# Continuous Disclosure Penalties –
# An Additional Agency Cost?

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**'The Pathology of Corporate Law'**

## Continuous Disclosure Penalties –<br>An Additional Agency Cost?


If the regulatory ideal is to achieve greater corporate transparency for a company's stakeholders, then an absence of continuous disclosure to the public gives rise to inequality of information. This information asymmetry, resulting from actions or omissions by company directors and executives, is recognised as an agency cost for stock exchange listed companies, particularly in terms of reputation and cost of capital. The company suffers an additional agency cost burden when the regulator imposes a penalty for a breach of the Listing Rules.

A critical evaluation of the Listing Rule penalties, imposed by the Financial Services Authority in the United Kingdom (UK) since 2000, reveals that they are invariably concerned with a failure of continuous disclosure. Will the restructured UK regulatory regime, post 1 July 2005, increase disclosure and reduce these agency costs? What are the implications of the UK penalties and disclosure regulation for Australian listed companies?



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**'The Pathology of Corporate Law'**

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**'The Pathology of Corporate Law'**

Within the theme of the Conference, the classical Latin *pathologia* is the branch of knowledge that in its extended use is 'the study or investigation of abnormality or *malfunction* in the moral, social, linguistic or other sphere'.[1] If the regulatory ideal is to provide greater corporate transparency, then information asymmetry through a failure of continuous disclosure of material information is a 'corporate malfunction'.

## 1. Introduction to Penalty Issues

A critical evaluation of those penalties imposed by the Financial Services Authority in the United Kingdom (UK) since 2000 for contraventions of the Listing Rules, reveals that they are invariably concerned with a failure of continuous disclosure. This particular corporate malfunction is usually the result of a failure by directors or company officers to disclose amendments to a financial forecast, or to otherwise issue public announcements that would avoid misleading the market. A company's failure to be proactive on continuous disclosure is not only a potential contravention of regulation but also compounds the agency costs. Any failure by a listed company's officers that increases the agency costs to the company is worthy of investigation, and failures that penalise the company's reputation and impede its ability to raise capital deserve special consideration.

The regulatory changes that were effected in the UK on 1 July 2005, as a result of the implementation of European Union (EU) Directives, provide the motivation for this paper. At a time of regulatory change, a study of the enforcement practice that existed under the previous regulation is the basis for evaluating the likely effect of the reforms. The purpose of this paper is to discuss the actual penalties that were imposed under the earlier regime. An understanding of the reason for the imposition of a particular penalty can assist directors and company executives in overcoming information asymmetry with continuous disclosure, and so prevent those breaches of the Listing Rules that provoke penalties and additional agency costs. This understanding can then provide a further degree of preparation for the likely impact of the new regulation.

The following issues are relevant to this understanding and will be discussed in this paper:

- Issue 1: What are the agency costs of continuous disclosure penalties?
- Issue 2: What was the regulatory basis of the penalties?
- Issue 3: What actual penalties have been imposed?
- Issue 4: What are the implications of new continuous disclosure regulation?

[1] *Oxford English Dictionary* 2005. www.oed.com/

Ongoing, continuing or voluntary corporate disclosure that is regulatory, but involves a degree of flexibility of timing and discretion on the part of directors and company officers, will mostly be referred to as 'continuous disclosure' throughout this paper.

### *1.1 Information Asymmetry - an Agency Problem*

This paper is a study of those instances of corporate malfunction, the failures of continuous disclosure, which initiate particular agency costs, the penalties, for the company. This malfunction arises from actions or omissions of company directors and executives that results in an inequality of information that is available to the various corporate stakeholders. When there is a failure to disclose, the asymmetry is greater as some stakeholders, unusually insiders, have more timely information than others. This can translate to abnormal variations in the entity's share price, which in itself can amount to an agency cost. Asymmetry of information is already recognised as an agency cost for stock exchange listed companies, in terms of loss of reputation and the cost of the added premium that will need to be paid by the company when it is raising funds.

Within the theory of agency, the company, as represented by the owners or shareholders, is the 'principal' and executive management and the board fulfil the role of 'agent' as in a traditional agency contract. Shareholders and mangers attempt to minimise the loss of value that results from the separation of ownership and control and this dilemma forms the basis of research into corporate governance.[2] As this separation of ownership and control leads to costs in monitoring the activities of the agent, the agency contract will include arrangements for the agent to regularly supply information to the principal.[3] The agency problem arises when the terms of the agency contract are not fulfilled and the agent fails to provide accurate and timely information to the principal. The agency problem in turn gives rise to agency costs; monitoring costs and residual costs for corporate reputation and funding.[4]

The agency problem is compounded if market movement in the company's share price alerts the regulator to a potential breach of the Listing Rules and the resultant penalty increases the company's cost of capital. When the regulator recognises a failure of continuous disclosure

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[2] Kevin Keasey, Steve Thompson and Mike Wright *Corporate Governance – Economic, Management and Financial Issues* OUP Oxford 1997, 2.

[3] Weetman P *Financial and Management Accounting* 3rd ed Prentice Hall London 2003, 17.

[4] Godfrey J, A Hodgson and S Holmes *Accounting Theory* 4th ed John Wiley & Sons Australia Ltd Brisbane 2000, 288.

as grounds for a breach of the Listing Rules, then the company must suffer the stigma and additional burden of the penalties that are imposed. Whether the breach is perpetrated by the company, here represented by the board as a whole, or by individual directors or executives, it amounts to an agency problem that can be costly for the company.

*1.2 Continuous Disclosure – a Regulatory Solution*

Under the terms of the traditional corporate contract, the agent must provide relevant information only to the principal. However, regulation exists to enforce further disclosure and to reapportion information to all stakeholders, including regulators, the public, potential investors and creditors, thereby overcoming information asymmetry. This regulatory demand should assist by minimising agency monitoring costs.

Relevant to the impact of agency costs is the actual regulation, and penalties that have been imposed as a consequence of that regulation. Sections 2 and 3 of this paper evaluate:

- Continuous Disclosure Regulation in the UK prior to 1 July 2005; and
- Analysis of Penalties Imposed in the UK prior to 1 July 2005.

If the officers of a company are able to interpret the new regulation, based on the precedent of the old regime, then they will have a clearer perception of the requirements of continuous disclosure and be able to evade the information asymmetry that adds to agency costs. To assist in this, Sections 4 and 5 of this paper is concerned with the:

- Implications of the Regulatory Changes post 1 July 2005, with reference to the London Stock Exchange (LSE) and, indirectly,
- Implications for Australian Regulation.

Issue 2, raised above in the Introduction, concerning the regulatory basis of the penalties, is discussed below in Section 2. The third issue relates to the actual penalties that were imposed by the regulator and will be analysed in Section 3. Issue 4 concerning the implications of the regulatory changes on the two selected stock exchanges, the UK is dealt with in Section 4, and Section 5 is devoted to the possible implications of these changes for Australian stock market regulation. Section 6 summarises the research findings and anticipates future regulation and research.

The UK and Australia are chosen for this paper, as they have similar regulatory traditions.

