ASIC

Australian Securities & Investments Commission

Current areas of concern to ASIC regarding corporate disclosure

An address by Jillian Segal, Deputy Chair, Australian Securities and Investments Commission, to the Australasian Investor Relations Association, Corporate Disclosure Practices Seminar, Sydney, 20 March 2002.

Introduction

Thank you for inviting me to join you today. I believe it was only seven months ago that our Chairman, David Knott, had the pleasure of launching the Australasian Investor Relations Association (AIRA), and of course, AIRA is now an important stakeholder, which is represented on our Corporate Governance Roundtable Group.

These are certainly interesting times to be discussing disclosure. Regulators all over the world are in the process of addressing whether their disclosure rules are rigorous enough in light of the problems/implications thrown up by recent corporate collapses – such as HIH and One.Tel in Australia, and Enron in the US – and the risks associated with inadequate disclosure. Clearly, we all have a stake in ensuring that the integrity of financial markets is maintained through proper disclosure. Although accounts are a key element of disclosure, in these brief comments I am just going to have time to raise a few matters in relation to prospectus and continuous disclosure, so I will not be able to cover issues associated with accounts, auditors and corporate governance generally.

As we have discussed already today, the Securities and Exchange Commission (SEC), for example, recently (March 4 & 6) convened roundtable discussions to examine proposals for better protecting investors by reforming financial disclosure and auditor oversight. Some of the key issues identified in relation to financial disclosure included:

- what information investors need to make informed investment decisions?;
- how financial disclosure could be made more intelligible?;
- what information is currently being inadequately conveyed?; and
- what type of information needs to be communicated more quickly, and how this could be accomplished?

Further, President Bush, in his Ten Point Plan, has raised access to "plain English" and prompt access to critical information as two of his key points. It will, of course, be significant for all of us to monitor developments in the United States. To the extent the disclosure regime is made more rigorous in the United States, regulators and legislatures elsewhere will need to give it careful consideration.

Corporate financial disclosure

When looking at the situation in Australia, we need to consider the context for our disclosure laws. Over the last few years, the trend in Australia has been progressively to relax the requirements for regulatory approval and pre-vetting of prospectus and other disclosure documents by the regulator. Detailed prescription of the contents of fundraising documents has also been removed. This trend reflects the view that responsibility for the contents of a prospectus should lie with those who are best placed to understand the proposal that is being offered, namely the directors and promoters. It also reflects the view that disclosure is the most effective regulatory tool and that prescriptive constraints can be relaxed, provided disclosure is maintained.

The Corporate Law Economic Law Reform Program Act 1999 (Cth) (CLERP) which commenced on 13 March 2000, removed the remaining requirement for ASIC to register prospectuses (which at that stage applied only to initial public offerings, managed investment schemes and debentures), and replaced it with a requirement that all prospectuses be lodged with ASIC (sections 718 & 727 of the present Corporations Act).

I think it is most important to reiterate ASIC's role in relation to fundraising documents. We know that many retail investors, and even some professional and media commentators, do not have a clear idea of the regulator's responsibilities in this area. At times, there have also been examples of promoters implying that a prospectus *lodged* with ASIC means an investment scheme is endorsed or even *guaranteed* in some way by ASIC. Let me make it clear that this is not the case. It is *not* ASIC's role to evaluate the "merits" of a particular company's business plan or investment scheme. ASIC's role is to ensure that directors and promoters provide investors with information in fundraising documents so that they can make an informed decision about the merits of a particular offer. Therefore, the fact that a prospectus is lodged with ASIC does not mean that ASIC "approves" or "endorses" the nature of the proposal/scheme in any shape or form. In some cases, ASIC will look at disclosure documents in the seven day period between lodgement and the end of the exposure period. In other cases, we will only do so in response to concerns drawn to our attention.

Clearly, it is important for disclosure documents to be "lodged" with ASIC so that if there are concerns or complaints, the regulator has immediate access to the document. However, it is important that this responsive capacity is understood. We are therefore considering whether we can improve investor understanding through the inclusion of "warnings" in prospectuses, which would be designed to improve consumer understanding of the risks of investments and the limited role of the regulator. From a policy perspective, we will also be considering what sorts of reforms may be desirable so that such warnings are included in investment offer documents.

As I am sure you all appreciate, at ASIC, we are committed to protecting investors and improving the quality of fundraising disclosure. It is vital that fundraising documents contain all the information an investor requires in order to make an informed investment decision. To that end, we have placed, and will continue to place, interim and final stop orders on prospectuses that fail to disclose adequate information to potential investors. To date, in 2002 we have issued stop orders over 19 companies (in the last calendar year, we issued stop orders over more than 77 companies). For example, ASIC recently placed an interim stop order over a prospectus, following concerns about material omissions in relation to the application of the company's working capital. The stop order was lifted after the company issued a supplementary prospectus, which satisfied ASIC's concerns about the omissions. We also recently placed an interim stop order over an Offer Information Statement (OIS) due to concerns that aspects of the OIS were misleading. ASIC was concerned that the OIS contained statements that may have attempted to limit the liability of the issuers contrary to the provisions of the Corporations Act.

