

BREACH OF CONTINUOUS DISCLOSURE IN AUSTRALIA

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Given that disclosure is important for the efficient functioning of capital markets, this paper explores the impact of infringement of continuous disclosure by Australian listed firms. We observe a significantly negative market reaction for our sample firms around the day an infringement is announced. Our findings also provide partial evidence of an increase in spreads and a decrease in price informativeness following the announcement of a breach. Overall, our results indicate that the market considers the breach of continuous disclosure to be a relatively important incident.

As recently as July 2013, the Australian Securities and Investments Commission (ASIC) stated that it views ‘continuous disclosure by listed companies as the bedrock of market integrity. It is essential to two of ASIC’s priorities: fair and efficient markets and confident and informed investors’ (Price 2013). In the same speech, the ASIC Commissioner also noted that perceptions of inequalities in access to information remain a concern for retail investors, with the potential to undermine investor confidence.

Timely disclosure is recognised to be critical in maintaining the integrity of financial markets (Raykovski 2004) and improving investor confidence (Mayanja 2010). Financial market authorities have been entrusted to regulate corporate disclosure to ensure information is released to the market in a timely and accurate fashion. It has been argued, however, that requiring continuous disclosure is insufficient without suitable enforcement measures (Ferrell 2004; Mayanja 2010). An enforcement action by stock exchange regulators, therefore, identifies a situation where a firm has failed in its obligation to keep the market fully informed. This breach of continuous disclosure also represents a situation where the informational efficiency of the market has most likely been harmed. An important question that arises from such a situation, and which has not sufficiently been examined, is how the market reacts to such a breach of disclosure rules.

Australia represents an interesting setting within which to examine the impact of a breach of continuous disclosure. Australia introduced a very strict disclosure regime, incorporating both scheduled disclosures on a semi-annual basis and an ongoing requirement to disclose anything that

would be expected to have an impact on the stock price. However, while the Continuous Disclosure Regime (CDR) was legislated in 1994, questions were raised regarding the impact of the regulations, in part as a result of weak enforcement (Raykovski 2004). In response, in 2004, ASIC was given the power to issue infringement notices, with associated financial penalties, as an alternative remedy to the existing civil and criminal penalties. These notices give ASIC the ability to address less egregious CDR breaches in a more timely manner and without the expense of a court case. It has been argued that this change would enable ASIC to enforce CDR more efficiently without the significant legal hurdles of court proceedings. Since the regulatory change in 2004, ASIC has become more active in enforcing the CDR, with a number of infringement notices being issued. The active enforcement environment since 2004 creates a good setting within which to investigate the market impact of these alleged breaches.

To date, research on the CDR in Australia has been limited, and has not addressed the market impact of infringement announcements. Brown, Taylor and Walter (1999) find an increase in total disclosure following the legislating of CDR in Australia, but the increase was limited to smaller firms with little analyst following, and for firms that are likely to report ‘bad’ news. Overall, their results show little support for the notion that the enactment has improved corporate disclosure. Chan et al. (2007) examine the effect of introducing continuous disclosure on management earnings forecasts. They find that the change in legislation and increased enforcement action by ASIC ~~have~~ has had a positive effect on management disclosures. Finally, Hsu (2009) examines the relationship between accounting earnings and the frequency of price-sensitive disclosures in Australia. Hsu shows that firms facing earnings declines (bad news) have a higher frequency of disclosures than firms anticipating earnings increases (good news). The results suggest that despite the disclosure requirements of the CDR, firms still exercise considerable discretion around what they disclose.