Stock market regulation in Australian, which shares a common law tradition with the UK but is not a Member State of the EU has, to date, largely followed the UK model of regulation.

**2. Continuous Disclosure Regulation in the UK prior to July 2005**

As explained above, the primary focus of this paper is the UK regulatory environment for listed companies and its associated continuous disclosure obligations. The changes in regulation that resulted from the implementation of EU Directives on 1 July 2005 are discussed in Section 4. The development of the regulatory environment before this date is outlined below.

Under the LSE guidelines to Continuing Obligations, a listed company was required to notify the exchange 'without delay' of 'all relevant information' that was not public knowledge and 'any major new developments in the company's sphere of activity' that could be price sensitive.[5] Any change in the financial condition or expected performance of a listed company needed to be disclosed.

The LSE's Listing Rules were commonly know as the *Yellow Book* but from December 1999 the LSE and the newly formed FSA cooperated to provide an approach to listing that retained the standards of the *Yellow Book* but minimised the duplication of the listing process.[6] It was then appropriate for the FSA to become the 'UK Competent Authority for Listing'.[7]

Effective 1 May 2000[8], the role of Competent Authority and the enforcement of the Listing Rules were no longer the responsibility of the LSE, which became a company listed on its own exchange. Shares in London Stock Exchange plc were listed on the main market from 20 July 2001.[9] The FSA, as the single statutory market regulator under the *Financial Services*

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[5] London Stock Exchange, 1999, *Continuing Obligations Guide*, Part 1 Disclosure of Price Sensitive Information, Listing Rule 9.1, 9.2; UK Listing Authority, December 2003, *Continuing Obligations Guide*, Appendix 3, Chapter 2 Disclosure of Price Sensitive Information.

[6] Financial Services Authority, December 1999, 'The Transfer of the UK Listing Authority to the FSA', *Consultation Paper* 37. www.fsa.gov.uk

[7] London Stock Exchange, 4 October 1999, 'New Arrangements for UK Listing Authority', *Press Release*.

[8] UK Listing Authority, 10 April 2000, 'Listing Rules', *Press Release*.

[9] London Stock Exchange, 6 November 2001, *Interim Report - Six Months ended 30 September 2001*, 3.

*and Markets Act* 2000 (UK), (FSMA)[10], now had responsibility for supervising the LSE. As a result, there was a 'two-stage admission process' for companies wishing to list securities in London: the company applied to the UK Listing Authority (UKLA), a division of the FSA, for admission to the Official List and then applied to the LSE for admission to trading on the stock market.[11] As the Chairman of the FSA quipped:

> 'So the old *Yellow Book* is now the FSA 'Purple Book'. The observant among you will note that the contents are almost exactly the same.'[12]

The Continuing Obligations, discussed above, remained essentially the same but were now contained in the Listing Rules of the UKLA. These Listing Rules were continually updated by amendments to Chapter 9 of the UKLA Sourcebook concerning Continuing Obligations under the Listing Rules. The disclosure procedure amended Listing Rules 9.1, 9.2 and 9.3A by stating that a company 'must notify the Regulatory Information Service without delay of all relevant information which is not public knowledge' and it must ensure that the information was not 'misleading, false or deceptive'.[13] These obligations were also reinforced by similar LSE disclosure standards 3.1 and 3.2.[14]

Although the FSA was now the Competent Authority, it had no power to impose a financial penalty for a contravention of the Listing Rules on either the company or an associated individual. As part of the transfer of functions to the FSA, the Competent Authority could only issue a private or public censure, or suspend or cancel the listing of securities.[15] It was restricted to publishing a public statement to the effect that an issuer of listed securities had

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[10] *Financial Services and Markets Act* 2000 (UK), Royal Assent 14 June 2000.

[11] Financial Services Authority, 1 December 2001, *Introduction to the Financial Services Authority*, London: 3, 14, 15; London Stock Exchange, May 2001, *Admission and Disclosure Standards*,1.1.

[12] Davies, H., Chairman of the Financial Services Authority, 25 May 2000, 'Maintaining Standards', Speech delivered at the *IFAC Conference*, Edinburgh.

[13] UK Listing Authority, 1 December 2001, *Listing Rules*, Chapter 9: 9.1, 9.2, 9.3A.

[14] London Stock Exchange, May 2001, *Admission and Disclosure Standards*, Part 2: 3.1, 3.2. In the updated July 2005 edition of this publication, Part 2: 3.1, 3.2 states that issuers must comply with all of the rules for listing as produced by their competent authority and the provisions set out in the standards.

[15] *Financial Services Act* 1986 (UK), as quoted in *Financial Services and Markets Act* 2000 Explanatory Notes, 14 June 2000, Section 91: Penalties for Breach of the Listing Rules, para 184; *Financial Services and Markets Bill*, 18 November 1999, s84(2) refers to Schedule 7 Transfer of Functions under Part VI; FSMA, Part VI Official Listing, s77 Discontinuance and suspension of listing.

contravened a requirement of the Listing Rules, if that contravention occurred before 30 November 2001.[16]

Effective 1 December 2001, the UKLA Listing Rules were amended to bring them into line with the provisions of FSMA. For the first time, the UKLA was able to impose financial penalties on issuers, directors and former directors, in addition to issuing public statements of censure.[17]

From the 17 November 2003, the FSA proceeded to combine its Markets and Exchanges Division with the subsidiary UKLA to create one division, the Markets Division, which is now responsible for both the primary and secondary securities markets. The FSA stated at the time that there was a convincing strategic rationale for running these two areas within one division.[18]

The decision anticipated the demise of the 'Purple Book' and the new Listing Rules that would be effective from 1 July 2005, as discussed in greater detail in Section 4. However, it is the pre-July 2005 regulation that is responsible for the penalties that are discussed in Section 3. The relevant aspects of the regulatory environment that existed at that time are analysed below under the headings:

- Listing Rules and LSE Disclosure Standards
- Listing Rules and the Combined Codes.

*2.1 Listing Rules and LSE Disclosure Standards*

As discussed above, from 1 May 2000,[19] enforcement of the Listing Rules was no longer the responsibility of the LSE. This responsibility fell to the FSA, initially through the UKLA until its merger with the Markets Division of FSA in 2003. However, the continuous disclosure obligations under the Listing Rules also continued to be reinforced by LSE

[16] *Financial Services and Markets Act* 2000 (Official Listing of Securities) (Transitional Provisions) Order 2001, Article 11; Financial Services Authority, 11 April 2003, Marconi plc, *Final Notice*, 8.

[17] Financial Services Authority, 18 October 2001, *Handbook Notice* 4: 13, 15.

[18] Financial Services Authority, 8 October 2003, 'FSA Announces Merger of UK Listing Authority and Markets and Exchanges Division', *Press Release* FSA/PN/105/2003.

