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Australian Securities & Investments Commission

Auditing continuous disclosure risk

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CHECK AGAINST DELIVERY

Introduction

I would like to thank the Institute of Internal Auditors for inviting me to speak at the SOPAC 2015 conference. Today I want to speak to you about the way in which ASIC thinks continuous disclosure should ideally work.

Compliance with continuous disclosure provisions goes to the heart of ASIC's priority of promoting fair and efficient markets, and this issue remains a central focus for ASIC.

The integrity and efficiency of our financial markets depends on all investors having access to market-sensitive information about listed entities at the same time. Leakage of information prior to market announcement can lead to continuous disclosure problems, insider trading, and an undermining of investor confidence. It can also pose threats to the outcome of corporate transactions. Recent matters like Newcrest serve to emphasise the significance of continuous disclosure for entities and for ASIC as the regulator.

A key idea that I'd like you all to think about is that good continuous disclosure compliance comes down to preparation and organisation. In particular, the internal audit function within an entity can play a critical role in avoiding the risk of continuous disclosure breaches.

Often when continuous disclosure is discussed in Australia, an image of management caught by surprise and paralysed by a difficult disclosure decision arises. This tends to create the impression that continuous disclosure is something that is done in an hour or so, and that it is done solely by a few key members of management. However, this is not the case.

I'd like to stress that many people within an organisation have a role to play in ensuring that continuous disclosure obligations are met.

When problems arise it is frequently because the right frameworks to comply with continuous disclosure were not in place, rather than the directors simply making an incorrect decision under pressure.

A number of recent continuous disclosure and insider trading cases demonstrate the importance of robust internal controls, and indicate that more proactive, preventative work could have been done in these cases to manage the process risks associated with continuous disclosure obligations.

Today I will focus on the following topics which I hope will be of interest to you, namely:

- an overview of the continuous disclosure obligations generally
- some findings from ASIC's report on the handling of market-sensitive, confidential information
- risk and audit considerations
- how best to minimise potential liabilities, and
- how to strengthen governance and compliance.

Continuous disclosure obligations

So why is this important for a company and its officers?

There are a number of serious and wide-ranging implications of an entity breaching its continuous disclosure obligations. Breaching this obligation is both a criminal offence and a financial services civil penalty provision.

Alternatively, if ASIC has reasonable grounds to suspect such a breach it may, by administrative action, issue an infringement notice imposing a penalty of up to $100,000.

Individuals involved in a listed entity's contravention of its continuous disclosure obligations can also face serious consequences.

In addition to this, there are serious reputational implications for the directors and officers involved, as well as the company itself. As you can imagine, a company's market price could be severely affected by such a breach and it could impact the market's long-term confidence in the company.

Bearing all of this in mind, I think there are two critical questions about continuous disclosure that all listed companies should consider:

- Do we know what, how and when, to disclose to the market?
- Do we have in place adequate systems to make sure we can comply with our obligations, and are all the right people properly apprised of the procedures to follow? These systems must also be monitored and reviewed to ensure that they remain adequate.

Corporations Act and Listing Rule requirements

At this point, I thought it might be useful for me to spend a little time on the continuous disclosure framework.

Listed entities are subject to the continuous disclosure obligations in s674 of the Corporations Act. This section provides statutory force for, and works in tandem with, the continuous disclosure listing rules of the ASX and other market operators.

In the case of ASX, the main continuous disclosure listing rules are found in ASX Listing Rules 3.1 and 3.1A.

Listing Rule 3.1 requires that once a listed entity 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 entity's securities, the entity must immediately tell the ASX that information.

However, the obligation under Listing Rule 3.1 does not apply if the entity is able to rely on certain limited exceptions in Listing Rule 3.1A. Importantly, to be able to fall within the exceptions the company must be able to show, amongst other things, that the relevant information is confidential. In other words, once confidentiality has been lost – for example, by a leak about the proposed transaction – the entity is obliged to disclose the relevant information to the market if that information is market sensitive.