Our paper empirically investigates how the market reacts to the imposition of an infringement notice by ASIC for a breach of CDR between 2004 and June 2012. We identify a number of firms that have been issued with infringement notices within our sample period, a total of 19 firms; however, one firm is omitted from the sample as it was delisted shortly after the event date. Appendix A provides an overview of the firms included in our sample.¹

Background to [the](#) Continuous Disclosure Regime

While Australia has had continuous disclosure rules written into the Australian Securities Exchange (ASX) listing rules² for decades, it was only included in the Corporations Act in 1994³ (Raykovski 2004). The law requires disclosure of security-related documents (prospectuses, investment statements, target statements and bidders’ statements), mandated semi-annual disclosure (interim financial reports, annual reports and accounts) and an ongoing requirement to immediately

disclose to the market any other material information. The requirement for continuous disclosure was included in the Corporations Act to allow for stricter enforcement, however, questions were raised regarding the enforcement by ASIC following the 1994 enactment. Desai and Ramsay (2011) argue that one issue impeding the efficient working of the CDR was the difficulty in enforcing the law prior to 2004.

The Corporations Act, the principle source of penalties for a breach of the CDR, allowed ASIC to pursue either a criminal or civil case against the company. Prior to 2004, criminal penalties amounted to 200 penalty units or imprisonment for up to five years while civil penalties amounted to fines of up to \$200,000. It was argued, however, that these processes were relatively slow and expensive, especially for minor infractions. As a result of reviews of the problems arising from the existing regulations, the Australian federal government enacted *The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (also known as CLERP 9), which strengthened the existing penalties and gave ASIC the ability to issue infringement notices.⁴

Infringement notices are an administrative penalty issued directly by ASIC, fining the company,⁵ but they are not an admission of guilt by the company and do not allow for further court action (Raykovski 2004). Infringement notices were ultimately designed to allow for less serious breaches to be penalised. Since the introduction of the new regulation, ASIC has taken a hard line in enforcing the statute (Hsu 2009). However, considerable discretion remains within the rules as a result of legislated exemptions to the requirement to disclose information immediately, for instance where deals are incomplete. This is compounded by the fact that the requirement to disclose is adjudged on an objective basis, meaning incorrect interpretations of what needs to be continuously disclosed are still liable. As a result, ASIC and the ASX have both been active in working with companies to clarify the rules and provide ongoing detailed guidance as to how the rules are interpreted, such as the recently released *ASX Guidance Note 8* (ASX 2013) and *Continuous Disclosure: An Abridged Guide* (ASX 2012b).

One question regarding the CDR is whether the market actually reacts following an enforcement action. Does tightening up requirements by issuing infringement notices actually reflect negatively on a firm?

Hypotheses and methodology

The market reaction to a breach of the CDR will provide an indication of the market's view of continuous disclosure and, in particular, if a breach increases the perception of firm risk. A breach suggests that a company has poor disclosure practices, making their stock prices less informative to investors, who may in turn consider investing in such a firm to be more risky. This is referred to as 'information risk'⁶ and has been modelled in the literature as an additional premium that investors

demand for bearing this risk component (Barry and Brown 1985 and 1986; Merton 1987). If a breach of the CDR matters, we would observe the effects of this increased information risk in a number of areas. The most obvious consequence is that investors would require a higher return as compensation for the risk. This would result in a decrease in the share prices of firms on the day of the announcement of a breach. Our first hypothesis is:

H1: Abnormal returns will be negative following a breach of CDR

To investigate the market reaction, we use the standard Brown and Warner (1985) event study methodology, with a pre-event period of 290 to 41 days to estimate our parameters. We calculate cumulative abnormal returns (CARs) over various windows around the day of a breach notice.

We also investigate two additional variables that may be affected by an increase in information risk due to a breach of CDR, namely, trade execution costs and firm-specific risk. Trade execution costs, as measured by the bid-ask spread, are compensation for risks faced by liquidity providers, such as information asymmetry. Given a breach notice suggests an environment with more unpriced information, we would expect spreads to increase to cover the additional information risk (Welker 1995; Bessembinder and Venkataraman 2009). We estimate the average percentage bid-ask spread using closing quotes and then average over our sample windows.

