.345	.354	.345	.337	.337	.231	.232	.241	.230	.217	.225
Size	.311	.306	.286	.311	.310	.312	.371	.374	.369	.379	.392	.384
	(.017)***	(.019)***	(.029)**	(.016)***	(.017)***	(.016)***	(.003)***	(.003)***	(.003)***	(.002)***	(.002)***	(.002)***
	1.364	1.358	1.332	1.364	1.363	1.366	1.450	1.453	1.446	1.461	1.480	1.468
Loss	-1.696	-1.689	-1.670	-1.661	-1.677	-1.683	-1.366	-1.392	-1.373	-1.395	-1.461	-1.492
	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***
	.183	.185	.188	.190	.187	.186	.255	.249	.253	.248	.232	.242
% Fit	74.2	75.5	74.8	75.3	75.1	75.1	71.6	72.3	71.8	72.5	72	72.7
R^2	.247	.247	.255	.247	.245	.246	.287	.284	.286	.283	.284	.283
n	465	465	465	465	465	465	465	465	465	465	465	465

(Table 12) Logit regression analysis on disclosure determinants of earnings forecasts by industrial companies during 2007 and 2008 with changes in the annualised diluted EPS

	2007						2008					
DilEPSΔAbs	**>10%**	**15%**	**25%**	**50%**	**100%**	**200%**	**>10%**	**15%**	**25%**	**50%**	**100%**	**200%**
Comply	-269	-.242	-.408	-.205	-.236	-.174	-.124	.072	.031	.146	.508	.622
	(.400)	(405)	(.128)	(.457)	(.496)	(.687)	(.721)	(.811)	(.906)	(.582)	(.120)	(.146)
	.764	.785	.665	.815	.790	.841	.884	1.075	1.032	1.157	1.662	1.863
Size	.286	.280	.266	.287	.283	.289	.346	.352	.350	.357	.374	.373
	(.043)**	(.048)**	(.062)*	(.042)**	(.046)**	(.041)**	(.009)***	(.008)***	(.009)***	(.008)***	(.005)***	(.006)***
	1.331	1.324	1.305	1.333	1.328	1.335	1.414	1.422	1.419	1.428	1.453	1.452
Loss	-1.688	-1.684	-1.658	-1.659	-1.672	-1.692	-1.229	-1.250	-1.247	-1.283	-1.436	-1.395
	(.000)***	(.000)***	(.001)***	(.001)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***	(.000)***
	.185	.186	.190	.190	.188	.184	.293	.286	.287	.277	.238	.248
% Fit	66.1	66.8	67.8	67.1	66.8	67.1	62.6	63.9	63.2	64.6	64.2	62.6
R^2	.163	.163	.169	.162	.162	.161	.166	.166	.166	.167	.175	.174
n	301	301	301	301	301	301	302	302	302	302	302	302

(Table 13) Logit regression analysis on disclosure determinants of earnings forecasts by industrial companies during 2007 and 2008 in a statutory format with changes in the annualised diluted EPS

	2007						2008					
DilEPSΔAbs	**>10%**	**15%**	**25%**	**50%**	**100%**	**200%**	**10%**	**15%**	**25%**	**50%**	**100%**	**200%**
Comply	-.010	-.333	-.519	-.095	.077	-1.53	.512	.156	.163	.232	.788	1.248
	(.979)	(.294)	(.081)*	(.758)	(.837)	(.751)	(.255)	(.668)	(.606)	(.464)	(.041)**	(.015)***
	.990	.716	..595	..910	1.080	.858	1.668	1.169	1.178	1.261	1.072	3.484
Size	.201	.181	.165	.198	.205	.197	.013	.009	.009	.018	.069	.050
	(.199)	(.249)	(.295)	(.206)	(.192)	(.208)	(.935)	(.954)	(.958)	(.913)	(.668)	(.759)
	1.223	1.199	1.180	1.219	1.227	1.218	1.013	1.009	1.009	1.018	1.072	1.051
Loss	-1.103	-1.078	-1.046	-1.083	-1.115	.1.094	-1.523	-1.488	-1.498	-1.529	-1.732	-1.860
	(.025)**	(.029)**	(.035)**	(.029)**	(.024)**	(.026)**	(.001)***	(.001)***	(.001)***	(.001)***	(.000)***	(.000)***
	.332	.340	.351	.595	.328	.335	.218	.226	.224	.217	.177	.156
% Fit	79.4	79.4	79.4	79.4	79.4	79.4	81.1	81.1	81.1	81.1	81.1	80.8
R^2	.068	.073	.083	.069	.068	.069	.089	.083	.083	.085	.103	.111
n	301	301	301	301	301	301	302	302	302	302	302	302

V CHAPTER FIVE: CRITIQUE AND CONCLUSION

There were significant differences in the level, content and informativeness of the continuous disclosures during the 2007 and 2008 financial years. Some companies communicated clearly, accurately and on a timely basis. However, overall the evidence suggests systemic non-compliance with Guidance Note 8 on disclosure of earnings expectations. It is likely that some investors were not able to make rational well-informed investment decisions across a significant proportion of the market.

The compliance analysis based on a 15 percent materiality threshold adopted a best-case scenario. Nevertheless, many companies failed to disclose changes in earnings expectations above this threshold. There were no consistent statistically significant associations between the absolute changes in annualised earnings levels and the provision of forecasts. In 2007 only 20 percent of companies that reported an annualised absolute diluted EPS change of more than 15 percent (compared to a prior forecast or the previous corresponding period) provided a forecast, and in 2008 the equivalent level was 27 percent. The descriptive and regression analyses indicated that smaller companies, resource companies and those expecting to report a statutory loss were less likely than other companies to provide a forecast. Conversely, a larger market capitalisation, classification as an industrial, and expecting to report a statutory profit, were important predictors of the disclosure decision.[1487]

There were statistically significant negative associations between disclosure in a statutory format and reporting a statutory loss or a declining year-on-year diluted EPS. The regression and descriptive analysis was consistent with the hypothesis that industrial companies avoided disclosing prospective losses or bad news within the public arena except as specifically mandated in the profit and loss account of the statutory reports. Outside of the reporting periods, these companies tended to either not provide forecasts or the forecasts provided were in a management-selected format that presented the loss or bad news in a positive light.

[1487] The level, content and quality of disclosures from some of the smaller listed companies were so poor that it wasn’t possible to even glean the real nature of the company’s activities. Some of these companies provided only one or two paragraphs of discussion within their statutory reports in addition to the required remuneration and corporate governance reports.

The regression analysis evidence of

- No consistent associations between the year-on-year absolute changes in earnings levels and the provision of an earnings update or forecast; and
- Statistically significant negative associations between disclosure in a statutory format and a statutory loss or a declining year-on-year diluted EPS result

can be variously interpreted. Some companies may believe that the Guidance Note 8 outline on disclosure of earnings expectations does not apply to them. Others may be interpreting “earnings” as something other than diluted EPS or EBIT. The descriptive analysis and anecdotal evidence suggest that (i) most resource companies see themselves in the former category, and (ii) many industrial companies prefer to adopt an earnings measure on an “underlying basis”, particularly when the earnings trend is negative.

These study findings need to be viewed in context. There are many uncertainties around the continuous disclosure obligations. The most obvious difficulties lie in the status and content of legal rules. In addition, the composition of the Australian market makes it difficult to determine the timing and content of the required disclosures.

A The Continuous Disclosure Rules

ASX Listing Rule 3.1 and Guidance Note 8 do not differentiate between companies depending on their industry sector, size or profitability. The rules and guidance on disclosure of earnings expectations apply to all Australian listed companies. However, ASX Listing Rule 3.1 and Guidance Note 8 leave many operational issues unanswered. Guidance Note 8 does not stipulate:

- The definition of earnings that it refers to.[1488]
- Whether earnings updates or forecasts must be in a statutory format.
- Whether forecasts must be inclusive of significant or non-recurring items, including mark to market adjustments, provisioning, revaluations or impairment write-downs.
- Whether forecasts must include continuing and discontinued businesses.

- Whether forecasts must be on a consistent currency basis.
- The appropriate location, format and labelling of forecasts.
- Whether companies must disclose changes in expected losses and changes from loss to profit or vice versa.
- Whether the ASX announcements must be complete or operate as standalone documents.

These ambiguities or lack of standards on the content and form of disclosures required under ASX Listing Rule 3.1 make it difficult for companies and investors to determine what compliance with the continuous disclosure obligations means in practice.

Regulatory policy documents confirm that the continuous disclosure regime is intended to encompass disclosure of everything that investors require to make a well-informed assessment of an investment. The ideals of "clear, concise and effective" disclosure are consistently used within Australian corporations law and policy documents.[1489] As previously outlined, Gibson defines

- "clear announcements" as information contained in a market release that is factual and expressed in an objective and clear manner;
- "complete announcements" as documents that can be read as a whole without reference to other documents to locate price sensitive information; and
- "accurate announcements" as disclosure of information that is factually correct, easily understandable, with due prominence to positive and negative information.[1490]

Gibson also suggests that company announcements must be "complete, readable and understandable".[1491]

I concur with the Gibson disclosure principles and definitions. For the announcements on earning expectations to be informative, investors must be able to find them, and the disclosures need to be timely, clear, complete and accurate. They also need to be in a

[1488] For example, earnings before interest, tax, depreciation and amortisation (EBITDA); earnings before interest and tax (EBIT); profit before tax (PBT); profit after tax (PAT); earnings per share (EPS); or diluted EPS.

[1489] *Corporations Act 2001* (Cth) ss 249L, 715A, 719, 942B, 942C, 947B, 947C, 1012C, 1013C, 1019I, 1019J. See also *Fraser v NRMA Holdings Ltd* (1995) 127 ALR 543; *Re Marra Developments Ltd* (1976) 1 ACLR 470.

[1490] Gibson, above n 1398, 11-12.

format that allows comparable analysis with prior years and other companies. In practice, the earnings forecasts or updates are only likely to assist investors wishing to make rational investment decisions if they are:

- quantitative in nature;
- complete;
- consistent;[1492]
- in a statutory format;
- clearly labelled as an earnings forecast;
- reasonably accurate; and
- timely.

However, among the companies who did provide a forecast, the content was often insufficient or too ambiguous for investors to make informed judgments on investment decisions. Thirty two percent of the forecasts in 2008 used a management selected format and 19 percent used a format that was not clearly explained. Furthermore, 57 percent of the forecasts were incomplete, including 41 percent that could not be numerically calculated using information provided through the ASX.

Ultimately, there is little point in companies providing forecasts or earnings updates in the public arena if:

1. An investor has to read all company announcements (sometimes hundreds of documents) in the hope there might be a forecast within them;
2. Having found a forecast, the content is not clear or indeed fathomable; or
3. The prospective or actual results of the company cannot be compared against other companies and securities.

Companies can easily address the first point. When a forecast is provided, it is not difficult to release it through the ASX as a standalone announcement with a label clearly indicating that it is an earnings update. It is not reasonable to expect investors to examine all periodic reports, brokers' presentations, prospectuses, media releases and

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[1491] Gibson, above n 1398, 6.
[1492] When a company provides more than one earnings forecast or updates throughout a year using the same specificity.

stand-alone announcements of every company to find possible earnings forecasts or updates.

Many of the issues associated with point two can also be relatively easily addressed. Companies need to provide disclosures that are complete and understandable without undue reference to other documentation. A large proportion of forecasts were specified as an expected change compared to an unstated prior year benchmark, with the expected change formatted as either a percentage number or range. To avoid ambiguity, companies should use absolute figures or ranges. This is particularly important when the forecast is in a management forecast and the benchmark referred to is not explained. Too often the content or meaning of the updates could only be established *after* the result was announced and the only explanation was in the result presentation. When companies changed the format of their management forecasts within a period, or the explanations of what was excluded in terms of significant and non-recurring items and write downs varied, it was sometimes not possible to work out what the earnings trends and relevant numbers were. The interpretative issues were made even more challenging when companies reported in currencies other than in Australian dollars, particularly when they reported in one currency and forecast in another.