[19] UK Listing Authority, 10 April 2000, 'Listing Rules', *Press Release*.

disclosure standards.[20] A new edition of the LSE Admission and Disclosure Standards[21] was issued in July 2005 to coincide with the restructured FSA Listing Rules. Here, LSE Standard 3 on Continuing Obligations states that the Exchange has a responsibility to ensure that it operates orderly markets. In order to achieve this, it is essential that companies admitted to trading on the LSE markets publish price sensitive information on a timely basis.

### *2.2 Listing Rules and the Combined Codes*

The Committee on Corporate Governance compiled the Combined Code,[22] which included Principles of Good Governance and the Code of Best Practice, from the Committee's Final Report of June 1998 and from the Cadbury and Greenbury Reports. It was published in May 2000 as a consolidation of the work of the three committees.

The Preamble to the Combined Code acknowledged, at point 3, that it was the intention of LSE to introduce a requirement for listed companies to make a disclosure statement in two parts. In the first part of the statement, the company was required to report on how it applied the principles of the non-mandatory Code and, in the second part of the statement, the company was required either to confirm that it complied with the Code provisions or, where this did not occur, provide an explanation for the non-compliance, at points 4 and 5.

Section 1 of the Combined Code[23] contained the corporate governance principles and Code provisions applicable to all listed companies incorporated in the United Kingdom. The first Code provision under the Financial Reporting Principle (D1) dealt with directors' responsibilities in preparing the company's accounts and also the auditors' reporting responsibilities. The second Code provision extended the board's responsibility to interim and 'other price-sensitive public reports and reports to regulators' as well as to information required to be presented by statutory requirements. Continuous disclosure is thus included as a corporate governance issue.

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[20] London Stock Exchange, Listing Rule 9.4 was replaced by UK Listing Authority *Listing Rules*, Listing Rule 9.4; London Stock Exchange, May 2001, *Admission and Disclosure Standards*, Part 2: 3.1, 3.2.

[21] London Stock Exchange, July 2005, *Admission and Disclosure Standards*.

[22] Committee on Corporate Governance (Hampel Report), June 1998, *The Combined Code: Principles of Good Governance and Code of Best Practice* (published May 2000, revised July 2003, hereafter the Combined Code), Financial Reporting Council, London. www.ecgi.org/codes

[23] Combined Code, June 1998: Code of Best Practice – Section 1 – Companies, D Accountability and Audit, D.1- Financial Reporting, Code Provisions D.1.1, D.1.2.

In July 2003, a new Combined Code on Corporate Governance superseded and replaced the June 1998 Code. The FSA announced that it would replace the 1998 Code that had been annexed to the Listing Rule with the revised Combined Code and would make consequential Listing Rule changes. The Financial Reporting Principle under the Combined Code is now found under C1[24] and it applies to reporting years beginning on or after 1 November 2003. The 1998 Code Provision D.1.2 that had extended the board's corporate governance responsibilities to continuous disclosure is now relegated to the title of 'Supporting Principle' under C1. In terms similar to the earlier provision, this Supporting Principle deals with the board's responsibility to present a balanced and understandable assessment of the company, which extends to other price-sensitive public reports and reports to regulators, as well as to information disclosure that is required by statute.

The principles of the July 2003 Combined Code, discussed above, are reinforced by the new Listing Rule LR 9.8 Annual Reports and Accounts, which is incorporated into the revised FSA Handbook as at 1 July 2005 and discussed further in Section 4. In the case of a listed company incorporated in the UK, of particular relevance to this paper is LR 9.8.6R (6)(b)(ii), which demands that the company must state 'in case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and (iii) the company's reasons for non-compliance'.

In this way the continuous disclosure obligation is again reinforced through the corporate governance principles. If the regulator considered these 'reasons for non-compliance' with the Combined Code inadequate, it could expose the company to a breach of the Listing Rule demand for continuous disclosure.

**3. Analysis of Penalties Imposed in the UK prior to 1 July 2005**

FSA adopted new powers under the FSMA on 1 December 2001. The disciplinary sanctions available to the FSA for breaches of the Listing Rules that take place on or after 1 December 2001 include a fine or a public statement. FSA has taken action for Listing Rule breaches after 1 December 2001 in the following instances: SFI, Sportsworld, Universal Salvage, Shell, Pace Micro Technology and MyTravel Group. To reinforce exposure of these penalties, the FSA wrote to listed retail companies, on 15 December 2004, reminding them of their duties

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[24] Financial Reporting Council, July 2003, *The Combined Code on Corporate Governance*, London: Code of Best Practice – Section 1 – Companies, C Accounting and Audit, C.1 Financial Reporting. www.asb.org.uk

under the Listing Rules to keep the market informed without delay of any developments in their businesses.[25]

Appendix 1 shows the Chronology of FSA Notices resulting from specific regulatory issues and the subsequent penalties imposed by the FSA. While adhering as much as possible to the chronology of the notices, the following discussion has grouped the penalties according to type in order to better illustrate the development of an enforcement precedent:

- Non-financial Penalties against the Corporation
- Penalties against the Corporation and the Individual.

### *3.1 Non-financial Penalties against the Corporation*

#### <u>3.1.1 Public Statement of Listing Rule Contraventions by Corporations</u>

(a) Iceland Group plc[26]

The first initiative by the FSA occurred on 26 April 2002 when it made a public statement concerning a contravention of the Listing Rules by Iceland Group plc, now known as The Big Food Group plc. Between December 2000 and 2 January 2001, Iceland twice contravened the requirements of Listing Rules 9.2 and 9.3A. The company failed to keep the market informed about price sensitive information and it also failed to take reasonable care that an announcement, when it was made, was not misleading. The Listing Rules required full disclosure to the market without delay concerning the significant deterioration of Iceland's financial trading performance between September 2000 and the beginning of January 2001.

Iceland's contravention occurred at a time following the FSA's designation on 1 May 2000 as the Competent Authority for the enforcement of the Listing Rules but prior to it assuming new FSMA statutory powers from 1 December 2001 (see 2.2 above).

(b) Marconi plc[27]

In 2003, there were two relevant incidences of FSA recognition of a failure of continuous disclosure by a listed company. In the first of these, FSA released a public statement on 11

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[25] Financial Services Authority, 14 July 2005, 'MyTravel fined £240,000 for Listing Rule Breach', *Press Release* FSA/PN/080/2005.

[26] Financial Services Authority, 17 June 2003, *Annual Report 2002/03*, Section 4 – Markets: 69; Financial Services Authority, 26 April 2002, 'FSA Announces Serious Breaches of the Listing Rules by Iceland', *Press Release* FSA/PN/040/2002.

[27] Financial Services Authority, 11 April 2003, 'FSA Announces Breach of Listing Rules by Marconi', *Press Release* FSA/PN/047/2003.

April 2003 concerning the contravention by Marconi plc of Listing Rule 9.2(c) on 4 July 2001. FSA found that Marconi failed to release price sensitive information to the market regarding a change in its expected performance for the half-year ending September 2001 and the full year to March 2002. Marconi's expectation of its performance changed in the afternoon of 2 July 2001 but it did not make an announcement until after the market had closed on 4 July 2001, which was after its securities had been had been suspended for a full day.