I should also mention that under the new financial product disclosure regime in Part 7.9 of the Corporations Act (as amended by the FSR Act), ASIC now has the power to issue stop orders where we detect, or are made aware of, valid prima facie disclosure concerns about a Product Disclosure Statement (PDS). This provision is modelled on, with some modification, the stop order powers in the fundraising provisions of the Corporations Act. To assist product issuers in complying with the PDS requirements, we have issued *Policy Statement 168 Disclosure: Product Disclosure Statements (and other disclosure obligations)* (PS 168), which contains "Good Disclosure Principles" when preparing a PDS. We will conduct selective compliance reviews of PDSs to determine whether they comply with the PDS requirements.

Following release of PS 168, ASIC also recently announced the first stage of a new project to foster better disclosure of fees and charges in PDSs for investment products. The first stage in the project will be the preparation of an options paper on how ASIC, industry and consumer groups can work together to produce effective disclosure of fees and charges for investment-linked managed investments, superannuation and life insurance products. The options paper will be prepared in consultation with industry and consumer bodies, and with the assistance of Professor Ian Ramsay.

Secondary sales

Before I move on to forward-looking financial information, I would like to briefly mention that on 7 March this year we released a new Class Order giving interim relief from the secondary sales provisions of the Corporations Act [ss707(3) and (4) – as amended by the FSR Act]. The secondary sales provisions are based on the concept of current disclosure being available to those retail investors buying in the secondary market. The new Class Order (CO 02/0272), which was varied last Friday (15 March), gives interim relief from the secondary sales provisions of the Corporations Act. The variation makes a number of technical changes to the Class Order made on 7 March, and follows further consultation with industry practitioners. Class Order 02/272, as varied, will be the basis of relief until 11 September 2002. ASIC will continue to consult on a range of issues raised by the amendments to s707 of the Corporations Act. If you would like further information, the Class Order can be obtained from our website.

Forward-looking financial information

The inclusion of financial forecasts that lack reasonable grounds is one of the most common reasons ASIC will put a stop order on a prospectus or other disclosure document. Indeed, only yesterday we placed an interim stop order on a prospectus, offering investors the opportunity to participate in the cultivation and selling of Sydney Rock Oysters. The interim stop order arises from ASIC's concerns that the financial forecasts provided in the prospectus were not based on reasonable grounds and that the project manager of the scheme is a deregistered company. We have also recently placed a final stop order, with consent, on the prospectus issued by Australian Cattle Fund Limited due to concerns, amongst other things, that the director's financial forecasts lacked several appropriate assumptions, and contained assumptions that ASIC considered hypothetical and not best estimate.

In light of growing concerns that disclosure practices in fundraising documents were not what they should be, in February last year ASIC provided interim guidance to both preparers and reviewers of disclosure documents about the provision of forward-looking financial information in such documents, particularly for start up enterprises. It appeared to us that too many prospectuses contained forward-looking financial information based on hypothetical assumptions contrary to our existing policy in this area.

This interim position has been further developed – we have recently issued, for public consultation, a draft policy statement (*PS 170 Prospective financial information*) on the use of prospective financial information, including financial forecasts, in prospectuses, disclosure documents and product disclosure statements. The draft policy makes it clear that prospective financial information must be based on *reasonable* grounds not on hypothetical assumptions. We believe what are "reasonable grounds" should be determined objectively in light of all of the circumstances of the statement. The draft policy contains a non-exhaustive list of factors that may indicate reasonable grounds for prospective financial information, although there may be other methods of establishing reasonable grounds.

As well as prospective financial information based on reasonable grounds, our draft policy provides that investors should also be given enough information to enable them to assess whether the prospective financial information is relevant and reliable (i.e. to form their own view about how reasonable the grounds are for making the statement). We are currently considering submissions on the draft and expect to release the final policy statement in the near future. Once finalised, the policy statement will replace *Practice Note 67 Financial forecasts in prospectuses*.

Continuous Disclosure

As with prospectus disclosure, we are also committed to our ongoing campaign, together with the ASX, to ensure that companies comply with their continuous disclosure obligations under the Corporations Act and the ASX Listing Rules. As most of you would know, in the early 90s, corporate Australia engaged in a vigorous debate about whether corporate reporting should be quarterly or continuous, introduced continuous disclosure rules and substantially improved our insider trading laws. These were all done in an effort to create a market in which investors could trade on equal terms and with confidence in its integrity.