The third point on comparability is critically important. The policy goal of adequate disclosure to allow investors to compare investment opportunities is longstanding, particularly in the Wallis Report in 1997.[1493] Mandatory accounting standards were introduced to enhance the context, reliability and accuracy of company reporting in Australia. The Australian and international accounting standards are independently determined and monitored. The statutory reporting framework encompassing these

[1493] Commonwealth, above n 447, 567-596. The Wallis Inquiry resulted in significant financial services reforms, including the introduction of uniform licensing and disclosure regimes for all financial products and financial service providers, as well as the licensing of financial markets and clearing and settlement systems. These changes were enacted primarily through the *Financial Services Reform Act 2001* (Cth) (FSR) and the *Financial Services Reform Amendment Act 2003* (Cth). The *Financial Services Reform Act 2001* (Cth) commenced on 11 March 2002, but existing market participants had two years to meet the licensing requirements. Section 760A of the *Corporations Act 2001* (Cth) states that the object of Ch 7 (inserted by the enactment of the *Financial Services Reform Act 2001* (Cth) is to 'promote confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services; and fairness, honesty and professionalism by those who provide financial services; and fair, orderly and transparent markets for financial products; and the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities'.

standards seeks to ‘present fairly the financial position, financial performance and cash flows of a company … [and to assist third parties] in making and evaluating decisions about the allocation of scarce economic resources … ‘.[1494] A major purpose of mandatory reporting is to allow investors and other users of the financial statements to more effectively analyse an individual company’s results over time and to compare companies across the market.[1495]

Accordingly, it is important that listed companies disclose using numbers in a statutory format or reconcile and explain any non-statutory numbers used. Otherwise, there is significant potential for management to report in a way that obfuscates reality or is misleading or obtuse to investors. It is easy for company management to provide consistently glowing positive statements and to claim that profits are growing over long periods when all the bad news is excluded as significant items, non-recurring items, discontinued business, non-cash items, restructuring costs, integration costs, write-offs, impairments, provisioning, acquisition or sale related costs, amortisation and so forth. All of the outlined categories are valid and such information can provide investors with valuable supplementary information to the statutory numbers when provided in context. However, if these figures are not reconciled with the statutory numbers, companies can simply change the management benchmarks emphasised and discussed within the continuous disclosures, depending on which format shows the company (and the company management) in the most favourable light.[1496]

Gibson, an ASIC Commissioner, indicates that company disclosures must give due prominence to positive and negative information. Some companies were straightforward in explaining economic, industry or company specific difficulties. However, most of the management discussion and analysis within the statutory reports predominantly drew attention to positive aspects of the result. Indeed, the optimistic bias presented in the disclosures from a few companies was so exaggerated as to be misleading. Much of this

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[1494] Australian Accounting Standards Board (AASB), *Frequently Asked Questions* <http://www.aasb.com.au/About-the-AASB/Frequently-asked-questions.aspx#qa770> at 2 July 2010.
[1495] AASB, above n 1494.
[1496] Given the integrated nature of company disclosures, these comments apply to periodic as well as continuous disclosures. The value and purpose of accounting standards are significantly undermined when the MD&A within the statutory reports and other periodic releases refer solely or predominantly to management selected figures.

“positive framing” is accepted under the current regulatory framework. However, optimistically biased disclosures can have significant consequences on investors and other stakeholders, particularly when a company is in serious financial difficulty.

As previously highlighted, the ASX includes many loss-making companies. The level and quality of disclosures from companies reporting statutory losses were especially poor. The proportion of sample companies that reported a statutory loss and provided a quantitative forecast was only 5 percent in 2007 and 9 percent in 2008. Moreover, the characteristic most consistently associated with a failure to provide a forecast or the provision of a forecast in a management selected format (rather than a statutory format) was a statutory loss. There were negative and statistically significant associations between industrial companies providing forecasts in a statutory format and those reporting statutory losses or reporting bad news. This evidence was consistent with the argument in the descriptive analysis that companies avoided disclosing prospective losses or provided forecasts in a management selected format.

Failures to disclose, or delayed or disguised disclosure, by companies in financial difficulty can have serious consequences on investors and other stakeholders. Examples of listed Australian companies that slipped into administration or receivership with few warnings or updates provided through the ASX during the 2008 financial year included ABC Learning Centres Limited, Compass Resources Ltd and Babcock & Brown Limited. In the case of ABC Learning Centres Limited, the ASX disclosures were bullish up until trading was suspended on 25 August 2008. However, the company went into administration on 6 November 2008.[1497] Compass Resources Ltd provided no warnings through the ASX of any impending issues until the company announced a potential capital raising on 27 January 2009.[1498] The company went into voluntary administration two days later,[1499] and on 18 February 2009 went into receivership.[1500] The management of Babcock & Brown Limited announced a strategic review on 21 August 2008; disclosed write-downs to negative net tangible assets on 7 January

[1497] The announcements relating to ABC Learning appear to have been removed from the ASX website.
[1498] Compass Resources Limited, *Update On Financial Position* (27 January 2009) ASX <http://www.asx.com.au/asx/statistics/announcements.do?by=issuerId&issuerId=317&timeframe=Y&year=2009> at 19 August 2009.
[1499] Compass Resources Limited, above n 1498, *Suspension From Official Quotation* (29 January 2009).
[1500] Compass Resources Limited, above n 1498, *Receivers and Managers Appointed* (18 February 2009).

2009;[1501] sought a trading suspension on 12 January 2009,[1502] and went into administration on 13 March 2009.[1503] There were also smaller listed companies who quietly went into administration during 2007 and 2008 without any warnings through the ASX announcement platform.

B ASX Market Composition

Companies within the resource, financial, real estate and infrastructure industries constitute a large proportion of the Australian market.[1504] Most of these companies develop or manage long-term assets or projects, which adds to the complexities of their business operations, risk management, financial disclosures and security valuations. The long-term nature of these businesses means that the short-term earnings or financial indicators of these companies are often not meaningful for security valuation purposes. A rational valuation needs to reflect the potential earnings of the business over a longer period. This makes it especially difficult to determine what the continuous disclosure obligations are in practice.

Careful policy consideration needs to be given to what information is required from resource, infrastructure, financial and loss making companies for investors to make informed judgments on investment decisions, and how this information is best provided on a timely basis. Under existing regulation, it is unclear whether:

- Resource companies are required to continuously disclose changes in earnings expectations in addition to the quarterly activity and cash reports.
- Financial companies are required to continuously disclose changes in earnings expectations after provisioning and mark to market adjustments.

[1501] Babcock & Brown Limited, *Update on Forecast 2008 Final Result* (7 January 2009) ASX <http://www.asx.com.au/asx/statistics/announcements.do?by=companyId&companyId=9276&timeframe=Y&year=2009 > at 2 July 2010.

[1502] Babcock & Brown Limited, above n 1501, *Suspension from Official Quotation* (12 January 2009).

[1503] Babcock & Brown Limited, above n 1501, *Appointment of Voluntary Administrator* (13 March 2009).

[1504] Companies within these sectors represented more than 60 percent of the companies within the S&P/ASX 200 index on 17 November 2008; with 28 financial companies (14 percent); 59 material and energy companies (30 percent), 19 real estate investment trusts (10 percent); and 14 infrastructure or utility companies (7 percent). Similarly, 60 percent of the 466 sample companies were within these sectors, including 48 financials, 169 material and energy, 40 real estate, and 22 transportation or utility.

- Utility, infrastructure and real estate entities are required to continuously disclose changes in earnings expectations and asset valuations as well as expected distributions.
- Companies with prospective or actual statutory losses are required to continuously disclose changes in earnings expectations, including changes in the loss levels.

It is difficult for financial companies to forecast provisioning levels or mark to market adjustments. Similarly, it is difficult for real estate entities to predict changes in property values, infrastructure entities to estimate construction costs or long-term traffic figures, and resource companies to estimate long-term commodity prices. Nevertheless, all of these sectors can significantly improve their public disclosures. The highlighted structural and sectoral difficulties explain some, but not all, of the outlined sectoral disclosure patterns. While sector generalisations are helpful, they have limitations. There are big differences in the nature of companies within sectors. Ultimately, individual companies need to understand what information the broader market needs to value its securities and must provide all of this information publicly. Companies need to clearly explain their management plans to deliver long-term shareholder value and the opportunities *and* risks in doing so. They must also update the market on a transparent and timely basis when they become aware of problems. Nobody wants to be the bearer of bad news. However, as outlined in Chapter Three, one of the primary rationales for mandatory disclosure is to ensure that *all* investors are informed about negative information quickly.

Finally, it is important to acknowledge the inherent limitations of the continuous disclosure regime. Informed judgments on investment decisions require access to comprehensive information on a regular basis. Pieces of company information are only meaningful to investors when understandable, accurate, timely and interconnected. Indeed, disclosures that are provided without context are more likely to mislead than to inform investors. The 2008-year provided a unique opportunity to examine disclosure issues under stress. During this period, many companies made large write-offs, incurred losses, increased provisioning, and needed to restructure, refinance or raise capital. Within this environment, a company’s cash, debt and capital positions, and its ongoing ability to service or refinance the debt were important market focuses. It was during these uncertain and volatile market phases that investors *most* needed companies to provide information on an open and transparent basis. These periods were also the times when rational investment decision-making was needed to counter gloom and a lack of investor confidence. However, few of the Australian corporate continuous disclosures provided all of this information. Analysis of these factors generally required the connections provided by a full set of financial accounts, notes to the accounts, and management discussion and analysis.

Reform proposals are outlined in Chapter Six to mitigate the identified issues around the continuous disclosure rules and processes.

CHAPTER SIX: LISTED COMPANY DISCLOSURE FRAMEWORK: CRITIQUE AND REFORM PROPOSALS

‘New opinions are always suspected, and usually opposed, without any reason but because they are not already common’[1505]

Listed company disclosure in Australia should be made in the public arena rather than on a selective basis. The information provided by companies should be clear, concise and effective, and should be in a form that allows comparative analysis. Without such disclosure, it is difficult for investors and other users of company information to make well-informed decisions and the likelihood of trading on inside or selectively disclosed information increases.

The thesis has investigated the extent and quality of information provided by listed companies through the ASX, and the likelihood of additional private or selective disclosure. The thesis research was designed around two initial hypotheses:

1. Some investors in ASX listed securities do not have access to sufficient information to make rational judgments on investment decisions under existing company disclosure regulation and practice.
2. Disclosure of a significant proportion of Australian listed company information is on a private or selective basis, resulting in information asymmetry.

Chapters Two to Five highlighted theoretical, conceptual, legal, regulatory, enforcement, and empirical issues arising under the listed company disclosure framework in Australia. The accumulated evidence and arguments strongly supported the initial hypotheses, suggesting that reforms to the framework are needed to enhance its fairness, public transparency and long-term economic efficiency.

This Chapter provides a synthesis of the thesis content to allow critique of the listed company disclosure framework on an integrated basis. I summarise the key thesis arguments on the need for mandatory disclosure regulation and the appropriate policy rationales, highlight the ambiguities under the company disclosure and insider trading regulation, consider the efficacy of the regulatory and enforcement regimes, and review the empirical research on listed company disclosure practices. General policy

[1505] John Locke, *An Essay Concerning Human Understanding* (1690) dedicatory epistle.

recommendations, issues for policy consideration, and my views are highlighted within individual parts on (i) the theoretical and conceptual bases for the disclosure framework; (ii) ambiguities under the regulation; and (iii) the regulatory and enforcement regimes. Specific reform proposals are also provided within the empirical discussion. These proposals seek to mitigate the identified issues around the periodic disclosure, continuous disclosure, and company briefing rules and processes. These reforms, if adopted, would provide more equitable access to company information and reduce the scope for trading on inside or selectively disclosed information. The consequential improvement in market transparency would enable investors and other stakeholders to make more informed decisions, strengthen market and corporate accountability processes, and enhance long-term economic efficiency.

However, the specific reform proposals and general policy recommendations will only be fully effective if implemented within a coherent, comprehensive and coordinated listed company disclosure framework. In a real sense, the framework is only as good as the weakest link and its efficacy, fairness and efficiency depend on the credibility and strength of the individual components. The framework needs to be founded on a solid theoretical basis, have clearly identifiable goals, and include a bold and effective regulatory and enforcement structure.

Chapter Six is in four parts.

1. Part I reviews the theoretical and conceptual bases for the listed company disclosure framework.
2. Part II reviews the regulation of the listed company disclosure framework.
3. Part III reviews the regulatory and enforcement regimes of the listed company disclosure framework.
4. Part IV reviews the empirical research on listed company disclosure practices and outlines and discusses specific reform proposals.

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I THE LISTED COMPANY DISCLOSURE FRAMEWORK: THEORETICAL AND CONCEPTUAL BASES

A Why Mandatory Company Disclosure Regulation is Needed

I argue in Chapter Three that the most significant questions within the mandatory disclosure debate concern *when* and *to whom* company disclosures are provided. These questions should be considered in a number of ways:

- Is it acceptable for companies to provide information to the market on a tiered or hierarchical basis?
- Are mandatory corporate reporting processes intended to provide only basic or core information?
- How much of the information already disclosed by companies privately to some investors should be publicly disclosed or readily accessible and available by all investors and stakeholders through the mandatory reporting processes?
- Should companies be required to use digital technologies to enable timely and equal access to information?

In previous decades, the means by which companies could disseminate information to large numbers of investors and stakeholders were limited. Given these limitations, company managers tended to build close private relationships and exchange information with selected institutions that it determined were important. Other parties relied on the more restricted information released in the public arena. This tiered or hierarchical approach to the provision of company information is described in the Holland empirical study in the UK outlined in Chapter Two. Holland concluded that the quality of private disclosure by listed companies in the UK was much higher than the public disclosure because the 'private discussion [was] much richer conceptually … [with] much deeper analysis'.[1506] He indicated that he was left with a sense that the public voluntary disclosure was designed to merely satisfy minimum market pressures and regulations.[1507] He argued that companies managed the private meetings around the publicly announced result announcements and slides to be able to claim they were

[1506] Holland, above n 242, 49.
[1507] Holland, above n 242, 64.

saying the same thing in private and public.[1508] I reached the same conclusions as Holland on the Australian equity market. However, markets that allow listed companies to provide limited sanitised information in the public arena, with additional rich information provided on a preferential basis are not transparent, and are unlikely to be optimally fair or economically efficient. In such markets, the preferred investors are not competing primarily on their analytical skills and the nonfavoured investors may be better off exiting the market.