Although the FSA released this public reprimand in 2003, the contravention relates to the period prior to 1 December 2001 and before the regulator had assumed its full statutory powers and the ability to impose a financial penalty.

3.1.2 Censures for Listing Rule Breaches by Corporations

(a) SFI Group plc[28]

The second action taken by FSA in 2003 occurred on 12 December when FSA released a public statement censuring SFI Group plc for breaches of the Listing Rules. This is the first action taken by FSA for such a contravention of the Listing Rules pursuant to the FSMA s91 powers assumed by UKLA on 1 December 2001 (see 2.2 above). The company's Preliminary Results Announcement released on 30 July 2002 was in breach of Listing Rule 9(3)A as it presented an overstated and overoptimistic view of SFI's financial results and its future prospects. SFI failed its continuous disclosure obligation to take reasonable care and to update the market on its financial prospects.

Under its full statutory posers, FSA could have chosen in inflict a financial penalty on the company or on a director or executive who was knowingly concerned. However, in this case the FSA maintained the *status quo* and only issued a public censure.

(b) Sportsworld Media Group plc[29]

As can be seen from Appendix 1, this action by the FSA on 29 March 2004, and the resultant penalties, transferred liability from the company to the responsible executive. The FSA censured Sportsworld Media Group plc for breach the Listing Rules but for the first time the

[28] Financial Services Authority, 12 December 2003, 'FSA Announces Serious Breach of the Listing Rules by SFI Group plc', *Press Release* FSA/PN/134/2003.

[29] Financial Services Authority, 29 March 2004, 'FSA Censures Sportsworld and Fines Former CEO £45,000 for Listing Rule Breach', *Press Release* FSA/PN/029/2004.

more severe financial penalty was imposed on Sportsworld's former Chief Executive Officer, Geoffrey Brown (see below 3.2.1(a)).

*3.2 Penalties against the Corporation and the Individual*

Instead of imposing a penalty in respect of a contravention of the Listing Rules, the FSA may 'publish a statement censuring' the company, as it did in the previous two cases.[30] However, under s91(1) of FSMA, if the FSA 'considers that an issuer of listed securities…has contravened the Listing Rules, it may impose a penalty of such amount as it considers appropriate.'[31] The power also extends to imposing a penalty on a director:

> s91(2) If in such a case, the competent authority considers that a person who was at the material time a director of the issuer…was knowingly concerned in the contravention, it may impose on him a penalty of such amount as it considers appropriate.[32]

<u>3.2.1 Financial Penalties for Listing Rule Breaches</u>

(a) Geoffrey Brown, former CEO of Sportsworld Media Group plc [33]

As discussed above at 3.1.2(b) and 3.2, this action by the regulator was the first to transfer liability for a breach of the continuous disclosure rule from the company to the responsible executive under FSMA s91(2). It was the first time that FSA used its statutory powers to fine a director of a listed company for a breach of the Listing Rules. The FSA censured Sportsworld Media Group plc for breaching the Listing Rules but the more severe financial penalty was imposed on Sportsworld's former Chief Executive Officer, Geoffrey Brown, who was fined £45,000 for being 'knowingly concerned' in the breach.

This penalty was evidence that the FSA was prepared to use its new powers under FSMA s91, as the breach occurred less than four weeks after the amendment was implemented from 1 December 2001. Changes in the company's business performance and expectations regarding its pre-tax profit that were known by 24 December 2001, were not conveyed to the market until 28 January 2002. This was a lapse in complying with the continuous disclosure obligations that resulted in an uninformed market.

[30] FSMA, Part VI Official Listing s91(3).

[31] Financial Services Authority, 14 July 2005, 'MyTravel fined £240,000 for Listing Rule Breach', *Press Release* FSA/PN/080/2005; FSMA, Part VI Official Listing s91(1).

[32] FSMA, Part VI Official Listing s91(2).

[33] Financial Services Authority, 29 March 2004, 'FSA Censures Sportsworld and Fines Former CEO £45,000 for Listing Rule Breach', *Press Release* FSA/PN/029/2004.

(b) Universal Salvage plc and (c) Martin Hynes, former CEO[34]

This is the first instance in which the FSA imposes a financial penalty on both the listed company and a person knowingly concerned. The FSA on 19 May 2004 fined Universal Salvage plc £90,000 for breaching the Listing Rules. Martin Hynes, former Chief Executive Officer of Universal, was also fined £10,000 for being knowingly concerned in the breach. The FSA found that the loss of a major contract, which was likely to lead to a substantial movement in the price of Universal's listed securities, was know by 16 April 2002 but the market was not notified until 23 April 2002. This loss also led to the company reporting worse than expected trading figures.

Although the chief executive suffered a moderate financial penalty in this case, it was the company that bore the greater regulatory penalty, implying greater liability by the board of directors as a whole. This contrasts with the previous instance of Sportsworld where the financial penalty was imposed only on the chief executive.

(d) Shell Transport and Trading Company[35]

The penalty imposed in this case is evidence of the potential punitive effect of statutory financial penalties. The FSA on 24 August 2004 imposed a fine of £17 million on Shell Transport and Trading Company, Royal Dutch Petroleum Company and Royal/Dutch/Shell Group of Companies for market abuse and breaches of the Listing Rules. Where a listed company's misconduct is particularly serious the FSA will take action under the market abuse regime[36] as well as the Listing Rules.[37] The fine was imposed on Shell as a result of unprecedented misconduct in relation to misstatements of its proven reserves and its failure to publish a timely correction prior to 19 April 2004.

The castigatory nature of the penalty reflects the seriousness of the misconduct and the impact it had on markets and shareholders. This is also evidence that the FSA is prepared to impose a penalty that reflects the market capitalisation of the group of companies involved. The swift

[34] Financial Services Authority, 10 May 2004, '£100,000 Levied in fines for Listing Rule Breach', *Press Release* FSA/PN/040/2004.

[35] Financial Services Authority, 24 August 2004, 'FSA Fines Shell £17,000,000 for Market Abuse', *Press Release* FSA/PN/074/2004.

[36] FSMA, Part VIII Penalties for Market Abuse, s123 Powers to impose penalties in cases of market abuse.

[37] FSMA, Part VI Official Listing, s91(1).

resolution of the case was made possible by co-operation between the FSA and the Securities and Exchange Commission in the United States.

A year after the corporate penalty was imposed, the FSA announced that it had been 'pursuing enquiries into the roles of certain individuals in the misstatement of Shell's hydrocarbon reserves'.[38] The enquiries had concluded and the FSA, without disclosing further details on the subject, decided that it would take no further action against the individuals.

(e) Pace Micro Technology plc[39]

Pace Micro Technology plc was fined £450,000 by the FSA on 27 January 2005 for breaches of the Listing Rules between 8 January and 5 March 2002. The company failed to update the market without delay of a change in its expected future revenue, which had been assessed by the company on 4 February 2002 but not disclosed. This investigation extended over a three-year period with the imposition of a relatively large fine, compared to those penalties imposed prior to the Shell Transport case, discussed above at 3.2.1(a) and (b).