A key piece of guidance on continuous disclosure is ASX's Guidance Note 8. ASIC worked closely with ASX on this guidance and strongly encourages listed companies to refer to it.

What to disclose?

An entity's continuous disclosure obligations are centred around the concept of 'material' or 'market-sensitive' information. So how do you know when something is material?

The Corporations Act says that material information is information that would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of the entity's securities.

Guidance Note 8 provides that when faced with a decision on whether information needs to be disclosed, it may be helpful to ask two questions:

- Would this information influence my decision to buy or sell securities in the entity at their current market price?
- Would I feel exposed to an action for insider trading if I were to buy or sell securities in the entity at their current market price, knowing this information had not been disclosed to the market?

At the end of the day, the determination of what is material is a judgement call for the entity and its officers.

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In determining the materiality of information, it is important to turn your mind to the market's expectations, and to what information investors would consider to be material to their decision to buy, sell or hold.

Think of the factors that are taken into account in pricing the stock – for example, expectations for the future (whether earnings or project-based), market share, etc.

It is important to not just focus on the numbers, but rather the strategic importance of information. This includes, for example, project performance where it relates to a major part of the entity's operations.

Importantly, an entity also needs to apply the same standards to good and bad news in determining whether to disclose to the market.

So, if conducting an internal audit, auditors may wish to review whether the entity has written guidelines for determining what is material information in the context of the entity's business and projects. Guidelines can be a useful tool for employees and officers when determining whether information is material, especially in high-pressure, time-critical situations.

When to disclose

The trigger for an entity's continuous disclosure obligation is the concept of becoming 'aware' of the information; then disclosing it 'immediately'.

When do you become 'aware' of information? This can occur at any time, including at board meetings, when draft accounts are prepared, during a meeting of the audit committee or at CFO meetings.

Under both the Listing Rules and the Corporations Act, an entity becomes aware of information as soon as an officer of the entity has, or ought reasonably to have, come into possession of the information in the course of the performance of their duties as an officer of that entity. This immediately triggers continuous disclosure obligations. I note that an officer is a director, secretary or senior manager of the entity.

This test highlights the risks of having poor systems and compliance arrangements. It is vital that appropriate reporting lines are established, otherwise the entity might be deemed to have been aware of information that should have been disclosed.

This takes us back to what I mentioned earlier about the need to have adequate systems in place – adequate communication systems are required to ensure the dissemination of material information throughout the entity.

Once the entity is aware, the obligation to disclose is 'immediate'. This means 'promptly and without delay', as opposed to instantaneously.

What is 'immediate' will depend on the facts of the situation. For example, where there is a market leak or rumour concerning your entity that has a material effect on the trading price or value of your securities, immediate could mean having a trading halt put in place

at the first available opportunity. Immediate in this context would not mean convening a board meeting and discussing the matter first.

In contrast, in the context of preparing earnings guidance, 'immediately' takes into account the entity's need to ensure the information is sufficiently certain and prepared properly after due diligence is undertaken.

An adequate response time will therefore be determined by the context. In the event there is uncertainty, Guidance Note 8 emphasises the importance of an entity making early contact with the ASX to discuss the options available where a difficult situation has arisen in respect of continuous disclosure obligations.

When reviewing an entity's continuous disclosure systems, auditors may wish to consider whether clear reporting lines have been established by the entity to ensure the right information flows to the right people. Without such reporting lines there may be a delay in disclosing material information, or such information may not be disclosed at all.

Handling of confidential information – Recent findings and recommendations

Before I turn to internal audit implications, I wanted to highlight some work ASIC did looking at continuous disclosure compliance in some specific contexts.

ASIC recently undertook a review of a number of listed entities and their advisers in order to consider the practices employed in our market to handle and protect confidential, market-sensitive information. You will recall that in order for the exemption from continuous disclosure to apply, the relevant information must, among other things, be kept confidential.

Following this review, we released ASIC Report 393 in May 2014 about handling confidential information.