As argued in Chapter Two, disclosure policy distinctions need to be principled and not based on fixed ideas. It is not appropriate in contemporary markets for policy makers, regulators or companies to predetermine or limit the content and format of publicly available company information based on simplistic preconceptions about investor capacity or participant roles. The debates around access to company information are radically changed by the advent of the digital era. Companies can enable public access or provide information to all investors and stakeholders rapidly and cheaply using digital technologies. By doing so, determinations on what information must be disclosed on a mandatory basis and what is material or immaterial information can be avoided. Public access to detailed company information does not preclude the dissemination of summary or tailored information where this is considered necessary or useful for some investors or stakeholders.

The empirical research outlined throughout the thesis suggests that the economic efficiency of a country is linked to or associated with extensive company disclosure standards, reduced information asymmetry, transparency, public trust, widespread investor participation, investor confidence, and effective legal protections for minority shareholders. However, the research also indicates that some company managers prefer to disclose material information selectively or privately rather than in the public arena, particularly when the news is adverse, there are conflicts of interest involved, or the company is in financial difficulty. Even when information is provided publicly, managers sometimes spin or disguise negative news by presenting it with an optimistic bias, particularly if able to do this legitimately within regulatory bounds. In practice, failures or delays in the public disclosure of corporate information or public reporting

[1508] Holland, above n 242, 49.

with an optimistic bias often have significant detrimental consequences on uninformed investors and the broader public.

I conclude in Chapter Three that carefully crafted and effectively enforced company disclosure law can promote public rather than selective disclosure of company information and enhance long term economic efficiency. To the extent that a mandatory disclosure framework achieves these aims, the regulation is well justified. As Fama and Laffer suggested in 1971,

> [i]n some cases where the firm would be the producer of information about itself, a social optimum can be achieved by means of legal disclosure provisions… That is, the firm is restricted by law both from selling information about itself and from giving preferential treatment to either its shareholders or outsiders in increasing information. Such a law destroys the firm' incentive to generate information for trading purposes.[1509]

However, when company management continue to believe and act as though they have broad discretion over the content, timing, manner and recipients of their disclosures, the rationales for a mandatory disclosure framework are significantly undermined.

B The Appropriate Rationales to Support the Listed Company Disclosure Framework

Most of the Australian disclosure and insider trading policy literature indicates that the primary rationales supporting the listed company disclosure framework are market fairness and market efficiency.[1510] The efficiency and fairness concepts adopted by policy makers, regulators and the judiciary determine the degree of access to information and investor protection under the company disclosure and insider trading regulation. However, the debates on the fairness and efficiency rationales underpinning the insider trading and company disclosure regimes have become confused.

An insider-trading regime, similar to that in operation today, was enacted in Australia in 1991 following two major reviews of insider trading policy. As outlined in Chapters

[1509] Eugene Fama and Arthur Laffer, 'Information and Capital Markets' (1971) 44 *Journal of Business Law* 289, 298.
[1510] See Chapter Two.

Two and Four, these reviews by the Anisman and the Griffiths Committee rejected Manne's argument that insider trading enhances market efficiency.[1511] The Griffiths Report indicated that even if insider trading enhances market efficiency by faster dissemination of information, the negative effects of insider trading on investor confidence outweigh these efficiency benefits. It identified the promotion of economic efficiency through improved investor confidence in the integrity of the market as one of the benefits of insider trading regulation.[1512]

The 2001 CASAC insider trading review committee described the market fairness rationale or theory in terms of the unerodable information advantage approach.[1513] The CASAC report suggested that the insider trading prohibition does not seek to eliminate the risks or trading advantages of participants due to superior skill, time, or commitment - the prohibition only applies to trading on price sensitive information that all market participants cannot gain access to by 'ordinary research, skill or analysis.'[1514] Similarly, the majority of CAMAC that reviewed the insider trading provisions in 2003 indicated that the

> focus of the insider trading prohibition should be on information that the market expects should be disclosed to all participants on an equal basis. To permit trading in these circumstances could give the informed persons an unfair advantage over other market participants and undermine confidence in the fairness and integrity of financial markets.[1515]

Within the company disclosure policy material, the consultation paper "Strengthening the Financial Reporting Framework" stated that

> Price sensitive information should be made available to all investors on an equal basis so that certain investors are not disadvantaged in comparison with others. The absence of selective disclosure is fundamental to market integrity.[1516]

Similarly, a report by the Parliamentary Joint Committee on Corporations and Financial Services indicated that 'the cornerstone of a fair and effective disclosure regime is that investors have access to materially price-sensitive information on an equal basis, so that

[1511] Griffiths Report, above n 56, [3.3.4].
[1512] Griffiths Report, above n 56, [3.1.2]. Economic efficiency is not defined in the Report.
[1513] CASAC, above n 61, 15.
[1514] CASAC, above n 61, 15.
[1515] CAMAC, above n 71, 48.

particular market participants are not disadvantaged in relation to others.'[1517] More recently, the Department of Treasury consultation paper on the infringement notice scheme stated that the 'continuous disclosure obligations of companies are vital in maintaining market integrity and ensuring market efficiency through open and equal access to relevant information.'[1518]

Mason P confirmed in *R v Firns* that the Griffiths report:

1. Rejected the Manne argument that insider trading enhances market efficiency;
2. Concluded that the effects of insider trading are outweighed by the negative effects on investor confidence;
3. Viewed equality of access as the critical factor; and
4. Laid down a clear policy vision to promote fairness in the market through equal access to information.[1519]

However, His Honour indicates that this clear policy approach became blurred in the legislative process.[1520] The Manne theory in defence of insider trading is cited, and it is subsequently suggested that the drafters who inserted the "readily observable matter" carve-out intended to promote economic efficiency. His Honour indicates that the words within the "readily observable matter" carve-out are opaque and legislative 'assistance is blurred by the conflicting [equal access and market efficiency] goals embedded in the essentially two-pronged definition of generally available information.' The Mason P conclusion that the convergence of the essentially incompatible policy goals has produced 'legislated astigmatism'[1521] arises because His Honour views the efficiency principles as pointing in the opposite direction to the equal access rationale.[1522] The finding that the equal access and efficiency rationales are in conflict and point in the opposite direction appears to be founded on, or influenced by, the Manne efficiency theory.

[1516] Commonwealth, above n 177, 130.
[1517] Commonwealth, above n 177, 103.
[1518] Commonwealth, above n 5, 2.
[1519] *R v Firns* (2001) 38 ACSR 223, 231.
[1520] *R v Firns* (2001) 38 ACSR 223, 231.
[1521] *R v Firns* (2001) 38 ACSR 223, 232.
[1522] *R v Firns* (2001) 38 ACSR 223, 232.

The Australian scholarly commentary outlined in Chapter Three also suggests that the equal access and market efficiency rationales are in conflict and that equal access needs to be traded off to ensure market efficiency.[1523] However, the commentators do not explain the nature of the conflict or how the rationales should be balanced on either a theoretical or empirical basis. These arguments also appear to be based on a price efficiency theory such as that expounded by Manne.

The Mason P and scholarly conclusions that the dual equal access and efficiency rationales are incompatible underlies many of the legal issues raised in the thesis. The perceived or actual "legislative astigmatism" allows policies that restrict access to company information to be readily justified on the basis of ambiguous efficiency principles.

The Griffiths report, Mason P, and the legal scholars do not discuss what they mean by price, market or economic efficiency, or the time horizon of any of these concepts or goals. However, differences in the content and timing of efficiency goals are critical. Policy rationales or decisions based on an end goal of short term price efficiency, or the interpretation of the insider trading and continuous disclosure provisions based on short term price efficiency notions, reflect a return to the arguments of Manne that were rejected by the Anisman and Griffiths Committees. As discussed in Chapter Three, price efficiency may or may not be aligned with optimal market efficiency at a particular point in time, and the degree of market efficiency may or may not reflect optimal economic efficiency.[1524] Optimal economic efficiency depends on optimal real capital or investment decisions. This makes it important to distinguish between very short and longer term efficiency measures (or efficiency anomalies), and between trading activity that simply involve wealth transfers between market participants and those that effect capital allocations and the real economy.

[1523] See Chapter Three. These parties need to explain: the nature of the alleged conflict between the fairness and efficiency goals; what form of efficiency they are discussing; the timeframe over which efficiency is being assessed; and how limiting equal access to company information enhances long term economic efficiency or the public interest.
[1524] The thesis definitions of price efficiency, market efficiency and economic efficiency were provided in Chapter One.

Manne argued in defence of insider trading in the 1960s and 70s on the basis of economic analysis. His initial article justified insider trading on the basis that it compensates entrepreneurial activity.[1525] In a later article entitled 'Insider Trading and the Law Professors', Manne altered his arguments and adopted a broader stance in defence of insider trading. Nevertheless, his economic analysis was limited to a price signalling theory; that insider trading promotes price efficiency because trading on the information ensures that it is quickly reflected in the security price.

An efficiency rationale focused solely on short-term price or market efficiency excludes or ignores the impact of wealth transfers from uninformed investors to those who have private (inside or selectively disclosed) information. However, even assuming a goal restricted to an absolute economic return measure (that is, a goal to increase the size of the economic pie without concern for the distribution of the pie), there are many instances where optimisation of short-term price or market efficiency is likely to reduce long-term economic efficiency. For trading on private information to enhance overall economic efficiency: the trading must provide effective price signals to the market; these price signals must be the most efficient mechanism for incorporating the relevant information within the share price; and the price signals must optimise efficiency across an entire market and real capital allocative processes. However, when trading is permitted on private information, the resulting price signal is noisier and the factoring of news into share prices is slower than when the information is widely disseminated. It takes a period of time for share prices to incorporate new information, and during this period, uninformed investors are not able to distinguish between trading volume and price movement based on credible private information and trading on an uninformed basis.

The arguments and theories outlined in Chapter Three that advocate selective disclosure to enhance efficiency are also weak. No compelling evidence was found to support the commonly cited theory that selective disclosure is required to incentivise analysts to produce research, which in turn is required to enhance market efficiency. The relationships or links between access to company information, selective disclosure, research production, and efficiency are diffuse and uncertain. In any event, access to

[1525] Manne, above n 579, 116.

private company information in Australia is not based on any requirement to produce research for third parties or the broader market. If it were, fund managers would not be provided with regular private access to company management.

I do not accept the theories or arguments in Chapter Three that companies need to disclose some information to favoured investors privately or selectively. However, I do not advocate informational parity, and I do not suggest that all investors are, or need to be, equally intelligent, skilled, committed or diligent. I conclude that regulation that requires equal access to company information based on an unerodable information advantage model is workable within a digital environment.

It is true that company managers and institutional or individual market participants have strong monetary and other incentives to engage in private or selective disclosure. It is also true that company managers and institutional or individual market participants can point to specified efficiency gains resulting from private or selective disclosure. However, the key issue for policy makers concerns the extent to which these "management, institutional or individual" incentives and efficiencies align with the incentives and efficiencies that serve Australia's long-term interests.[1526] The debates around selective disclosure and efficiency change significantly when the adopted efficiency goal is long-term economic efficiency rather than short-term price or market efficiency. The relevant test becomes does private disclosure to selected investors enhance the net long-term economic efficiency of Australia. While it is not possible to conclusively answer this question, or to design an empirical test that incorporates all relevant market participant incentives and economic measures, the probable answer is no.

The global financial crisis highlighted the significant gaps between institutional and public interest goals and incentives, the extent to which externalities arise when large areas of market activity are based on short term institutional or individual incentives, and the significant accountability and governance issues when company information is

[1526] An imperfect analogy may assist scholarly readers. Individual Australian students and universities could legitimately argue that providing some students with private advance knowledge on pending exam questions is efficient because it would save students revision time and lower course failure rates. However, this process is unlikely to enhance the long-term interests of Australia.

not transparent (that is, readily available in a format that is clear, concise and effective). The disciplines that flow from public disclosure and scrutiny are needed to discourage managerial, institutional and individual excesses that inevitably arise in markets driven by self-interest and profits.

Competition among investors should be based on superior analytical skills rather than on who can get the best access to company management. As highlighted in Chapter Three, there is a pattern around the globe of some companies blacklisting institutional and retail investors who criticise, ask penetrating questions, or publish a sell recommendation. The management of HIH excluded analysts and others who made critical comments or recommendation,[1527] media reports confirm blacklisting continues to occur in Australia, Australian institutional investors publicly admit they 'seek to curry favour with management in order to preserve their information networks,'[1528] and a survey of institutional investors indicated that a majority expected exclusion from stock offerings and exclusion from company briefings following a sell recommendation.[1529] However, all investors and corporate stakeholders must be able to write independent reports, scrutinise and criticise company management, and sell a company's shares, without fear of losing access to company information. Otherwise, all forms of efficiency are weakened, and market and corporate accountability processes are severely undermined.