(f) MyTravel Group plc[40]

The investigation of MyTravel Group plc also took three years and resulted in a fine by the FSA, on 14 July 2005, of £240,000 for a breach of the Listing Rules in July 2002. Although the fine was imposed two weeks after the new regulatory regime was implemented on 1 July 2005, as discussed in Section 4 of this paper, the FSA noted that under paragraph 9.2 of the version of the Listing Rules that applied at the time of the breach, the company must update the market 'without delay'. In July 2002, MyTravel UK, a division of MyTravel, identified balance sheet exposures of £24.3 million, which had not been accounted for in the previous year's published accounts.

Following a change in its own expectation of its performance for the financial year ended 30 September 2002, MyTravel decided that no announcement needed to be made to the market, as it expected that these exposures would be offset by certain non-recurring gains to be made in the financial year 2002. Although the company's

[38] Financial Services Authority, 9 November 2005, 'FSA closes enquiries into Shell individuals', *Press Release* FSA/PN/118/2005.

[39] Financial Services Authority, 27 January 2005, 'Pace Micro Technology fined £450,000 for Listing Rule Breaches', *Press Release* FSA/PN/010/2005.

[40] Financial Services Authority, 14 July 2005, 'MyTravel fined £240,000 for Listing Rule Breach', *Press Release* FSA/PN/080/2005.

financial position was unknown to the market, the view was taken on or about 31 July 2002 by the chief executive and the financial director that the exposures would be off-set and no announcement needed to be made to the market. No professional advice on the matter was sought from the firm's external advisers or the regulators.

The FSA regards the disclosure obligation as a fundamental protection for shareholders and vital to the smooth operation of efficient, orderly and competitive markets. In spite of this, the FSA did not take any action against individual directors or executives as it accepted that they were not knowingly concerned in the contraventions. This illustrates that mitigating circumstances, such as the belief that the exposure could be offset, will be taken into account before exposing individuals to financial penalties.

<u>3.2.2 Financial Penalties for Market Abuse</u>

(a) Robert Middlemiss, Company Secretary of Profile Media Group[41]

On 10 February 2004, the FSA imposed a fine of £15,000 on Robert Middlemiss for market abuse.[42] He was company secretary of Profile Media Group, a company listed on the Alternative Investment Market sponsored by the LSE. The FSA stated that pursuant to FSMA s123, the Market Abuse Code applied to everyone and it would continue to pursue those who, on the basis of unpublished information, dealt in the company's shares ahead of the public announcement. Middlemiss was involved in assessing and forecasting the impact of changes in the group's trading figures and he avoided a personal loss of £7,000 by selling his own shares on 26 April 2002, before news of the company's poor performance was publicly announced.

This instance of insider trading by Middlemiss could have been precluded by more timely disclosure by the company of the unpublished inside information regarding its profit expectations. The financial penalty imposed on Middlemiss has been included in this sample because of the considerable overlap that now exists between the market abuse regime and the Listing Rules. The market abuse regime was introduced through the FSMA to apply to conduct from the 1 December 2001. Misuse of company information is one of the three types

[41] Financial Services Authority, 2004, *Annual Report 2003/04*, 21; Financial Services Authority, 10 February 2004, 'FSA Fines Individual £15,000', *Press Release* FSA/PN/013/2004.

[42] FSMA, Part VIII Penalties for Market Abuse, s123 Powers to impose penalties in cases of market abuse.

of behaviour[43] defined as market abuse for which the FSA can impose financial penalties. The action by FSA anticipates the revised listing regime of 1 July 2005 that places greater emphasis on the disclosure of 'inside information' (see 4.2.2 below).

3.2.3 Convictions for Misleading Market Statement

(a) Carl Rigby and (b) Gareth Bailey, former Directors of AIT Group plc[44]

In FSA's first criminal prosecution for the offence of market misconduct, three former directors of AIT Group plc appeared at the City of London Magistrates Court and were transferred to Southwark Crown Court for trial. The charges related to a misleading trading announcement that was made contrary to s397 of FSMA.[45] The requisite degree of intention or recklessness is necessary as the criminal standard of proof for s397 offences.

On 18 August 2005, in the case of *R v Rigby, Bailey and Rowley*,[46] the jury at Southwark Crown Court convicted former directors Carl Rigby and Gareth Bailey. Another director, Alistair Rowley, was acquitted. The directors recklessly issued a statement that was misleading, false and deceptive in that it stated that the company's turnover and profit were both in line with expectations. The forecasted profit depended on the inclusion of revenue from three contracts that 'did not exist'. Between 31 May 2002 and 13 June 2002 the share price fell from 492.5p to 38.5p. The directors did not announce a correction to the financial forecast and so failed to prevent the establishment of a false market in the company's securities.

Sentencing took place on 7 October 2005. Rigby, the former Chairman and Chief Executive, was sentenced to 3.5 years imprisonment and was disqualified from being a company director for 6 years. Bailey, the former Finance Director, received a sentence of 2 years imprisonment and was disqualified from taking up a directorship for 4 years.[47]

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[43] FSMA, Part VIII Penalties for Market Abuse, s118(2) outlines market abuse as behaviour that (a) is based on information which is not generally available, or (b) is likely to give a false or misleading impression of the market, or (c) would be likely to distort the market in investments.

[44] Financial Services Authority, 2004, *Annual Report 2003/04*, 21.

[45] FSMA, Part XXXVII Offences, s397 Misleading statements and practices.

[46] Financial Services Authority, 18 August 2005, 'FSA Secures Convictions in First Criminal Market Abuse Case', *Press Release* FSA/PN/ 091/2005.

[47] Financial Services Authority, 7 October 2005, 'Former Directors sentenced for Criminal Market Abuse', *Press Release* FSA/PN/106/2005.

In addition, at an asset confiscation hearing held on 11 November 2005, the Court ordered Rigby, whose assets were valued at £3 million, to pay £208,796 in compensation to investors, £381,273 by way of confiscation of assets and £250,000 by way of costs. The latter sum would have done little to defray the FSA's total costs for the investigation and litigation of £1.96 million. Bailey was ordered to pay £141,686 in compensation. The Court ordered that all private and institutional investors should be paid in full with the exception of one corporate pension scheme. In this instance it was ruled that the investment decision was not based on the misleading statements.[48] The element of reliance as a prerequisite for compensation had apparently not been proved.

*3.3 Summary of Analysis*

In passing sentence in the above case, His Honour, Judge Elwen, said:

> 'Every member of the public, having savings in direct investment on the stock market or by and through products themselves tied to stock markets, is injured if the integrity of the market is damaged by misleading information of this kind being announced to the market.'[49]

Judge Elwen could well have added that the lack of a correction to the misleading statement once it was made, was evidence of a failure by the directors to ensure that the company met its continuous disclosure obligations under Chapter 9 of the UKLA *Listing Rules* 2001 and the LSE *Admission and Disclosure Standards* 2001 that existed at that time (see 2.2 above). As directors, they also neglected their corporate governance responsibilities in not providing an explanation for non-compliance with the old 1998 Code Provision D.1.2, now replaced by C1 of the 2003 Combined Code (see 2.2.2 above). Based on this legislation, and the ensuing penalties, it is possible to frame responses to the research questions posed at 1.2:

- *What actual penalties have been imposed?*

The penalties documented above in Section 3 and in Appendix 1 provide the answer to the first research question with a review of the penalties that were actually applied by the FSA since 2000. These penalties illustrate FSA's growing confidence as its role as regulator was tested and its enforcement powers were expanded.