H2: Firms spreads will increase following a breach of CDR

We also consider the *zero-return metric*, proposed by Lesmond et al. (1999) and Ashbaugh-Skaife et al. (2006).⁷ The zero-return metric measures the amount of price-sensitive information entering the market, where a higher percentage of zero-return days (days considered to be without significant information or trading) indicates less informationally efficient share prices. We estimate the spreads and zero-return metric over three, six and 12-month windows both before (*PRE*) and after (*POST*) the issuance of an infringement notice, and test for statistical difference in the two sub-periods.⁸ All data was collected from Thompson Reuters Datastream.

H3: Firms specific information will be lower following a breach of CDR

Findings

Market reaction

We find significant negative results around the announcement of an infringement notice over all the event windows considered. Specifically, we observe an -3.69% return on the announcement day building to a return of -4.88% over the window $(0, +3)$.⁹ This suggests that the Australian market may have taken a few days to fully incorporate the breach into stock prices. Announcements of a breach of continuous disclosure are not frequently received by the market, therefore the under-

reaction on the event day when compared to CARs over (0,+3) may be due to the difficulty in determining the implications of a breach and the extent of its impact on information risk. However, the delay may also be due to low trading volumes over the sample period for some sample firms, which may have slowed the market's ability to impound the information of the breach into the price.

Table 1 Here

Trade execution costs

Although we expected trading costs to increase as a result of the higher information risk demonstrated by an infringement notice, we see little conclusive evidence of this. Table 2 demonstrates that spreads increase over all three windows. However, the *t*-test only indicates statistical significance at the 10% level in the six- and 12-month *POST* period, and not at all for the three-month window.

Table 2 Here

Zero-return metric

Likewise, we see little conclusive evidence that the percentage of zero-return days has changed significantly. In Table 2 we observe significance only for the six-month window, although again, all the results are in the expected direction. The lack of statistical significance for both spreads and the zero-return metric measures may be the result of the size of the sample.

Conclusion

The 2004 introduction of the infringement notice regime was in response to perceptions of weak enforcement of continuous disclosure, particularly for less serious breaches. The introduction of the infringement notice has given ASIC the ability to deal with breaches of continuous disclosure in a more timely and less expensive manner, ultimately allowing for greater enforcement. Our study demonstrates that investors in the market appear to value the more informationally efficient environment it promotes, as evidenced by the negative market reaction to the announcement of an infringement notice. This provides some support for the CDR in Australia. Notably, the infringement notices have served their purpose as enforcement is more common now; of the 19 breaches identified, all but two were infringement notices. Also, in support of comments made in a speech by the Commissioner of ASIC (Price 2013), **we found few breaches of continuous disclosure in our sample period. This suggests that the market is broadly complying with the CDR regime and it would appear to suggest that the regime is**

functioning well. It also provides support for the efforts of ASIC and the ASX in engaging actively with the market regarding the interpretation and application of the CDR.

Notes

¹ Searches were conducted on the ASIC website, Factiva and other sources for notification of infringement notices. We took the announcement date as the first date where the details of the infringement notice were first disclosed.

² Listing Rule 3.1 (ASX 2012a).

³ Previously covered by section s1001A prior to 2001 and s674 after 2001.

⁴ Part 9.4AA of the Corporations Act.

⁵ Penalties were set based on the size of the firm. For firms with a market capitalisation of less than \$100 million, the fine is \$33,000. For firms between \$100 million and \$1 billion, the fine is \$66,000 and for firms with a market capitalisation of greater than \$1 billion the fine is \$100,000 AUD (*Corporations Act 2001*, s1317DAE(6)).

⁶ 'Information risk' is the risk borne by an investor relating to the possible non-disclosure of information (Barry and Brown 1986).

⁷ Ashbaugh-Skaife et al. (2006) conclude that *ZR* is a better measure for the level of firm-specific information and outperforms the traditional measure of price synchronicity (Morck et al. 2000). We have performed the latter analysis as well and do not obtain any significant results comparing pre-post breach event.

⁸ To ensure the robustness of our results we investigated the potential for other confounding events within the period around the breach notice. With the exception of one company removed as it delisted soon after the event date, we found no announcements that we believed would impact our findings. More formal testing was not possible due to the sample size.