I conclude in Chapter Three that the most effective way to minimise potential conflicts of interest and enhance long-term economic efficiency is to promote transparent corporate disclosure in the public arena. A company disclosure framework that requires equal access to company information enables vigorous competition among *all* institutional and retail investors who are able to process, analyse and trade on the information. Equality of access does not prevent anyone from the gathering in and processing, disseminating or trading on publicly available information. Informational

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[1527] Commonwealth, above n 33, Vol 1 72-73, Recommendation 46; Westfield, above n 552, 135.

[1528] Alan Kohler, *Secrets and Lies* (2 December 2008) Business Spectator. <http://www.businessspectator.com.au/bs.nsf/Article/Secrets-and-lies-LWRDP?OpenDocument&src=srch> at 3 December 2008; Lisa Murray, '"Blacklisting" Hard to Wipe Out', *Australian Financial Review* (Sydney), 23 April 2003, 52.

[1529] Findlay et al, above n 773, 10 footnote 2. I have been blacklisted or removed from company contact lists following requests for very basic information.

advantages can be achieved without access to private information. Rewards for investor diligence and initiative can and should be achieved through insightful analysis of publicly available information.

Manne did not provide any scholarly empirical evidence to support his theory or arguments. Further, he made a series of assumptions, most of which are now open to question on theoretical and empirical grounds.[1530] Manne assumed high levels of insider trading occurences; long delays until public release of most inside information; full disclosure was not a credible alternative to permitting insider trading; the public was unsophisticated and incapable of ensuring company information was accurately absorbed into share prices; and there was no visible evidence that investors had lost confidence in markets that allow systemic insider trading.[1531]

In the intervening period since the Manne publications, the bodies of empirical research published by finance, economics and accounting scholars on determinants of market and economic efficiency, and links between efficiency, company disclosure and insider trading, are extensive. Nevertheless, I was not able to find any empirical research that suggests that markets or economies are more efficient over the long term by permitting systemic trading on private information. Instead, the scholarly research on insider trading outlined in Chapter Three suggests that any short term price efficiency gains arising from trading on inside information are significantly outweighed over the long run by increases in market volatility and reductions in other efficiency measures such as bid ask spreads, liquidity, price accuracy and capital costs. The global research also suggests that countries with enforced insider trading laws gain economic benefits through enhanced liquidity, more informative stock prices, and lower costs of capital. These findings are implicitly acknowledged in the insider trading and company

[1530] For more detailed analysis of the Manne efficiency theory, see Gill North, 'A Re-examination of the Manne Efficiency Theory and the Insider Trading and Company Disclosure Efficiency Rationales' (2011) 25 *Australian Journal of Corporate Law* forthcoming

[1531] Henry Manne, 'Insider Trading and the Law Professors' (1975) 23 *Vanderbilt Law Review* 547, 547-572. At pg 566, Manne defines an 'efficient market [as] one in which capital will be allocated to its highest-return uses, thus ensuring that capital goes into those uses with the greatest individual and social utility.' He suggests subsequently that the desirability of efficiency in a market ultimately relates to individual goals but concedes that the 'gains from efficiency are diffuse and often specifically unidentifiable.' Thus, Manne appears to argue that a market that permits insider trading simultaneously leads to optimal individual and social utility. However, he does not define optimal individual and social utility and he does not provide any disclosure policy commentary and they support the Griffiths Committee recommendations in 1989.

In any event, Manne used the price signalling theory to oppose company disclosure regimes and regulation prohibiting insider trading. Thus insider trading and company disclosure regulatory frameworks that limit investor access to company information on the basis of the Manne principles are incoherent and untenable. A goal to optimise short-term price efficiency without consideration of other efficiency and economic factors may conflict with the equal access goal. However, an end goal of short term price efficiency is counter productive. Provisions that purport to promote equality of access but which simultaneously permit trading on private information in order to enhance short-term price efficiency are easily undermined. Indeed, policy and judicial decisions based on short-term price efficiency goals tend to result in outcomes that negate the rationales for establishing the insider trading and company disclosure regimes in the first place. The immediate practical effect of adopting short-term price efficiency and equal access as the rationales underpinning an insider trading or company disclosure regime, or interpreting the provisions as a convergence of these rationales, is to place a large portion of trading activity based on selectively disclosed or confidential company information into the 'unlikely to be enforced or largely unenforceable' basket. Empirical research suggests the longer term outcomes are information asymmetry, shaken investor confidence in the integrity of the market, and less than optimal economic efficiency. In other words, the ultimate outcomes are directly counter to the intended regulatory purposes.

Apart from the Griffiths report that referred to economic efficiency as a rationale for insider trading regulation, Australian policy makers refer to price or market efficiency rationales. However, the Fama ECMH uses short-term price efficiency as a means to an end; the end goal being the efficient allocation of scarce capital. Similarly, the appropriate efficiency rationale for company disclosure and insider trading policy is long-term economic or allocative efficiency. A high level efficiency goal and a long time horizon are needed to enable policy decisions to be assessed on a broad basis

economic analysis or arguments on the factors or connections required to optimise price efficiency, efficiency across an entire market, and the efficiency of real world capital allocations.

incorporating competing systemic efficiency measures, agency and incentive issues, and short and longer term costs and benefits.

The goal of long-term economic efficiency is likely to be best achieved in contemporary markets by policies that promote transparent corporate disclosure in the public arena. Empirical studies were outlined from legal, accounting, finance and economic scholars using many different measures, samples and designs. The studies suggest that the economic efficiency of a country is linked to or associated with high company disclosure standards, the quality of law enforcement, reduced information asymmetry, widespread investor participation, legal protections for minority shareholders, and public trust. This evidence suggests that sustainable long-term economic outcomes created through efficient markets depend on investor confidence and a perception by the broader public that markets operate on a fair basis. Investor confidence in the integrity of the market relies on investors having genuinely equal access to information and the absence of systemic insider trading or selective disclosure.

II THE LISTED COMPANY DISCLOSURE FRAMEWORK: THE REGULATION

'A clever theft was praiseworthy amongst the Spartans; and it is equally so amongst Christians, provided it be on a sufficiently large scale'[1532]

The proposed theoretical and conceptual foundations for the Australian company disclosure framework might be viewed as uncontroversial. However, the "sting" for many investors arises from regulatory ambiguities and potential gaps or limits on the degree of access to company information, investor protection and potential enforcement actions under the periodic disclosure, continuous disclosure and insider trading regimes.

I argue in Chapter Four that the efficacy of Australian corporate disclosure regulation ultimately succeeds or fails on an integrated basis. While users of company information want to be informed about company developments on a timely and

[1532] Herbert Spencer, *Social Statics* (1850) Pt ii, ch 16, 3.

complete basis, few investors are concerned with the discrete disclosure regime under which information is provided or the particular provisions that may have been breached when required company disclosures have not been made. The efficacy of the integrated disclosure framework depends on whether the regimes provide sufficient certainty on what market disclosure or activity is required or prohibited, the effectiveness of the enforcement regimes, and whether the regimes are providing equal access and enhancing long-term economic efficiency.

The nature and scope of the insider-trading regime is largely determined by the requirement that the information is material but not "generally available".[1533] However, the judiciary, policy advisors and market participants have indicated there are significant uncertainties around the "generally available" provisions. Justice Kirby has suggested that policy makers need to carefully consider what the insider trading prohibition is concerned with.[1534] Justice Rolfe indicated in *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* that the insider trading provisions are difficult to interpret because of apparent internal inconsistencies and they require policy reconsideration.[1535] Mason P confirmed in *R v Firns* that the convergence of essentially incompatible policy goals within the readily observable matter provision has produced "legislated astigmatism".[1536]

In 2003 the government asked CAMAC to review the insider-trading regime, with a particular focus on the published information and readily observable matter limbs of the "generally available" provisions. A majority of the Committee concluded that the scope of the published information test is ambiguous and the ambit of the readily observable matter test is even more uncertain.[1537] Indeed, they described the breadth of the readily observable matter test as indeterminate.[1538] The majority proposed significant amendments to the published information and readily observable matter tests to mitigate these uncertainties. In contrast, the minority thought these provisions are generally

1533 *R v Hannes* (2000) 36 ACSR 72, 136; *R v Rivkin* [2004] NSWCCA 7 (5 February 2004) [196]; *ASIC v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 62 ACSR 427, 498.
1534 See, eg, Kirby, above n 41, 154, 168.
1535 *Ampolex Ltd V Perpetual Trustee Company (Canberra) Ltd & Ors (No 2)* (1996) 14 ACLC 1514, 1522.
1536 (2001) 38 ACSR 223, 234.
1537 CAMAC, above n 71, 13.
1538 CAMAC, above n 71, 48.

working. They recommended some amendments to the readily observable matter test but concluded that the published information test should remain as it is. The government responded with a Position and Consultation paper in 2007. The PCP concluded that the existing published information test is working. It presented three options to address the readily observable matter test uncertainties, including:

1. the CAMAC minority proposed amendments;
2. the inclusion of notes to the existing provisions; and
3. a model that reflects the Brudney approach.

However, no legislative changes to the insider trading provisions have been made following the CAMAC review and the PCP consultation process.

The most significant legal problem lies in the potential circularity of the "generally available" carve-outs.[1539] Disclosure of company information to large institutional investors may by its very nature constitute "publishing" of the information or making it "readily observable" on the basis that this enhances short-term price efficiency. On this interpretation, information disclosed at general analyst briefings or to a selected group of institutional investors may be "generally available".

I also argue in Chapter Four that the interpretation of materiality in insider trading case law diminishes equal access because it equates materiality with short-term price efficiency.[1540] I used the *Citigroup* case to outline a hypothetical scenario relating to private knowledge about the Toll takeover bid for Patrick. The insider trading case law suggests that participants who have private knowledge about pending takeover bids, capital raising or earnings news prior to an announcement through the ASX can legitimately trade once the market reflects the information to a significant or substantial extent through unusual price or trading volume movements or reasonably specific speculation in analyst reports or news sources.

Under these materiality principles, ASIC is only likely to initiate enforcement actions very early in the leakage or tippee chains when the information is clearly not "generally

[1539] See ASIC, above n 326, 22.
[1540] See Chapter Four.

available" and can still provoke spikes in the security price or trading volume.[1541] It may be difficult for ASIC to successfully prosecute market participants who trade in the securities of a company after movement in the volume or price of the relevant security or those who are able to manipulate their trading to achieve only gradual movement in the prices or trading volumes.

There are also significant ambiguities around the continuous disclosure regulation. The questions that persist around the "generally available" and materiality provisions in the insider-trading regime extend to the continuous disclosure regime. However, the extent to which the insider trading case law on the "generally available" and materiality provisions applies to the continuous disclosure regime is uncertain because the relationship between the continuous disclosure and insider trading regimes is unclear. The common elements suggest that the legislators intended some relationship and scholarly parties argue that the two regimes are linked. However, Mason P indicated in *R v Firns* that while possible alignment between the criminal regulation of insider trading activities and the continuous disclosure obligations might be a worthy suggestion or goal, this needs to be considered by legislators and not the judiciary. His Honour indicated that as it stands currently, 'Division 2A and its criminal sanctions do not link themselves with the scheme of statutory reinforcement of ASX's continuous disclosure rules.'[1542]

Listing Rule 3.1 requires notification of the relevant information regardless of whether the information is "generally available".[1543] However, the practical and legal effects of the differences in the listing rule and statutory continuous disclosure provisions are uncertain. It is not clear how the drafters intend the two regimes to operate independently or in tandem. There is no case law on the listing rule as standalone regulation. There are also many uncertainties around the status, content and enforceability of ASX Listing Rule 3.1. As discussed in Chapter Five, Guidance Note 8 to ASX Listing Rule 3.1 leaves many issues around the nature and scope of the continuous disclosures obligations ambiguous.[1544]

[1541] See Chapter Four.
[1542] *R v Firns* (2001) 38 ACSR 223, 235.
[1543] See Chapter Two for an outline of the ASX Listing Rule 3.1 elements.
[1544] See Chapter Five.

I conclude in Chapter Four that it is difficult to describe with any confidence what market activity *is prohibited* under the insider trading regime because of significant uncertainties around the requirement that the information is material but not "generally available". Further, there is even greater uncertainty on what disclosure *is required* under the periodic and continuous disclosure regimes. The combined ambiguities around the continuous disclosure and insider trading regimes mean the extent to which selective disclosure in Australia is prohibited or enforceable is largely indeterminate. The SEC, FSA and academic commentators confirm that the most significant trading problems and losses arise from systemic professional insider trading on either a transactional or longer-term basis. However, none of the successful insider trading actions in Australia to date have involved systemic professional trading on inside or selectively disclosed information, and uncertainties around the "generally available" and materiality provisions are likely to limit such enforcement actions going forward.

The accumulation of regulatory uncertainties results in a listed company disclosure framework that potentially provides minimal protection to investors. To the extent that: information is "generally available" upon release to some institutional investors; information is readily observable when it is referred to in analyst reports, news services and or closed briefings but not disclosed through the ASX CAP; the materiality requirement within the insider trading and continuous disclosure regimes requires evidence of sharp short-term price movements linked to the relevant information; or information becomes immaterial due to unusual movement in the price or trading volumes of the relevant securities; the pool of likely successful enforcement actions is diminished. In other words, the potential breadth of the "generally available" and materiality provisions in the insider trading and continuous disclosure regimes may extinguish most of the investor protection against systemic professional trading on inside or selectively disclosed information.