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[48] Financial Services Authority, 11 November 2005, 'Former AIT Directors ordered to compensate Investors', *Press Release* FSA/PN/120/2005.

[49] Financial Services Authority, 7 October 2005, 'Former Directors sentenced for Criminal Market Abuse', *Press Release* FSA/PN/106/2005.

- *What was the regulatory basis of the penalties?*

As a result of FSA's increasingly dominant role, and in answer to the second research question, we can see how the enforcement of penalties has changed over time. Underpinning all these changes is the legislative transformation that was discussed in detail in Section 2 of this paper.

From public statements of reprimand for breaches of the Listing Rules in 2001 (see Iceland Group plc and Marconi plc at 3.1.1 above), the FSA moved cautiously to exercise its full authority acquired under an amended FSMA from 1 December 2001. The first instances were only public censures under FSMA s91(3) applied to SFI Group and Sportsworld Media Group (see 3.1.2 above). From early 2004, the FSA moved to imposing financial penalties under ss91(1) and (2) in the six cases discussed at 3.2.1. All the above cases involved a breach of the Listing Rules resulting from a failure of continuous disclosure obligations.

Finally, the market abuse regime was also introduced from the 1 December 2001 and FSMA, Part VIII Penalties for Market Abuse, s123 was applied in the case of Robert Middlemiss and two years later to Shell Transport (see 3.2.2 and 3.2.1(d)). In 2005 the FSA was successful in its severest test to date when the Court imposed custodial sentences, disqualification of directors and asset confiscation following the convictions of Rigby and Bailey for misleading market conduct (see 3.2.3 above). This case is also evidence that the FSA is willing to exercise its full powers to apply for criminal penalties for breaches of the new Disclosure Rules that constitute an offence under FSMA s397 (see 4.2.2 below).

## 4. Implications of the UK Regulatory Changes post 2005

In passing sentence in the above case, His Honour, Judge Elwen, said:

> 'Every member of the public, having savings in direct investment on the stock market or by and through products themselves tied to stock markets, is injured if the integrity of the market is damaged by misleading information of this kind being announced to the market.'[50]

Judge Elwen could well have added that the lack of a correction to the misleading statement once it was made, was evidence of a failure by the directors to ensure that the company met its continuous disclosure obligations under Chapter 9 of the UKLA *Listing Rules* 2001 and the LSE *Admission and Disclosure Standards* 2001 that existed at that time (see 2.2 above). As

[50] Financial Services Authority 'Former Directors sentenced for Criminal Market Abuse' *Press Release* FSA/PN/106/2005, 7 October 2005.

directors, they also neglected their corporate governance responsibilities in not providing an explanation for non-compliance with the old 1998 Code Provision D.1.2, now replaced by C1 of the 2003 Combined Code (see 2.2.2 above).

The penalties documented in Section 3 and in Appendix 1 illustrate FSA's growing confidence as the regulator tested and expanded its enforcement powers. From public statements of reprimand for breaches of the Listing Rules in 2002 (see 3.1.1 above), the FSA moved to exercising its authority under FSMA and applying to the Court for custodial penalties following the convictions of Rigby and Bailey (see 3.3.2 above). This case is also evidence that the FSA is willing to exercise its full powers to apply for criminal penalties for breaches of the new Disclosure Rules (see 4.2.2 below).

The penalties, discussed in Section 3, were all related to contraventions of regulation committed prior to the 1 July 2005 and were the basis of the first two research questions raised at 1.2 above. It is now appropriate to address the final question, concerning the implications for continuous disclosure of the new regime, by way of the:

- Implications of the EU Directives for Continuous Disclosure
- Implications for UK Regulation post 1 July 2005
- Implications for Australian Regulation.

*4.1 Implications of EU Directives for Continuous Disclosure*

As first mentioned in Section 1, the regulatory changes effected in the UK from 1 July 2005, as a result of the implementation of the EU Directives, provide the motivation for this paper and an opportunity to address the question of the likely implications of these Directives.

The EU does not directly impose a regulatory system on the European stock exchanges. Instead, the relevant organisation, the European Commission (EC) will address Directives to Member States, including common law jurisdictions such as the UK and Ireland. It is the Commission that proposes a new regulatory measure. The Council of Ministers, representing the Member States, can then approve the proposal and enact the Directive.

The 1979 EEC Admissions Directive stated that:

> 'The company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the

> general course of its business, lead to substantial movements in the prices of its shares.'[51]

The UKLA Chapter 9 Continuing Obligations under the Listing Rules, discussed previously at 2.2, which replicated the Directive quoted above had the notation CARD Article 68 and 81 written alongside Listing Rule 9.1. This notation was a reference to the Consolidated Admissions and Reporting Directive (CARD)[52] of the European Parliament and the Council of Ministers. CARD was concerned with the admission of securities to official stock exchange listing and the information to be published on those securities.[53] New EU Directives have replaced most of CARD[54] with the Prospectus Directive[55] and the Market Abuse Directive[56]. The Commission adopted the two technical regulations required to implement the Prospectus and Market Abuse Directives in April 2004. The Prospectus Directive Regulation applied from 1 July 2005, which was also the deadline for Member States of the EU to implement the framework for the Directive.[57]

FSA undertook a major review of the listing regime to accommodate the impact of these Directives on UK company law and the European regulatory framework.[58] It then published its 'final Listing Rules and Prospectus Rules at the June board meeting…to come into effect on 1 July 2005'.[59]

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[51] European Commission 'The Admissions Directive of 5 March 1979: coordinating the conditions for the Admission of Securities to Official Stock Exchange Listing' *Directive* 79/279/EEC Annex Schedule C, 5(a) Additional Information.

[52] European Commission *Directive* 2001/34/EC. www.europa.eu.int

[53] UK Listing Authority *Sourcebook* February 2004 Amendment to Listing Rules, Definitions – Directives.

[54] Financial Services Authority 'Review of the Listing Regime' *Discussion Paper 14,* 30 July 2002 at 15.

[55] European Commission *Directive* 2003/71/EC.

[56] European Commission *Directive* 2004/39/EC.

[57] European Commission, Securities 'Commission Adopts Two Technical Measures to Implement the Prospectuses and Market Abuse Directives' *Press Release* IP/04/563, 29 April 2004.

[58] Financial Services Authority *Review of the Listing Regime* Update 21 March 2005.

[59] Financial Services Authority 'FSA Publishes Final Rules for New Listing Regime' *Press Release* FSA/PN/043/2005, 28 April 2005.