The review focused on how market-sensitive information was handled and protected in two particular scenarios:

- briefings given by listed entities to analysts and institutional investors, and
- the handling of information prior to the announcement of a market-sensitive corporate transaction.

Both of these scenarios require an entity to have adequate and functioning systems in place to ensure that it meets its continuous disclosure obligations.

Analyst briefings

In recent times a spotlight has been shone on analyst briefings and whether some listed entities are disclosing material information to analysts before telling the rest of the market.

Many of you will be aware of the outcome of ASIC’s civil penalty proceedings against Newcrest Mining for briefing analysts on confidential, market-sensitive information ahead of it being disclosed to the market. In a series of select briefings to analysts, Newcrest’s investor relations manager disclosed market-sensitive information regarding Newcrest’s expected gold production and capital expenditure for the 2013–14 financial year.

The information in question had not been announced to the market at that time and had a significant impact on analysts and institutional investors alike.

The lesson from this is that listed entities should have procedures in place which ensure that they do not disclose market-sensitive information in their communications. But, importantly, entities need to monitor and assess whether these policies are actually being followed on a consistent basis. Our past experiences show that it’s not unusual for a company to have good policies and procedures on paper, but compliance turns out to be patchy.

On a broader note, when conducting an audit it is recommended that auditors check whether the entity has done the following:

- Firstly, check whether the entity has made access to analyst and investor briefings as broad as possible and as quickly as possible, including through making webcasts, podcasts and transcripts publicly available.
- Secondly, check whether the entity has considered existing market guidance for listed entities. There are a number of useful best-practice guidelines available, including guidance on investor relations, which deal with these issues. Also look at ASIC’s Regulatory Guide 62 *Better disclosure for investors* (RG 62), which sets out ASIC’s guidance for listed entities about briefing analysts, and refer to ASX Guidance Note 8, which contains a wealth of guidance on the continuous disclosure obligation.
- Finally, think about how the entity deals with issues of perception as well as what the law and listing rules might strictly require. Market perception is a key consideration for listed entities. If the market thinks that an entity is favouring a select audience, serious commercial consequences can follow. Good boards will think about the ‘front page’ test as well as legal obligations.

Unannounced corporate transactions

The second area we looked at was the handling of information prior to the announcement of a market-sensitive corporate transaction.

In preparing ASIC’s report, we interviewed a number of listed entities and their advisers on the management of confidential, market-sensitive information in the context of a recent corporate transaction. We primarily focused on pro-rata rights offers in our sample.

In the transactions that we reviewed, we found that most of the small- to mid-market capitalisation entities relied heavily on advisers to determine how to handle confidential information about their unannounced corporate transactions. We caution that delegation

of this responsibility has risks. This is particularly so when the interests of the listed entity and the adviser do not perfectly align, such as in underwritten capital raising transactions.

With that in mind we make the following recommendations to listed entities, and we suggest that when conducting an audit, an entity's compliance with the recommendations is considered:

- Ensure that comprehensive written polies on unannounced corporate transactions are in place, and that they are understood within the listed entity and are consistently followed. The entity should also be aware of best-practice guidelines and follow them where appropriate.
- Talk to advisers about what procedures they have in place to make sure the entity's information will be protected. Stress the importance of this issue with advisers. Make sure confidentiality agreements or other appropriate arrangements with advisers and other service providers are in place.
- Consider the number and timing of soundings required prior to the announcement of the transaction, particularly where soundings may be conducted in a live market. Query why the sounding can't be conducted the night before the announcement of the transaction.
- Think carefully about the use of a trading halt to manage the information leakage risks (including commercial risks) posed by soundings.
- Ensure that the entity has composed draft requests for trading halts and draft ASX announcements so that the entity can move quickly to make market announcements if it detects a leak.

Risk and audit implications

Role of internal audit

So you will see from what I have said, there is no 'one size fits all' solution to addressing continuous disclosure risk, as in many cases the risk will depend on the nature and structure of the business. But we think there are a number of common elements that should be considered in any internal audit of this kind.