Finally, there are weaknesses and ambiguities in the listing rule and statutory periodic disclosure provisions. As argued in Chapters Two and Four, the status, content and enforceability of the periodic disclosure listing rules on preliminary final and management discussion and analysis reporting are ambiguous.[1545] The statutory provisions on management discussion and analysis reporting within the half year and annual reports are also weak.

The efficacy of the Australian listed company disclosure framework ultimately succeeds or fails on an integrated basis. Policy and scholarly commentary suggests intended theoretical and empirical links across the periodic disclosure, continuous disclosure and insider trading regulation.[1546] However, the regimes appear to be currently operating on a standalone basis.

The looseness of the periodic disclosure listing rules and Listing Rule 3.1, the minimal standards on management discussion and analysis within company reports and disclosures, combined with the potential breadth of the "generally available" and materiality carve-outs within the insider trading and continuous disclosure regimes, allow companies high degrees of discretion on the content, timing, means and recipients of their disclosures. This discretion allows significant leeway to companies and favoured investors when determining appropriate or legal conduct, and potentially allows wide scope for insider trading and selective disclosure to occur legitimately or otherwise.

To ensure a coherent and effective comprehensive listed company disclosure framework, I encourage policy makers to consider the gaps and critical links across the individual regimes, and the nature and scope of the comprehensive listed company disclosure framework. The listed company disclosure framework needs to be strengthened and more tightly defined to mitigate regulatory uncertainties, to enable disclosure regulation and enforcement to be considered and implemented on a genuinely integrated basis, and to promote equal access and enhance long-term economic efficiency.

[1545] See Chapter Two.
[1546] CASAC, above n 61, 1.

The broad discretion or "flexibility" around the company disclosure and insider trading rules is reflected in the regulatory and enforcement regimes and the empirical study findings, as discussed in the following two parts.

III THE LISTED COMPANY DISCLOSURE FRAMEWORK: THE REGULATORY AND ENFORCEMENT REGIMES

'[While Australia has] comparable legislative disclosure standards to those in the UK and the US … these disclosure requirements have not been enforced … [L]ax enforcement undermines legal protection of investors.'[1547]

Responsibilities for supervision and enforcement of the corporate disclosure regimes in Australia are currently split between the ASX and ASIC. As highlighted in Chapter Two, ASIC are responsible for actions taken under the company disclosure and insider trading statutory regimes. However, the enforcement structure applying to the ASX disclosure listing rules is not clear. The preliminary final report provides Australian investors with the most comprehensive periodic information on a timely basis. In addition, ASX Listing Rule 3.1 that requires continuous disclosure when a listed Australian company becomes aware of materially price-sensitive information is one of the most important provisions within the disclosure framework. However, responsibilities for monitoring and enforcement of the preliminary final reporting and continuous disclosure listing rules might best be described as in limbo.

The ASIC indicated in July 2010 that market operators are responsible for monitoring and enforcing their operating rules, including the listing rules. The ASX confirms that it is responsible for enforcing compliance with the ASX Market and SFE Operating rules. However, enforcement of the disclosure listing rules appears to be limited to price queries, aware letters, and the suspension of smaller companies when periodic reports are not filed. No evidence could be found of any monitoring or enforcement of the listing rules governing preliminary final reporting and the Australian Accounting Standards Board states that it has no jurisdiction over these reports. This leaves the most

[1547] Dignam et al, above n 1108, 642, 644-645, 648.

important periodic disclosure report in Australia, the preliminary final report, largely unsupervised and arguably unenforceable. Lawrence, the general manager of surveillance at ASX, indicates that the exchange remains responsible for monitoring compliance with Listing Rule 3.1, with breaches of the listing rule referred to ASIC for action. This leaves the legal status of ASX Listing Rule 3.1 blurred. There is no case law on the ASX periodic or continuous disclosure listing rules as standalone regulation. Furthermore, even if the ASX chose to become more active in enforcing the continuous and periodic disclosure listing rules, its enforcement options are limited, as it is unlikely to suspend or delist a larger company[1548] and it appears to be unwilling to utilise ss 793 or 1101B of the Act.

As outlined in Chapter Five, published investor and ASIC stakeholders views on the listed company disclosure culture and enforcement regimes in Australia are generally negative. Even some of the largest institutional investors complain about significant levels of insider trading and information asymmetry. Highly respected institutional investors indicate that the company disclosure issues of most concern are trading on private information about pending takeover bids, capital raisings and earnings releases.[1549] Some investors complain that there is a high incidence of heavy trading in the days leading up to the ASX announcements of these events.[1550] These complaints are supported by independent research by ASIC, which found that the processes around the management and handling of confidential company information in Australia are suboptimal and below international standards.

The investor commentary, the ASIC stakeholder views, and the supporting ASIC evidence suggest that Australian regulators need to take a more vigorous approach to corporate disclosure matters. Most of the ASIC initiated court actions to date have involved insider trading rather than breaches of the periodic or continuous disclosure

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[1548] The listed companies with the largest market capitalisations provide most of the ongoing revenue and profit to the ASX in the form of listing fees, charges relating to company information, clearing and settlement commissions, and fees associated with capital raisings. A delisting or suspension of these companies for a breach of the listing rules would therefore result in a significant loss of income to the ASX, particularly if the delisted or suspended companies moved their listings to another stock exchange.

[1549] See Chapter Four.

[1550] These are also the typical scenarios that form the basis of most of the insider trading and continuous disclosure enforcement actions.

provisions. Nevertheless, the insider trading enforcement actions are likely to represent only the tip of the iceberg in terms of insider trading occurrences.

A primary focus by the Australian regulators on compliance with, and enforcement of, the periodic and continuous disclosure obligations is likely to be the most credible risk based approach to promote equal access and optimise long-term economic efficiency. First, a significant proportion of Australian adults have an investment in ASX listed securities, either indirectly or directly. Company information provided under the periodic and continuous disclosure regimes constitutes the largest body of information provided by Australian corporates to investors and other stakeholders. Secondly, regulatory measures designed to ensure better compliance with the periodic and continuous disclosure regimes (and to thereby reduce potential future incidences of insider trading) are likely to ultimately represent a lower risk approach and a more efficient use of resources than a primary focus on insider-trading litigation. Such preventative measures could be expected to cost less, achieve better disclosure outcomes, and result in less significant detrimental consequences on investors and other stakeholders over the long run. In practice, most cases of insider trading arise when companies fail to comply with their periodic and continuous disclosure obligations. A failure by companies to periodically or continuously disclose, or selective disclosure by companies to a small group of investors, often affects a significant proportion of investors in the relevant company with large amounts of money involved. When professional parties have private information on a pending takeover bid, capital raising, or earnings announcement, these parties are likely to trade until the security price reflects the relevant information. During this period, the uninformed parties (those without the private information) that rationally trade on the basis of fundamental security valuations incorporating information within the public arena often sustain significant trading losses (or lost opportunity gains). The number of impacted parties and the extent of the sustained losses are likely to be greatest when the traded securities are issued by companies with the largest market capitalisations. Thirdly, successful insider trading litigation is very difficult, time consuming and expensive.

I do not suggest that all litigation should be wound down. Instead, I argue for a recalibration of the regulatory priorities with an emphasis on compliance with, and where necessary enforcement of, the periodic and continuous disclosure obligations. ASIC is sometimes criticised for a policy based on achieving a high litigation success rate. Such a policy is an efficient use of taxpayer funds but inevitably results in a failure to prosecute cases with less certain outcomes. However, the 2009 annual report states that ASIC is 'taking on the difficult cases, where, whether we win or lose, we use the case, consistent with the principles of a model litigant, to test important principles which clarify the law on issues in the public interest (e.g. insider trading).'[1551] Baxt argues that ASIC should run more test cases and that legislation should only be revised if these test cases throw up deficiencies in the current legislation.[1552] This argument aptly applies to the corporate disclosure regulation, particularly the continuous disclosure provisions. Given the critical importance of the continuous disclosure regime within the broader company disclosure framework, I encourage the ASX and ASIC to initiate test cases to better define these obligations and determine whether the existing regulation is achieving the goals of equal access and long-term economic efficiency. For instance, there is no case law on Listing Rule 3.1 and only very limited case law on the "generally available" and materiality provisions under the statutory continuous disclosure regime.

Corporate transparency, equality of access and investor confidence in the integrity of the market are significantly diminished when some investors are able to regularly trade on information that has not been released through the ASX. Trading by investors with private advance knowledge about pending takeover bids, capital raisings and earnings news is based on misappropriated confidential information and is virtually riskless, while trading based solely on observations of movements in security prices or trading volumes is speculative and risky. Many investors cannot get access to this information resulting in an unerodable information advantage.

The policy principle of wanting to encourage independent investor initiative and diligence is sound. However, this principle should not, and need not, be applied to allow profitable trading on leaked confidential company information. I concluded in Chapter Four that enforcement actions involving leakage of confidential company information

[1551] ASIC, above n 1024, 3.
[1552] Bob Baxt, 'Aspects of Market Integrity – What Next?' (Paper delivered at a University of Sydney Faculty of Economics and Business Conference on Aspects of Market Integrity – Where Next?, Sydney, Hilton Hotel, 1 October 2009).

should, where possible, be initiated under the continuous disclosure provisions. The regulators need to support their proposed best practice benchmarks on the handling of confidential company information[1553] by encouraging early disclosure of the information through the ASX or better protection of the confidential information at its source.

To summarise, market participant commentary, ASIC stakeholder feedback and ASIC research on the handling of confidential company information suggest that Australian regulators need to take a bolder and more focused approach to corporate disclosure matters. I argue for a recalibration of the company disclosure regulatory priorities with a primary focus on compliance with, and enforcement of, the periodic and continuous disclosure obligations. Such a regulatory approach is the most credible risk based approach to provide equal access and enhance long-term economic efficiency. I encourage ASIC to initiate test cases to define the periodic and continuous disclosure obligations more clearly. I suggest these actions should promote timely disclosure of company information through the ASX, particularly disclosure of earnings matters, takeover bids and capital raisings.

The uncertainties, ambiguities and issues summarised in Parts II and III are clearly reflected in the empirical research on listed company disclosure practices.

IV THE LISTED COMPANY DISCLOSURE FRAMEWORK: THE EMPIRICAL RESEARCH AND REFORM PROPOSALS

The focus of the thesis empirical study outlined in Chapter Five was continuous disclosure, and more specifically, compliance with Guidance Note 8 on disclosure of earnings expectations. The study examined earnings disclosures because timely announcements by company managers on earnings expectations are needed for investors to make well-informed decisions and to ensure genuinely equal access to material company information.

[1553] The ASIC website advises that publication of these standards has been deferred.

ASX Guidance Note 8 to Listing Rule 3.1 links the continuous disclosure obligation on earnings disclosure to the materiality of absolute earnings changes. Note 8 generally requires companies to provide an update through the ASX when an expected change in earnings from a prior forecast or the previous corresponding period exceeds 10-15 percent. However, the regression analysis found no consistent associations between absolute changes in annualised diluted EPS or EBIT levels and the provision of earnings updates or forecasts prior to a financial year-end. The proportion of sample companies that reported year-on-year absolute diluted EPS changes of more than 15 percent (compared to a prior forecast or the previous corresponding period) and that provided a forecast prior to the financial year-end was only 20 percent in 2007 and 27 percent in 2008. In other words, 80 percent of these companies in 2007 and 73 percent in 2008 failed to publicly update the market on the material expected change in earnings. In addition, a high proportion of the earnings announcements that were provided were not clear, concise or effective.

The global scholarly studies outlined in Chapter Three on company disclosure of bad or negative news present a depressingly consistent picture. Holland concluded that companies in the UK only released bad news in the public arena when there was a well-publicised problem, a profits warning, or a clear regulatory requirement. Studies by Pastena and Ronen, and Kothari et al suggested that company managers in the US delayed the release of bad news.[1554] The Graham et al study found that unprofitable companies were more likely than other companies to delay the release of bad news than other companies. In addition, when corporate managers publicly release bad news, they often attempt to disguise or present it in as positive a light as possible. Studies by Pastena and Ronen, and Miller found disclosure patterns consistent with managers highlighting positive news and avoiding discussion on bad news.[1555] Rogers and Stocken found managers were more likely to issue forecasts that were biased when it was more difficult for investors to detect the bias.[1556]

I observed similar patterns in my empirical study of listed company disclosures in Australia. Many companies that expected to report a declining diluted EPS result or a

[1554] Kothari et al, above n 517.
[1555] Miller, above n 516, 173, 201.

statutory loss during 2007 and 2008 either failed to provide an earnings forecast or update, or the forecast provided was in a management-selected format that presented the loss or bad news in a positive light. The evidence on a combined basis was consistent with the argument that many companies tried to avoid disclosing prospective losses or bad news within the public arena, except when specifically mandated in the profit and loss account of the statutory reports. Nobody wants to be the bearer of bad news. However, one of the primary rationales for mandatory disclosure is to ensure that *all* company investors and stakeholders are informed about negative company information quickly.[1557]

Gibson, an ASIC Commissioner, describes the continuous disclosure regime as sitting over the formal documents and as a regime that rather than being prescriptive, 'requires inclusion of "everything investors and their advisers reasonably require to make an informed assessment of the investment".'[1558] She indicates that the key elements of the company disclosure regimes are:

1. Disclosure of price sensitive information to the market in a timely fashion;
2. Announcements that are not false, misleading or deceptive; and
3. Announcements that are clear, accurate and complete.[1559]

Gibson defines "clear announcements" as information contained in a market release that is factual and expressed in an objective and clear manner; "complete announcements" as documents that can be read as a whole without reference to other documents to locate price sensitive information; and "accurate announcements" as disclosure of information that is factually correct, easily understandable, with due prominence to positive and negative information.[1560]

Gibson highlights that it is 'both the quality of information as well as the quantity of information which is crucial in determining whether disclosure advances the transparency and fairness of a market.'[1561] She indicates that the listed company documentation must be "clear, concise and effective". That is,

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[1556] Rogers et al, above n 519, 1254.
[1557] See Chapter Three.
[1558] Gibson, above n 24, 5.
[1559] Gibson, above n 1398, 6.
[1560] Gibson, above n 1398, 11-12.
[1561] Gibson, above n 327, 5.