The FSA ‘Purple Book’ has gone and is now restructured into the Listing Rules, Prospectus Rules (reflecting the Prospectus Directive on primary listing) and Disclosure Rules (reflecting the requirements of the Market Abuse Directive).[60] The new Disclosure Rules closely follow the language of the Market Abuse Directive and, as a result, ‘the language and format of the Disclosure Rules are different from those of the Listing Rules’.[61] Whether this will clarify or further obscure the continuous disclosure requirement is a subject for future study.

### *4.2 Implications of UK Regulation post 1 July 2005*

Since 1 July 2005, a primary listed issuer of equity securities in the UK must consider the company’s continuous disclosure obligations in the three sets of Rules found in the *FSA Handbook* under ‘Listing, Prospectus and Disclosure’.[62] An issuer will be required to comply with the Listing Rules (LR 7,9,10,11,12,13), the continuing aspects of the Prospectus Rules (for example PR5.2 – Annual Information Update) and the Disclosure Rules (DR).[63] For continuous disclosure, the most relevant issues are the:

- FSA Listing Rules and Listing Principles
- FSA Listing Rules and Disclosure Rules
- LSE and EU Regulation.

#### 4.2.1 FSA Listing Rules and Listing Principles

Listing Rule LR 7.2 outlines the Listing Principles. The continuous disclosure requirement is found at LR 7.2.1R Principle 4, which states that a ‘listed company must communicate information to holders and potential holders of its listed equity securities in such a way as to avoid the creation or continuation of a false market in such listed equity securities’. FSA has limited the application of the Listing Principles to those issuers with a primary listing of equity securities as they are subject to greater obligations under the Listing Rules and the Disclosure Rules. It has recast the old Listing Principle 4 to now ‘create an overarching obligation on issuers to avoid the creation or continuance of a false market in their listed securities’.[64]

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[60] Ibid.

[61] Financial Services Authority ‘List!’ *UKLA Publications* Issue 9, June 2005 at 2.

[62] Financial Services Authority *FSA Handbook*, 1 July 2005.

[63] Financial Services Authority ‘The Listing Review and Prospectus Directive’ *Consultation Paper* 05/7, April 2005 at 28-29 (5.7).

[64] Financial Services Authority ‘The Listing Review and Implementation of the Prospectus Directive’ *Consultation Paper* 04/16, October 2004 at 25 (3.19, 3.20).

The FSA believes that Principle 4 should be pitched at a 'high level' to guide a corporation's thinking and decision-making in relation to its disclosure obligations and the information it releases to the market. In controlling the release of information to the market, it is important that issuers observe the 'spirit' of the rules, as well as the letter, and this obligation is more clearly expressed by the requirement for issuers to 'avoid the creation or continuation of a false market' in their listed securities. The principle is designed to ensure that issuers keep the market updated with accurate and timely information.

4.2.2 FSA Listing Rules and Disclosure Rules

Listing Rule LR 7.2 containing Listing Principle 4 is supported by Listing Rule 9, which includes the important cross-reference guide to the Disclosure Rules that incorporate the obligations of the Market Abuse Directive:

> LR 9.2.5G Compliance with the Disclosure Rules – a listed company, whose securities are admitted to trading on a regulated market in the United Kingdom, should consider its obligations under DR2 (Disclosure Rule 2).[65]

Any loopholes are closed by LR 9.2.6R relating to a listed company that is not already required to comply with DR 2 but must comply as if it were an issuer for the purposes of the disclosure rules. LR 9.2.7R and 9.2.8R deal with compliance with the Model Code regarding dealings in securities by directors, managers and employees.

The old Listing Rules aligned disclosure requirements with the actual securities listed in the UK. However, the Market Abuse Directive imposes a more general requirement for Disclosure of Inside Information (DR2)[66] relating to the issuer, even if that information would only have a significant price effect on securities listed outside the relevant Member State.

In implementing the Directive, FSA strove to minimise changes to the old regime under Chapter 9 of the Listing Rules but it is clear that the new statutory referral to the Disclosure Rules with the emphasis on 'inside information' differs from the old regime. Also, the Directive language, which deals with delaying disclosure and selective disclosure, is different from the old Listing Rules. DR2 applies to an issuer whose financial instruments are

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[65] Financial Services Authority *FSA Handbook*, 1 July 2005, Listing, Prospectus and Disclosure: Listing Rules. http://fsahandbook.info/FSA/index.jsp

[66] Financial Services Authority 'Implementation of the Market Abuse Directive' *Policy Statement* 05/3, March 2005 at 3.18, 3.22.

admitted, or for which a request for admission to trading has been made, on a regulated market in the UK. The purpose of Chapter 2 of the Disclosure Rules is to promote prompt and fair disclosure of relevant information to the market:

> DR 2.2.1R Requirement to disclose inside information – An issuer must notify a RIS [regulatory information service] as soon as possible of any inside information which directly concerns the issuer unless DR 2.5.1R applies;
>
> DR 2.5.1R Delaying disclosure – An issuer may, under its own responsibility delay the public disclosure of inside information such as not to prejudice its legitimate interests provided that such omission would not be likely to mislead the public; any person receiving the information owes the issuer a duty of confidentiality and the issuer can ensure the confidentiality of that information.
>
> DR 2.5.7G Selective disclosure may be made to another person… if there is a confidentiality obligation and the recipient has a valid reason to receive the information.[67]

<u>4.2.3 LSE and EU Regulation</u>

An additional consideration for the regulator is the role of the FSA Listing Rules in the event of a merger between the LSE and a European exchange. The FSA has said that it is indifferent to the nationality of ownership of an entity that it regulates and it has considered the possibility that a new owner may decide to operate the LSE from another EU Member State. All formal regulatory control would then be transferred from the FSA to the 'home' regulator of that Member State. This could alter the regulation of LSE's markets and the ability of FSA to enforce the UK listing regime and to pursue market abuse.[68] Continuous disclosure may suffer as a result, in spite of the 'over-arching requirement' under the EU Market Abuse Directive for Member States to 'ensure that issuers of financial instruments inform the public as soon as possible of inside information':[69]

A FSA submission on the possibility of a LSE merger states:

> 'Whilst the basic requirements within Europe are based on the EU Admissions Directive, there is perceived to be a degree of divergence in practice across Europe. The UK is viewed by investors as having more comprehensive and regular disclosure

[67] Financial Services Authority *FSA Handbook*, 1 July 2005, Listing, Prospectus and Disclosure: Disclosure Rules.

[68] Financial Services Authority *London Stock Exchange Mergers Enquiry* FSA Submission to the Competition Commission 12 May 2005 at 9-10.