⁹ To control for the impact of small firms and thin trading, we investigate just the seven firms making up the Tier 2 and Tier 3 firms (the larger firms). The findings remain consistent albeit with greatly reduced power.

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APPENDIX: OVERVIEW OF SAMPLE COMPANIES

Company Name	Sector	Type	Date of announcement	Penalty (\$)
Astron	Materials	Infringement	18-Jul-06	66,000
Acuvax	Pharmaceuticals, Biotechnology & Life Sciences	Infringement	8-Dec-06	33,000
Avastra Sleep Centres	Pharmaceuticals, Biotechnology & Life Sciences	Infringement	12-May-06	33,000
BC Iron	Materials	Infringement	1-Mar-12	66,000
BioProspect	Pharmaceuticals, Biotechnology & Life Sciences	Infringement	8-Mar-12	33,000
Centrex Metals	Materials	Infringement	12-Mar-08	33,000
Chemeq	Pharmaceuticals, Biotechnology & Life Sciences	Breach	24-Dec-04	500,000
Citigold Corporation	Materials	Infringement	22-Sep-10	33,000
Commonwealth BOA	Banks	Infringement	14-Oct-09	100,000
Leighton Holdings	Capital Goods	Infringement	16-Mar-12	300,000
Navigator Resources	Materials	Infringement	15-Jun-12	33,000
Nufarm	Materials	Infringement	1-Dec-10	66,000
Q Technology Group	Technology Hardware & Equipment	Infringement	17-Feb-06	33,000
Raw Capital Partners	Software and Services	Infringement	1-Aug-07	33,000
Rio Tinto	Materials	Infringement	5-Jun-08	100,000
FYI Resources	Materials	Infringement	1-Aug-05	33,000
Sub-Sahara Resources NL	Materials	Infringement	29-Apr-08	33,000
Fortescue Metals Group	Materials	Breach	3-Mar-06	Ruling-no breach

TABLE 1: Cumulative abnormal returns

Window	CAAR
-10, +10	-0.0229**
-3, +3	-0.0335***
-2, +2	-0.0321***

-1, +1	-0.0013*
0, +1	-0.0274**
0, +3	-0.0488***
0	-0.0369***

Note: *, **, *** indicates significance at the 10%, 5% and 1% level, respectively.

TABLE 2: Trade execution costs and zero return metrics (spread)

	3 months		6 months		12 months	
	PRE	POST	PRE	POST	PRE	POST
Panel A: Trade Execution Costs						
Mean	0.0655	0.0768	0.0678	0.0809	0.0640	0.0974
Median	0.0269	0.0292	0.0323	0.0289	0.0273	0.0346
St Dev	0.1142	0.1491	0.1199	0.1386	0.1229	0.1750
Min	0.0000	0.0000	0.0020	0.0000	0.0029	0.0017
Max	0.4098	0.6233	0.4783	0.4876	0.5097	0.5578
Mean Diff		0.0113		0.0131*		0.0335*
<i>t</i> -test		(0.8661)		(1.4182)		(1.5000)
Observations		18		18		17
Panel B: Zero-Return Metrics						
Mean	0.3642	0.3898	0.3536	0.3955	0.3360	0.3404
Median	0.2937	0.2698	0.2738	0.2421	0.2381	0.2500
St Dev	0.3361	0.3755	0.3137	0.3670	0.2992	0.3203
Min	0.0000	0.0000	0.0000	0.0000	0.0079	0.0079
Max	1.0000	1.0000	0.8968	1.0000	0.9127	0.9722
Mean Diff		0.0256		0.0419**		0.0044
<i>t</i> -test		(1.2941)		(2.1739)		(0.1885)
Observations		18		18		17

Note: Significance of the difference between PRE and POST samples is calculated using the matched-pairs *t*-test for means and the Wilcoxon Mann Whitney signed-rank test for medians. PRE(POST) indicates either the 3, 6 or 12 months before (after) the announcement of an infringement notice. * indicates significance at the 10% level, ** indicates significance at the 5% level.

Ends

<<sections marked in orange are potential breakout quotes>>