> [d]ocuments must be readable – if they are lengthy, there must be a clear road map to enable the readers to select the information they need to make as sensible decision. They must be understandable. The content must be clear and relevant to the investment decision at hand. The risk must be put up front and in one place.[1562]

The disclosure principles outlined by Gibson are sound, and they closely align to the thesis arguments and issues highlighted in the empirical study analysis. The periodic reports and continuous disclosures should provide clear, concise and effective information about critical matters and should not be tools for management spin. All company disclosures and briefings should provide genuine analysis of material items rather than lengthy discussion of immaterial matters or boilerplate explanation. Company management need to regularly communicate their strategies, plans, operational, trading and financial positions and the main business risks to all investors and stakeholders. Most company managers have strategies and plans that are constantly revised in the light of changing circumstances and developments. If they don't, the market should know about it.

Issues associated with the periodic reporting and continuous disclosure regulation and practices were highlighted in Chapters Two and Five. The most important of these related to the preliminary final reporting processes, and the management discussion and analysis required, lack of risk analysis, insufficiency of information, lack of clarity, and the undue spin and optimistic bias in the periodic reports and continuous disclosures. Proposed reforms are outlined to mitigate these issues:

I recommend that:

1. The ASX listing rules relating to when continuous disclosure is required and the form of the required disclosures are strengthened.
2. The preliminary final reporting regime is included within Chapter 2M of the *Corporations Act 2001* (Cth).
3. A statutory quarterly reporting regime is introduced.

[1562] Gibson, above n 24, 5.

4. The management discussion and analysis (MD&A) requirements that currently apply to annual reports, to the preliminary final, half year and proposed quarterly reports are extended.
5. Mandatory risk disclosures in the periodic reports are introduced.
6. ASX listing rules relating to online periodic company reports are introduced.
7. The ASX continuous disclosure listing rules are amended to require open access to general company briefings.

These proposals are outlined in more detail under sections on continuous disclosure, periodic disclosure and company briefing regulation and practice.

A Continuous Disclosure Regulation and Practice

Recommendation 1: Strengthen the ASX listing rules relating to when continuous disclosure is required and the form of the required disclosures.

I propose that:

- ***All continuous disclosures reference numbers in a statutory format, with any numbers that are not on a statutory basis reconciled to the statutory numbers;***
- ***All continuous disclosures are presented as complete stand-alone documents;***
- ***All continuous disclosures that provide earning updates or forecasts are clearly labelled as such;***
- ***All continuous disclosures are on a consistent currency basis; and***
- ***Supervision and enforcement of the listing and statutory continuous disclosure rules to rest with ASIC.***

Regulators and legislators should consider the differences in the listing rule and statutory continuous disclosure obligations and whether this is an optimal regulatory approach. Consideration should also be given to what information needs to be provided by resource, infrastructure, financial and loss making companies to enable informed judgments on investment decisions, and how this information is best provided on a timely basis within the integrated disclosure framework.

The empirical study outlined in Chapter Five found that many listed companies failed to update the market about changes in expected earnings on a timely basis. In addition, a high proportion of the earnings disclosures that were provided were not readily understandable by investors. Consequently, the level, content and quality of the continuous disclosures were sometimes insufficient for rational investment decisions.

There are no standards around the clarity, completeness or form of the information provided in the continuous disclosures, making connections to prior information and comparable analysis difficult. However, company information provided without context can be misleading rather than informative, particularly when the information is presented with a large dose of management spin.

General company announcements need to be timely, complete, and accurate. Earnings forecasts in particular, are only likely to assist investors wishing to make rational investment decisions if they are:

1. Quantitative in nature;
2. Complete;
3. Consistent;
4. In a statutory format;
5. Clearly labeled as an earnings forecast or update;
6. Reasonably accurate; and
7. Timely.

Continuous disclosures should prima facie reference statutory based numbers. The statutory numbers are prepared in accordance with mandatory accounting standards. These standards are intended to provide users of the reports with a reliable and accurate picture of the company's position, in a form that allows investors to compare the results of the company with the historical performance and with other companies and securities across the market.[1563] When company management provide commentary on selected numbers that are not in a statutory format, without explanation or links to the statutory figures, the disclosures tend to be ambiguous and there is significant potential for the management to report in a way that obfuscates reality or is misleading to investors.

Continuous disclosures should also operate as standalone documents. Investors should be able to understand the earnings updates and other disclosures without having to reference numerous other documents to interpret them. It is not difficult for companies to provide earnings disclosures as individual announcements through the ASX or within the statutory reports, rather than within documents such as general slide presentations. Any earnings disclosures should be clearly notified by the ASX announcement heading. It is unrealistic to expect all investors to read every ASX announcement, particularly when some of the slide presentations are formatted as 20-megabyte documents. It is also unreasonable to expect investors to reconcile figures in different currencies. A company's statutory reports and other earnings disclosures should be provided on a consistent currency basis. That is, a company's reports and disclosures should consistently use either one or two currencies.

Some of the continuous disclosure issues highlighted in the study analysis require further consideration and debate. The composition of the Australian market, which includes a large proportion of companies that are loss making or that manage long dated assets, makes it especially difficult for companies and investors to determine what the continuous disclosure obligations require. The ASX and legislators should consider what information needs to be provided by resource, infrastructure, financial and loss making companies to enable informed judgments on investment decisions, and how this information is best provided on a timely basis within the integrated disclosure framework. All listed companies need to clearly explain their plans to deliver long-term shareholder value, and the opportunities and risks in doing so. Most importantly, all stakeholders need to be updated on a transparent and timely basis when company management become aware of problems.

The significant differences in the listing rule and statutory continuous disclosure provisions, and the co-regulatory structure governing the continuous disclosure obligations results in unnecessary ambiguity. Policy makers should consider whether the differences in the listing rule and statutory provisions are warranted and beneficial. If so, Listing Rule 3.1 needs to be supervised and enforced. I propose that supervision

[1563] See Chapter Five.

and enforcement of the listing rule and statutory continuous disclosure obligations should rest with ASIC.

B Periodic Disclosure Regulation and Practice

The proposed reforms to periodic disclosure regulation and practice are outlined within discussion on preliminary final reporting, quarterly reporting, management discussion and analysis reporting, and online company reporting.

1 *Preliminary Final Reporting*

Recommendation 2: Strengthen the regulation governing preliminary final reporting.

I propose that:

- ***the preliminary final reporting regime is included within Chapter 2M of the Act;***
- ***with mandated comprehensive notes to the financial accounts;***
- ***enhanced management discussion and analysis reporting; and***
- ***enforcement of the preliminary final and annual reporting to rest with ASIC.***

As highlighted in Chapter Two, the preliminary final report is the most informative report provided to investors in Australia on a timely basis. It must therefore provide all of the financial and non-financial information required for investors to make well-informed decisions. However, the ASX Appendix 4E requirements relating to the notes and applicable accounting standards in the preliminary final reports are ambiguous. Companies are largely free to select the general form of the report and the extent to which management commentary and notes to the accounts are provided. My review of corporate disclosures during 2007 and 2008 found significant variations in the form and content of the preliminary final reports. Critical notes to the financial accounts and substantive management commentary were often missing.

The rules governing the content and applicable accounting standards in the preliminary final reports need strengthening. Notes to the financial accounts (including details of the diluted EPS figure), explanations on the financial results and other MD&A are important to evaluate the recurring and non-recurring components of the result and to understand the historical and prospective positions of the company. The MD&A should reference the statutory numbers (those in the profit and loss account) to enable trend and market wide analysis. Any numbers provided or referenced on a non-statutory format should be reconciled to the statutory numbers.

Responsibilities for monitoring and enforcement of the preliminary final reporting rules require urgent clarification and strengthening. Inclusion of the preliminary final rules within Chapter 2M of the Act would result in a more coherent full year reporting regime. This change would enable ASIC to supervise and enforce the preliminary final and annual reporting processes as an integrated reporting regime.

2 *Quarterly Reporting*

Recommendation 3: Introduce a statutory quarterly reporting regime.

I propose

- ***the introduction of a statutory quarterly regime within Chapter 2M of the Act***
- ***on a comprehensive basis including financial statements, notes to the accounts, and MD&A;***
- ***on an unaudited and online basis;***
- ***with additional company or director liability limited to reporting that is dishonest, misleading or reckless; and***
- ***with supervision and enforcement of the quarterly regime to rest with ASIC.***

As discussed in Chapter Two, Australian policy makers and legislators have historically considered and rejected quarterly reporting on the basis that such reporting is not necessary in addition to the continuous disclosure obligations. However, the periodic and continuous disclosure regimes have different purposes and both regimes must be effective for investors to remain well informed. A six month gap between the half year and preliminary final reports in Australia is a long time for investors to wait for financial updates and management commentary, particularly for companies that have poor disclosure cultures or when the business environment is less stable.

Critics of quarterly regimes cite excessive time and cost involved in the preparation of the reports, feared overload of investor information, and undue investor focus on short-term performance.[1564] However, the marginal cost of quarterly reporting or quarterly statements on an online unaudited basis would be low even for the smallest listed companies and the potential benefits of a comprehensive quarterly reporting regime are expected to significantly outweigh the negatives. More regular management updates would enhance corporate transparency and market fairness due to more equitable access to information, with a reduced impact from selective or private disclosure of information between reporting periods.

The substance of the argument about undue focus on short-term performance is unclear. When there is no quarterly reporting and assuming no selective disclosure of the performance trends, market uncertainty and price volatility is likely to be higher during the six months between reporting periods. More regular company reporting generally reduces market uncertainty. Moreover, the arguments that quarterly reporting results in an undue focus on short-term performance and there is a feared overload of investor information, combined with the argument that quarterly reporting is not needed in addition to a continuous disclosure regime, is difficult to comprehend. If a company has continuously disclosed all material information including a change in its earnings expectations prior to the release of a quarterly report, and the subsequent quarterly result reflects the earlier disclosure, the market focus on the performance of the company and the extent of information provided is not likely to be significantly different. Even if company managers think that markets overreact to released results, market responses to “known facts” are inherently more informed than reactions to uncertain or unknown positions.

The most significant problems arising under the existing framework are failures by listed companies to provide timely updates through the ASX on changes in earnings expectations, and the lack of content and clarity of many of the announcements provided between reporting periods. The empirical evidence outlined in Chapters Two to Five suggests that some institutional investors with regular access to company management are made aware of the short-term performance trends and this is reflected in the share price. However, other investors are left without complete, accurate and understandable company information to make rational investment decisions on a timely basis.

The listed company disclosure framework currently includes a preliminary final report with minimal notes and MD&A, a half year report with minimal content and management commentary, and a continuous disclosure regime with significant ambiguity around the timing and content of the required disclosures. A lack of substantive content in the preliminary final and half year reports, and uncertainties around the continuous disclosure regime, leave many investors relying on the ASX announcements with long delays between the disclosures provided and significant gaps in the information provided. These delays and gaps leave undue scope for trading on inside and selectively disclosed information to occur.

The content provided within the continuous disclosures is generally far more limited than in a periodic report with a full set of accounts. For example, the 2008-year provided a unique opportunity to examine disclosure issues under stress. Within this environment, a company's cash, debt and capital positions, and the ongoing ability to service or refinance the debt, were important market focuses. However, the thesis study found that few of the listed company continuous disclosures during 2008 provided all of this information. Proper analysis of these factors generally required comprehensive financial accounts including notes to the accounts and management discussion and analysis.