My view is that we are still fighting the war on "disclosure". I believe the problem is that prompt disclosure is not an integral part of our corporate culture. Many companies regard their disclosure obligations as an impediment to their business. So, they seek to avoid disclosure unless they receive legal advice that it is absolutely required. Some examples of reasons for non-compliance we have come across include:

- Delaying releasing the bad news until they had some good news to "balance" it with;
- Delaying reporting a failure to meet a vital product development approval because they continued to accept management assurances that the technical difficulties were just about to be solved. This continued for nearly 12 months;
- Delaying disclosure, because having had concerns with the CEO making statements in the past, they required board sign off on the ASX announcements, but did not establish a process for dealing with them between quarterly meetings of the board; and
- Delaying disclosure because it fuels media rumours – while we are sympathetic to claims that disclosure may lead to media rumours, we do not condone non-disclosure based on this reason.

The efficacy of Australia's continuous disclosure rules depends in large part upon the willingness of our corporate community to observe their spirit and purpose. Failure to do so undermines public confidence in the disclosure regime and will increase pressure for more prescriptive disclosure obligations.

To improve disclosure, we need to recognise that unless investors have confidence that the market is informed and that there is equal access to price sensitive information, we cannot hope to attract and retain investor support for our markets. Asymmetric information can clearly have a damaging impact on retail investor confidence in the integrity of our markets.

Consequently, we need to address the underlying attitudes towards disclosure, and above all, we need a commitment from all market participants towards changing those attitudes and developing a "culture" of voluntary disclosure and compliance, supported by effective regulatory sanctions against those who offend. ASIC and ASX need to work together to develop a clear understanding of what is meant by "continuous disclosure" in certain situations, such as in response to market rumour or press speculation.

FSR Act and the power to fine

As you are all aware, "disclosure" is an issue that lies at the heart of the FSR Act. The FSR Act empowers ASIC to seek civil penalties for market misconduct matters including breaches of the continuous disclosure provisions for the first time. This means that contraventions of the continuous disclosure provisions are now subject to both civil penalties and criminal consequences.

While ASIC has long supported the extension of the civil penalty remedy to market offences, we do not believe that these reforms alone will suffice. The very basis underpinning the continuous disclosure regime is the provision of price sensitive information to the market in a timely fashion. Consequently, the ability to institute a quick regulatory response to contraventions of the continuous disclosure provisions is of particular importance, given that these types of contraventions have an immediate impact on the market. While our intervention can speed up and, in some cases, cause proper disclosure, instituting formal proceedings, even of a civil nature, is not necessarily the best means of regulating and improving disclosure conduct. In addition, there are issues connected with the burden of proof and with the Courts' approach to evidentiary and procedural requirements in civil penalty matters that may tend to limit their practical use to ASIC.

Although ASIC has decided to take no further action in relation to a suspected breach of WMC Limited's (WMC) market disclosure obligations in October 2001, it is a good case for illustrating the need to review the sanctions available to the ASX and ASIC in relation to breaches of disclosure. ASIC's investigation into WMC followed an ASX referral relating to price movements in WMC shares and speculation about possible takeover discussions between WMC and Alcoa Inc (Alcoa) in October 2001. In response to a query by the ASX on 12 October 2001, WMC referred to general speculation about possible asset break-ups or takeovers, but stated that it did not need to make any announcement to the ASX. It was only when ASX explicitly required WMC to confirm or deny speculation of takeover discussions on 17 October 2001 that the company confirmed its discussions with Alcoa. There appeared to us to be no good reason why the disclosure made on 17 October should not have been made on 12 October.

ASIC has been advised by senior counsel that although there is a good arguable case that WMC breached ASX continuous disclosure rules in the period prior to 17 October 2001, there is considerable doubt that any effective remedy is available to ASIC under the Corporations Act. Similar to our investigation into AMP (which also resulted in no further action), the WMC case clearly highlights the complexity of the disclosure regime, the difficulty of satisfying the current requirements for disciplinary action, and the need to review the sanctions available to the regulator.

It is for these reasons that we have raised for discussion and debate, the importance of fines for market offences such as late or inadequate disclosure. Such a debate has certainly been conducted in the UK where our regulatory counterpart, the Financial Services Authority (FSA), has been given considerable powers to levy financial penalties under the Financial Services and Markets Act 2000, which commenced in November last year. We believe a power by ASIC to impose fines of substance would add discipline to the market's processes – not just because of their financial impact, but more importantly perhaps through their public nature. Senator Campbell has indicated that he awaits a detailed proposal from ASIC, after which he will consider this proposal carefully.

Conclusion

At the risk of stating the obvious, let me conclude by saying that it will be a challenging year for all of us as we move forward under the FSR Act. Disclosure is certainly an issue that lies at the heart of the new regime, not to mention the integrity of our markets.

To maintain that integrity, disclosure needs to become an integral part of our corporate culture – to do that we need a strong commitment from all market participants towards changing the underlying attitudes towards disclosure, and developing a "culture" of voluntary disclosure and compliance.