Framework

Firstly, an auditor should review the entity's risk management framework and consider what controls and treatments are in place to address continuous disclosure risks and whether these are adequate.

As part of this framework, an auditor might question whether the business units have been profiled to determine which units are most likely to obtain market-sensitive information that should be disclosed under an entity's continuous disclosure obligations.

An auditor should also consider the key systems used by specific business units to assist in the flow of information. Have these systems been designed appropriately to meet continuous disclosure obligations, and has there been a sufficient level of testing to assess that the systems are operating effectively?

Also consider whether the entity has addressed the appropriateness, adequacy and awareness of relevant policies and procedures on continuous disclosure.

In terms of the specific controls to put in place, depending on the type of institution concerned, relevant industry guidance has been published by the Governance Institute of Australia, Australian Investor Relations Association, and AFMA. All of these may be relevant in getting the control framework right.

Compliance

After reviewing the systems and framework in place, an auditor should question how the entity will monitor compliance with the controls framework.

An auditor should also consider whether there are adequate resources for the compliance system or program.

How best to minimise potential liabilities

ASIC expects entities to have in place procedures to *identify* and *respond* to events that may trigger their continuous disclosure obligations

We expect that board members and their advisers will be aware of the entity's policies and be adequately trained in how to deal with situations as they arise.

At a practical level, some of the steps an entity can take to minimise risk in this area include the following:

- Have delegations in place for who has authority to speak on behalf of the entity – whether in response to an ASX 'price query' or 'aware' letter, or when the entity becomes aware of information that needs to be released to the market.
- Have a written 'rapid response' plan and make sure all board members, their advisers and senior staff are fully apprised of its contents. This plan and the systems that fall within it need to be subject to periodic review and stress testing to ensure effectiveness.
- Have a plan for when an entity will consider a trading halt is appropriate and have a template 'request for trading halt' letter ready for use at all times.
- Make it a practice to prepare a draft announcement where there is prior notice of an event that is likely to require an announcement to be made.
- Monitor the market and the information it is trading on. The entity should monitor significant media outlets, including any relevant social media, for leaks or rumours that may require correction.

Remember, if an entity is not turning its mind to its obligations on a day-to-day basis, then it may not be able to adequately and accurately respond to the market, which could give rise to potential liability – both for the company and the directors personally.

With the appropriate systems and training in place, however, the entity will be able to focus on the disclosure instead of the process.

Strengthening governance and compliance

We consider that the existing guidance provided by ASIC, ASX and industry bodies on continuous disclosure obligations is sound. The challenge for listed entities and their advisers is to implement this guidance in a consistent manner and approach issues with a view to following the spirit underlying the guidance.

ASIC's key focus in this area is therefore not on more guidance but on assessing whether entities and advisers are implementing the guidance in a consistent manner and, if not, taking appropriate enforcement action.

In relation to enforcement action, our supervision of financial markets has been bolstered recently by the successful rollout of our new market surveillance system. The system was purpose built and designed to handle the dynamics of our financial markets.

ASIC acknowledges the delicate balancing act that entities must undertake to comply with their disclosure obligations.

We understand the difficulty of the task and, to that end, ASIC thinks very carefully before taking any action on continuous disclosure breaches.

However, the potential damage to the market that can be sustained from an entity failing to abide by their continuous disclosure obligations is serious and wide-ranging, and ASIC will use its enforcement powers to highlight the importance of this obligation if needed.

Conclusion

ASIC has the people, powers and systems to detect misconduct, and will act when misconduct occurs following the poor handling of confidential information, resulting in a breach of an entity's continuous disclosure obligations. Our recent action in this space highlights the risks for companies and their directors in getting it wrong and so we welcome the interest of the Institute of Internal Auditors on this topic.

The key message I hope to impart today is that when it comes to satisfying continuous disclosure obligations, the focus should be on preparation and ensuring the right systems and controls are in place.

I am happy to take any questions.

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