Investors can only make rational judgments on investment decisions on a timely basis if they have ready access to regular and comprehensive company information, in formats that are understandable and which allow comparability across the investment spectrum. As a spokesman of the Association for Investment Management and Research indicated, the 'voice of the investor has for too long been marginalized in the debates on financial reporting ... [Investors] need … *regular*, *comprehensive* reporting of financial

[1564] CASAC, above n 43, 6.

information … They need it in *accepted formats* … *based on generally accepted accounting standards* …'[1565]

The existing practice whereby some listed Australian companies provide quarterly reports, others provide cashflow statements, and some provide no substantive updates at all between the half year and annual reports, is not optimal. A comprehensive quarterly reporting regime is required to provide investors relying on ASX announcements with regular, comprehensive and standardised information necessary to build a solid framework from which to value securities and understand company developments between reporting periods.

The operation of a continuous disclosure regime in Australia should not preclude consideration of enhancements to the periodic disclosure regime, such as the introduction of quarterly reporting. Most listed companies in the US are subject to listing rule continuous disclosure obligations and the UK has broadly similar continuous disclosure requirements to those in Australia. Yet these countries have continued to strengthen their periodic disclosure obligations. Quarterly regimes have become the norm in international markets. Listed companies in North America have provided quarterly reports (Form 10-Q) since the 1970s. Europe has also introduced a quarterly regime that requires interim management statements when comprehensive quarterly reports are not provided.

3 *Management Discussion & Analysis Reporting*

Recommendation 4: Extend the statutory regulation governing management discussion and analysis reporting.
Recommendation 5: Introduce mandatory risk disclosures in all of the periodic company reports.

I propose

- ***that the MD&A requirements that currently apply to annual reports are extended to the preliminary final, half year and proposed quarterly reports;***

[1565] Chartered Financial Analysts, above n 100. I added the italics for emphasis.

- ***with the required MD&A referencing numbers in a statutory format;***
- ***the introduction of mandatory risk disclosures in all of the periodic reports; and***
- ***supervision and enforcement of the MD&A and risk disclosure rules to rest with ASIC.***

As explained in Chapter Two, company managers are best positioned to provide stakeholders with the most valuable discussion and analysis on company developments. MD&A is required for

> a narrative explanation of companies' financial statements; … to provide the context within which financial statements should be analyzed; and to provide information about the quality … and potential variability of a company's earnings and cashflow.[1566]

Investors can only invest rationally if the information required to estimate the sustainable earnings of companies is available on a timely basis. High quality MD&A reporting is necessary for security valuation.

Risk disclosures are also necessary to make informed assessments on companies' financial positions, operations, business strategies and prospects. Companies need to clearly explain their foreseeable opportunities *and* risks, and the controls to manage or mitigate these risks. Management discussion on potential risks is especially important during periods reflecting significant economic, industry, business or earnings change. All investors and stakeholders must be updated on a transparent and timely basis, particularly when company management become aware of problems.

While MD&A was not the primary focus of the thesis empirical research, the study encompassed a review of all disclosures made by the sample companies through the ASX. This review found that some reports and announcements provided very little management discussion or analysis, particularly those from smaller companies. I specifically looked for any risk commentary within the periodic reports and continuous disclosures but such occurrences were rare. I also noted how negative news or events were portrayed to the broader market. Some companies were straightforward in explaining economic, industry or company specific difficulties. However, most of the

[1566] SEC, above n 144.

management discussion and analysis solely or predominantly drew attention to positive aspects of results or developments. Much of this positive framing is accepted under the current regulatory framework. However, optimistically biased disclosures can have significant consequences on investors and stakeholders, particularly during periods of uncertainty or when a company is in serious financial difficulty.

As outlined in Chapter Two, the rest of the world has increasingly recognised MD&A as an integral part of corporate reporting.[1567] In the UK, the annual, preliminary final, half-yearly and quarterly reports must include an outline of the important events and their impact on the financial results, with a description of the principal risks and uncertainties. In the US, Item 303 of Regulation S-K requires listed companies to include extensive MD&A in their quarterly and annual reports.

MD&A as well as risk outlines and analysis can be rapidly and cheaply disseminated in the public arena within the statutory reports or through webcasts, audio casts and teleconference calls. I propose that the s 299A MD&A requirements that currently apply to annual reports are extended to preliminary final and half yearly reporting, and to the proposed quarterly reports. The inclusion of more comprehensive notes and MD&A in half year and preliminary final reports is needed to enable all investors to make more informed assessments about company prospects and to value company securities. The required MD&A should be extended to include an outline of material business risks and uncertainties.

4 *Online Company Reporting*

Recommendation 6: Introduce ASX listing rules relating to online periodic reports.

I propose that

- ***All periodic company reports are uploaded onto the ASX and company websites using single pages and black and white lettering;***
- ***All periodic reports to include an electronic table of contents to allow easy user manipulation;***

- ***All periodic reports to include a mandated upfront summary performance table; and***
- ***All periodic reports to be downloadable and printable without pictures.***

The Australian company reporting framework requires most investors to download and process financial information and related management discussion and analysis from online half year, preliminary final and annual reports. The Australian company result periods are concentrated, with most companies reporting within three to four weeks after the relevant period end. Most investors monitor a range of companies, and the trading halts following the release of half year or full year results during market hours are only 10 minutes. This makes easy online access to company reports and management commentary critical for investors to have timely and equal access to company information.

The thesis empirical study presented in Chapter Five found that listed Australian companies have not significantly adjusted their reporting for the online environment. Most of the online annual reports contain a lot of pictures, some are presented as double pages, and some are close to unreadable because of the colours used. The reports are generally uploaded as one very long document, and the individualised and bulky layouts make them difficult to manipulate online. Within the reports, clear, concise and effective management commentary or explanation is often lacking. As Gibson, an ASIC Commissioner suggests, the management discussion and analysis in the annual reports is 'sometimes so formulaic that it communicates very little to the reader'.[1568] At the other end of the spectrum, the content in the half year and preliminary final reports, particularly from the smaller listed companies, is often minimal.

Companies need to think about how to more effectively communicate with their stakeholders. The annual report needs to be less of a public relations document and include more useful information. An important feature of periodic reports should be an upfront summary performance table over a period of ten years or the period that the

[1567] See Chapter Two.
[1568] Belinda Gibson, ASIC Commissioner, 'Facilitating Capital Raising for Corporate Australia' (Speech delivered at the Corporate Finance World Australia 2009 Conference, 10 November 2009) 8.

company has been listed. The mandated content should include all of the key statutory performance indicators including dividends paid, net profit, EPS and diluted EPS.

Finally, listed companies and their stakeholders should share the benefits of the digital era. While Australian listed companies have rapidly embraced online dissemination that provides cost savings, some have been slow to adopt technological changes that broaden access and enhance the quality of information provided to investors and stakeholders.

A general comparison between the company reports in Australia and the equivalent reports in the US is illuminating. The US quarterly and full year reports can be easily accessed and downloaded from the SEC maintained EDGAR website or hard copies can be ordered. While many parties may argue that the 10K and 10Q reports are too prescriptive, their standardised formats have significant advantages. These reports do not contain pictures, an electronic table of contents is provided, specific information is generally easy to find, the period-end number of shares on issue is on the front page, and the reports are formatted in self-contained pages making them easily readable on-line. The prescribed format requires companies to address the mandated sections, including commentary on the recurring and non-recurring elements of the result. This approach makes it difficult for management to comment only on positive aspects of the performance. The standardised formatting also allows investors to more readily compare performance trends and investment options for individual companies and across the market. Some US companies are supplementing their financial reports with spreadsheets and additional information.

C Company Briefings Regulation and Practice

Recommendation 7: Extend the continuous disclosure listing rules to require open access to general company briefings.

I propose

- ***that the continuous disclosure listing rules are extended to require open access to general analyst company briefings;***
- ***with reasonable notice of the access details provided through the ASX company announcement platform; and***
- ***with all private briefings recorded.***

As discussed in Chapter Two, briefings are an important means by which listed Australian companies provide information to the market. Some investors and analysts have regular access to company management through general and private briefings. However, Australian companies are not required to provide open access to the general analyst briefings or to provide the market with transcripts of the question and answer sessions. In addition, no public disclosures are required on the content discussed at private briefings. Although companies are required under the ASX listing rules to provide a PowerPoint summary of the management presentations, there is no evidence of this rule being monitored or enforced.

Most of the listed company briefings in Australia continue to be on an invitation basis only and companies remain free to blacklist or exclude analysts and investors when they ask penetrating or critical questions, or for any other reason. The recommendation by the HIH Royal Commission that the prohibition on blacklisting be upgraded from Guidance Note 8 to a full listing rule has not been implemented. There are currently no legal remedies available to persons that are blacklisted or excluded from access to company management or the information provided at briefings.

The CASAC Discussion Paper in 2001 suggested that private briefings should be the subject of future debate because while they ‘may not involve disclosure of inside information [they] still raise questions of fairness and equal access to corporate information.'[1569]

The title of the 2009 CAMAC review – "Aspects of Market Integrity" - suggests the primary focus was aspects of market integrity. However, the Ministerial reference on corporate briefings didn't address any market fairness or equal access issues. Instead, CAMAC was asked to examine the role that analyst briefings play in Australia's financial markets including whether the role is a positive one that leads to greater market efficiency.

The CAMAC report findings and submissions were summarised in Chapter Two. Most of the submissions argued for continued closed or private briefings on efficiency grounds.[1570] However, none of them explained what they meant by efficiency or net efficiency, discussed the potential negative effects of closed or private briefings such as selective disclosure and reduced public transparency and accountability, or highlighted the benefits of equal access and transparent company disclosure in the public arena. The only discussion on market fairness or equal access issues in the submissions and report were the broad-brush arguments that material price-sensitive information must be released through the ASX under continuous disclosure regulation, and that liability under insider trading regulation may arise when trading is based on information that is materially price-sensitive and not generally available. Some of the submissions argued that briefings add to the formal information provided to the market. However, the real issue is whether the market would be more informed by open access to the briefings.

[1569] CASAC, above n 61, 2.

[1570] As a reminder, the Law Council of Australia Committee submission suggested that 'more information reaches the market as a result of analyst briefings than the market would otherwise get in the absence of those briefings'. The Australian Financial Markets Association submission argued that if an analyst 'chooses to focus on certain aspects of public information … or seek clarification on discrete points…[and this information] were made freely available to the public it would discourage the production and publication of any research'. The Securities & Derivatives Industry Association submission asserted that only the largest of institutional investors have the resources to assess the true value of a company and its securities. The Business Council of Australia submission claimed that webcasting is too costly and burdensome. In contrast, the Australian Investor Relations Association submission suggested that 'a majority of listed companies do use widely accessible webcasts and conference calls'. They argued that private briefings 'ensure the accuracy of the data and assumptions underlying analyst valuations [and this is] essential if the market is not to be misled'.

As outlined in Chapter Two, Gibson, an ASIC Commissioner, conceded in 2009 that 'perhaps the most informative material provided by companies to investors is provided at the investor analyst briefings that usually occur when the annual and half yearly results are announced'.[1571] She further noted that the 'analysts briefings to investors released with the annual results are often more informative' than the annual reports,[1572] and the briefing material is 'usually approved by the board … [It] is usually prospective and looks over the company's business model and analyses the various segments'.[1573]

The ASIC submission to the CAMAC review acknowledged that there may be real and perceived fairness issues 'in relation to private briefings with well-connected analysts potentially having access to more detailed and higher quality discussion with management.'[1574] Nevertheless, the submission concluded that:

- the briefings provide a *net efficiency benefit*,[1575] 'provided the law is complied with';[1576]
- access to these briefings should remain discretionary because '[c]ompanies are best placed to determine what is the most effective and efficient disclosure mechanism in their particular circumstances';[1577] and
- 'it is not practicable or appropriate to require all private briefings to be recorded.'[1578]

It is difficult to reconcile the ASIC commentary and stated aspirations for fairness, equal access, investor confidence and clear, complete and accurate company disclosure, with regulatory policies that allow dissemination of 'perhaps the most informative company material provided to investors' on a discretionary basis behind closed doors. Sadly, the parliamentary review failed to move the focus in Australia from private

[1571] Gibson, above n 327, 8-9.
[1572] Gibson, above n 327, 11.
[1573] Gibson above n 327, 8-9.
[1574] ASIC, above n 326, 20.
[1575] I added the italics for emphasis. No definition of net efficiency is given in the ASIC submission and no evidence or argument provided to support the conclusion that closed briefings enhance net efficiency.
[1576] ASIC, above n 326, 20.
[1577] ASIC, above n 326, 21.
[1578] ASIC, above n 326, 22. No argument is provided to support the conclusion that recordings are impracticable or inappropriate.

company disclosure to favoured investors towards public or “systemic”[1579] transparency. Overtime, this lack of transparency is likely to detract from potential economic efficiency.[1580]

Most Australian parties argue or imply that closed or private briefings merely clarify information already in the public domain. However, a significant proportion of the information required for securities valuation in Australia is provided at company briefings, particularly during result periods. The result briefings typically provide significant management, discussion and analysis on the financial and non-financial aspects of the released results and company outlook. Company management, the AIRA, and evidence from open access briefings confirm that briefings provide discussion on strategy, industry trends, competitive issues, growth opportunities, future targets, and interpretation of the announced financial results. Such information is material for all rational investors, so the notion that all of the information provided at general and private briefings is immaterial and not price sensitive is simply not credible. As Holland suggested, the continuation of private or closed briefings allows companies to manage private meetings around the publicly announced result announcements and slides to be able to claim that they are saying the same thing in private and public. However, in practice, ‘the information content of [the published material] is very much less than that of the private exchange.’[1581] Investors in Australia without access to company briefings are often left with poor quality information.

The thesis empirical study confirmed that much of the “meaty” company information required for securities valuation was provided in the briefing slides. When the full briefing content was not accessible in the public arena, the company information set available to excluded investors was significantly more limited than the rich information set provided to those with access to general analyst and private analyst briefings.

[1579] See Commonwealth, *Super System Review Final Report* (June 2010)”Cooper Review” 14. The Cooper Report defines “systemic transparency” as disclosure to the system at large, including regulators, academics, analysts, advisers and informed investors. Restricting disclosure to “informed investors” could be defined as circular. Moroever, the word system may impose institutional limits. I prefer the term “public transparency” because after nearly thirty years of capital market and corporate experience, I’m convinced that unrestricted sunlight is critical for fair and efficient capital markets.

[1580] A change to the corporate governance guidance is unlikely to result in significant change to the number of companies who provide open access. As outlined in Chapter Two, the ASX has been “encouraging” companies to use technology to improve access to information for many years.

Without the additional briefing information, many investors did not have sufficient information to make rational well-informed investment decisions. To the extent that value relevant information was provided at closed or private briefings, equality of access in Australia was diminished and there was information asymmetry across the market.

The scholarly studies on access to conference briefings in the US, which were summarised in Chapter Three, suggest that open access policies enhance equality of access and market efficiency through reductions in information asymmetry and more rapid price response to earnings announcements. None of the studies found evidence consistent with a "chilling" in the amount of information provided by companies during conference calls post Reg FD. Indeed, those that examined the impact of open access suggested or implied an improvement in the quality of information provided to the wider market because of the richness of the information provided during the conference calls.

Australian policy material consistently espouses the importance of transparency, equal access and investor confidence in the integrity of the market. Independent scholarly research and market observation suggest that open access policies improve equality of access and economic efficiency. Global empirical research also points to economic benefits for countries that promote enhanced corporate disclosure and protect the rights of minority interests. Accordingly, policy makers must explain how investors without access to the information provided at company briefings are able to rationally value listed Australian securities, why company briefing information needs to be disclosed on a private rather a public basis, and how policies that allow private or closed company briefings benefit the public interests and economic efficiency of Australia rather than simply the interests and profits of the invited investors.

I propose the introduction of mandatory open access to general company briefings, reasonable notice of the access details through the ASX, and mandatory recording of all private briefings. An open access policy would effectively counter the practice of blacklisting of investors by providing all parties with public access to the information

[1581] Holland, above n 242, 49.

provided at general briefings. The requirement to record any private briefings would mitigate the risks of selective disclosure and assist the supervisory and enforcement processes.

D Proposed Reforms: Cost / Benefit Analysis

The expected benefits from the proposed reform measures should not be underestimated. More comprehensive periodic reporting and the introduction of mandatory open access to company briefings would provide more equitable access to company information and reduce the scope for trading on inside or selectively disclosed company information. The improved market transparency would enable more informed decision-making, strengthen corporate, institutional and gatekeeper accountability, and enhance likely long-term economic efficiency.

The expected costs to implement the proposals are minimal, and may in practice be cost neutral or provide a net saving. Listed companies are already making significant cost savings though the provision of periodic reports online, and the trend of providing information electronically is likely to continue. The online unaudited comprehensive quarterly report may involve additional preparatory costs for some companies such as aggregation costs and professional adviser fees. However, these costs are likely to be significantly less than the cost savings arising from the move from hard copy to online dissemination of the periodic reports. The provision of online unaudited quarterly statements as required under European regulation would involve even less cost. The provision of more comprehensive notes to accounts and MD&A in the periodic reports is not expected to be costly either. Most, if not all, listed Australian companies, including smaller capitalised companies, already disclose this information at briefings. The costs to publicly disseminate information are low even for the smallest listed companies. Indeed, it is significantly less costly for companies to disseminate comprehensive information to the broader market using webcasts and teleconferencing than to conduct a series of one-on-one or small group meetings. Individual or small group meetings are expensive because they require significant amounts of company management time.

CHAPTER SEVEN: CONCLUSION

'Great companies exist only because they are created and safeguarded by our institutions; and it is our right and our duty to see that they work in harmony with these institutions. The first requisite is knowledge, full and complete; knowledge which may be made public to the world.''[1582]

The thesis has investigated the extent and quality of information provided by listed companies through the ASX, and the likelihood of additional private or selective disclosure. Many Australians choose for varying reasons to invest in ASX listed securities directly. These parties and other company stakeholders require public access to listed company information and not just information that has been filtered through third party intermediaries. Companies elect to list on the ASX in order to be able to raise significant levels of capital from the public. A listing encompasses an obligation to keep the market fully informed of all material information on a timely basis unless the information is commercially confidential or proprietary.

The information provided by listed companies through the ASX and at company briefings should be clear, concise and effective and presented in a form that enables comparative analysis. Without such information, investors and other users of company information cannot make well-informed decisions. Moreover, to the extent that the publicly available information falls short of these standards, the likelihood of trading on inside or selectively disclosed information increases.

My empirical study found the level, content and quality of information provided in the periodic reports and continuous disclosures during the 2007 and 2008 financial years were highly variable. Some listed companies provided a large amount of rich information, while others disclosed only minimal information. The information released on a timely basis through the ASX by some companies was limited to an interim report with minimal notes and management commentary, a preliminary financial report with minimal notes and management discussion and analysis, and a small number of additional announcements.[1583] Many company managers failed to provide updates

[1582] Theodore Roosevelt, State of the Union Message To Congress (3 December 1901).
[1583] I encourage policy makers and regulators to randomly select listed companies from different industry and size categories and review all of their disclosures for a couple of years. It is difficult to convey in words how limited the public information is from some companies.

between reporting periods of material changes in their expected earnings, as required under Guidance Note 8 to Listing Rule 3.1. Further, many of the earnings updates or forecasts that were provided were incomplete, disjointed or ambiguous. The most valuable management discussion and analysis released through the ASX for security valuation purposes was generally found within the analyst briefing slide presentations. However, many investors did not have access to the management commentary and question and answer sessions of these briefings, and were left with incomplete or poor quality information. It is likely that many investors relying on company information disclosed through the ASX struggled to make rational investment decisions across a substantial proportion of the equity market.

Carefully crafted and effectively enforced company disclosure law can promote and enhance the transparency and timeliness of company information provided in the public arena. To the extent that mandatory disclosure achieves these aims, the regulation is well justified. However, when company managers continue to act as though they have broad discretion over the content, means, timing and recipients of their disclosures, the rationales for a mandatory company disclosure framework are significantly undermined.

The empirical study findings suggest that many listed Australian companies provide only the minimum information required within the public announcements, with additional rich information disclosed on a private or selective basis to some investors. Favoured institutional investors have access to, and notice of, the general analyst briefings. In addition, they have continuous access throughout the year to management discussion and analysis through private briefings with company executives, both in person and by telephone. Most, if not all, listed Australian companies provide some investors with extensive explanation, discussion and analysis on their financial results and qualitative matters. Management feedback and commentary on forecast assumptions is also provided to some investors on a private basis.

The way in which insider trading and disclosure policy in capital markets is enacted, enforced and interpreted can have profound consequences on market participants and the broader community. In financial markets, company information is valuable, whether obtained legally, illegally, because of a favoured relationship, or through skill and diligence. Consequently, the real debate concerns how much of the information currently disclosed by companies privately or selectively should be publicly disclosed or accessible through the mandatory reporting processes.

My empirical study findings are consistent with other studies and commentary on listed company disclosure practices in Australia. Published ASIC stakeholder responses and market practitioner views paint a negative picture on the disclosure culture and enforcement regimes. These negative stances are supported by research from other scholars and independent studies by ASIC. Most of the scholarly research on the continuous disclosure regime suggests or infers significant noncompliance with the continuous disclosure obligations, and a concomitant likelihood of selective disclosure. At the end of 2009, Gibson, an ASIC Commissioner, stated in unequivocal terms that listed company processes around confidential information are suboptimal and below international standards. Gibson also indicated that institutional practices to obtain company information on a selective basis are "pushy". This body of evidence suggests that a significant proportion of Australian company information is provided on a private, selective or hierarchical basis.

Commentary from Australian listed companies, market practitioners, businesses and consumers, reveals a large gap in expectations between listed companies and their stakeholders on disclosure practices and enforcement. Most investors likely assume they have a right to be provided with equal access to company information and that any trading on inside or selectively disclosed information will be investigated and enforced. However, the listed company disclosure framework is weakened by significant regulatory gaps and uncertainties and conservative enforcement. No legislative amendments have been made to the insider trading provisions following the CAMAC or PCP reviews, the periodic and continuous disclosure regimes have not been comprehensively reviewed for several years, and the company disclosure and insider trading regimes operate on a piecemeal rather than an integrated basis.

The status and enforceability of the periodic and continuous disclosure listing rules appear to be in limbo. In addition, the potential breadth of the "generally available" carve-outs and the narrowness of the materiality test applied in insider trading case law make it difficult to determine the nature and scope of the prohibited activity and required disclosure under the statutory insider trading and continuous disclosure regimes. The combined uncertainties around the insider trading and continuous disclosure regimes mean the extent to which selective disclosure in Australia is prohibited and enforceable is largely indeterminate. This indeterminacy is most acute in relation to professional systemic trading on inside or selectively disclosed information.

A lack of definitional clarity around the efficiency rationale or goal is creating many of the ambiguities in the listed company disclosure framework. To ensure a coherent listed company disclosure framework that serves Australi's long term public interests, the appropriate efficiency rationale is long-term economic efficiency. A high level efficiency goal and a long time horizon are needed to enable the policy and judicial decisions to be assessed holistically incorporating competing efficiency measures, agency and incentive issues, and short and long term costs and benefits. A long term economic efficiency rationale complements the markets fairness rationale, as scholarly empirical research on global markets consistently links economic growth with public trust, high company disclosure standards, the quality of law enforcement, protection of minority shareholder rights and broad capital market participation. The combined thesis evidence suggests that sustainable economic growth created through efficient capital markets depends on the promotion of investor confidence and a perception by the public that markets operate on a fair basis. In other words, equal access and transparent corporate disclosure in the public arena are necessary preconditions to economically efficient markets over the long term.

A recently commissioned report on the superannuation system in Australia suggests that financial markets benefit greatly from systemic transparency, defined as disclosure to the system at large.[1584] I agree with this view, but I define the transparency goal more broadly as "public transparency".[1585] The report on the superannuation system concluded that systemic transparency is largely missing. Similarly, I find public transparency in the listed equity market is deficient. There is simply too little high quality company information available in the public arena. The global financial crisis reminds us in

[1584] Commonwealth, above n 1579, 14. The Report states [at page 14] that systemic transparency is largely missing in the Australian superannuation system.

spectacular fashion that the health of modern markets, real economies and people's lives are closely interconnected. When the full spectrum of market disciplines and corporate accountability processes are not able to fully operate due to a lack of public transparency, the economic and human consequences can be devastating.[1586] In Australia, equal access policies and practices are especially critical because people's life savings are invested in compulsory superannuation and the market operates with the largest proportion of direct investors in the world.

The listed company disclosure standards and practices in Australia are well below international best practice. To achieve a fairer and more efficient listed company disclosure framework, a significant change is required from policy makers, regulators and listed companies to move the disclosure culture from a private club[1587] to a more open and competitive environment. Mandatory company reporting must be timely, rich and price-informative to be of significant value to a country. All parties should have access to information that companies choose to disclose to some investors, and should be made aware of negative corporate developments as well as positive news on a timely basis. Listed companies can provide this information easily and cheaply in the public arena using the ASX company announcement platform, emails, websites, webcasts, and audio and telephone facilities.

In Chapter Six, I outlined general policy recommendations, issues for policy consideration, and specific reform proposals. To be fully effective, these recommendations and proposals should be implemented within a coherent, comprehensive and coordinated listed company disclosure framework. The framework needs to be founded on a solid theoretical basis, have clearly identifiable goals, and include a bold and effective regulatory and enforcement structure. If adopted, the recommendations and proposals would result in: more equitable access to company

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[1585] As outlined in Chapter Two, I define this to include access to company information for existing investors, potential investors, analysts, employees, regulators, the media, scholars, policy makers, professional bodies and all other corporate stakeholders and interested parties.

[1586] The regulatory priority should be to improve the effectiveness of the disclosure regimes.

[1587] See Dignam et al, above n 1108, 642. Dignam and Galanis concluded that the Australian listed market was characterised by: significant blockholders engaged in private rent extraction; institutional investor powerlessness; a strong relationship between management and blockholders, which resulted in a weak market for corporate control; and a historical weakness in public and private securities regulation, which allowed the creation and perpetration of crucial blocks to information flow.

information; reduced scope for trading on inside or selectively disclosed company information; improved public transparency; more informed investor and stakeholder decision-making; greater market and corporate accountability; enhanced investor confidence in the integrity of the market; and ultimately higher economic efficiency.

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