[69] Commission of the European Communities *Proposal for a Directive of the European Parliament and of the Council on Insider Trading and Market Manipulation (Market Abuse)* 2001/0118(COD) Brussels 30 May 2001 Article 6.1 at 19.

than Continental Europe…The comparatively high incidence of disclosure in the UK market may also be attributable to the relative size and maturity of that market compared with those elsewhere in Continental Europe…the number of companies meriting analysts' research and the sophistication of the investor community drives greater demand for increased information disclosure.'[70]

## 5. Implications for Australian Regulation

*5.1 Continuous Disclosure Regulation*

Most of the Australian colonies passed legislation modelled on the English Companies Act of 1862.[71] Also, early evidence of Australian listing rules dates from the 1890s, as the stock exchange's listing application, to be completed by a company requesting quotation of its securities on the stock exchange, includes the condition that it must agree:

> '…to give prompt notification of all calls, dividends, alteration of capital, or other material information'.[72]

This established the principle that a listed company must release relevant information to the market on an ongoing basis. As such, it is an early forerunner of Australian Stock Exchange (ASX) listing rule 3.1.

The Companies and Securities Advisory Committee (CASAC) investigated the need for a statutory based regime of continuous disclosure in June 1991. This resulted in the report on Enhanced Statutory Disclosure[73] that proposed a number of reforms to legislation. Following these recommendations, the original continuous disclosure provision, s1001A, was introduced over a decade ago on 5 September 1994 to complement enhanced disclosure and reinforce ASX listing rule 3.1. From 15 July 2001, the *Corporations Act* 2001 (Cth) then replaced the *Corporations Law* that had been part of the National Scheme Laws. Both the statutory provision, s1001A of the *Corporations Act*, and the complementary listing rules have been amended and were subject to further alteration with the implementation of CLERP 9.[74] The revised listing rule 3.1, supported by the amended provision s674, requires listed companies

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[70] Financial Services Authority *London Stock Exchange Mergers Enquiry* FSA Submission to the Competition Commission 12 May 2005 Annex A: *Primary Market Comparative Regulation Study – Key Themes Report* by PriceWaterhouseCoopers April 2002 at 22.

[71] Australian Stock Exchange Limited. www.asx.com.au

[72] Salsbury S and K Sweeney *The Bull, the Bear and the Kangaroo: The History of the Sydney Stock Exchange* Sydney Allen & Unwin 1988 at 203.

[73] Companies and Securities Advisory Committee (CASAC) *Report on an Enhanced Statutory Disclosure System* Sydney September 1991 at 1. Hereafter referred to as CASAC (1991).

[74] *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act* 2004 : Schedule 6 Continuous Disclosure.

to notify ASX immediately if there is any information that 'a reasonable person would expect to have a material effect on the price or value' of the company's securities.

Under a much earlier version of listing rule 3A(1), companies had long been required to notify the stock exchange immediately of:

> '...any information concerning the company or its subsidiaries necessary to avoid the establishment of a false market in the company's securities or which would be likely to affect materially the price of those securities'.[75]

This obligation to avoid a 'false market' was reintroduced by ASX listing rule 3.1B from 1 January 2003. ASX addressed the 'confidentiality' carve-outs element of listing rule 3.1 by the insertion of 3.1A and restated the need to prevent a 'false market' in 3.1B. This amendment retains the 'carve-outs' or exclusions but modifies the listing rule to allow ASX to ask the entity to 'give ASX the information needed to correct or prevent a false market'.[76]

However, the responsibility lies with ASX to request the information under listing rule 3.1B. In contrast, the FSA places 'an overarching obligation on issuers'[77] as it stresses that it is important for issuers to observe the 'spirit' of the rules. The recast Principle 4 in FSA LR 7.2.1R, places the onus on the listed company, which 'must communicate information to holders and potential holders of listed equity securities in such a way as to avoid the creation or continuance of a false market' (see 4.2.1 above). Although compliance with the 'spirit' of the rules remains implicit in the wording of ASX listing rule 3.1, it is stated explicitly in listing rule 19.2 that:

> An entity must comply with the listing rules as 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 the listing rules are based.[78]

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[75] Redmond P *Companies and Securities Law* Sydney Law Book Company 1st ed 1988 at 604; R Bruce, B McKern, I Pollard and M Skully eds *Handbook of Australian Corporate Finance* Sydney Butterworths 4th ed 1991 at 482. Also, Australian Stock Exchange Limited 'Proposed ASX Listing Rule Amendments Enhanced Disclosure' *Exposure Draft* July 2002 at 55.

[76] Australian Stock Exchange Limited 'Proposed ASX Listing Rule Amendments Enhanced Disclosure' *Exposure Draft* 19 July 2002 1-130 at 45 and 49, Section 2 Continuous Disclosure 2.16, 3.1A.2; *ASX Listing Rules* 3.1, 3.1A and 3.1B, 1 January 2003

[77] Financial Services Authority 'The Listing Review and Implementation of the Prospectus Directive' *Consultation Paper* 04/16, October 2004 at 25 (3.19, 3.20).

[78] *ASX Listing Rules* Chapter 19 Interpretation and Definitions introduced 1 July 1996, issued January 2003.

ASX links the above mandate specifically with the requirements of listing rule 3.1 by repeating rule 19.2 in the guidance notes for continuous disclosure. This reinforces the demand that listing rule 3.1 should not be interpreted in a restrictive or legalistic manner but the company must comply with in the 'spirit' of continuous disclosure:[79]

> 'The spirit of disclosure, of keeping the market fully informed of material information, runs through all of ASX's Listing Rules...it is the key to market integrity.'[80]

*5.2 Continuous Disclosure and Insider Trading*

The drafting similarities between the insider trading and the continuous disclosure provisions are not coincidental. The two provisions reveal both sides of the one issue; non-disclosure can result in insider trading, while full and timely disclosure is designed to eliminate insider trading. A legislative connection between the prescription to disclose material information and the prohibition on insider trading was initially recognised as 'prohibited conduct' with the proximity of the former s1001A to s1002G. The focus was redirected in the amended legislation, if not in practice, by the repositioning of continuous disclosure in a separate chapter adjacent to prospectus disclosure. It was probably anticipated that compensation for this amendment would be greater emphasis on the disclosure obligation in both these contexts.

This repositioning may have come at the expense of the warning that could be conveyed when continuous disclosure was previously associated with other forms of 'prohibited conduct' in Chapter 7 of the *Corporations Act*. The nexus between these two concepts is less apparent since the amendments of the *Financial Services Reform Act* 2001 (Cth) separated the two provisions, with continuous disclosure at s674 and insider trading at s1043A.

The *Financial Services Reform Act* commenced on 11 March 2002.[81] This legislation amended the *Corporations Act* by transferring the continuous disclosure provision from its former position in Chapter 7, Part 7.11 Division 2 on Prohibited Conduct, to a new Chapter

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[79] Ibid, Guidance Note on Continuous Disclosure par 26 issued 1 July 1996, replaced by Guidance Note 8 par 30 issued September 2001. Compliance with the 'spirit' of continuous disclosure now receives greater prominence under the heading *Continuous Disclosure - Best Practice* in par 10 issued January 2003.

[80] Australian Stock Exchange Limited *Continuous Disclosure–The Australian Experience* 20 February 2002, 4.

[81] Australian Securities and Investments Commission 'What is the FSRA?' *ASIC Policy and Practitioners* Financial Services Reform 8 October 2001; 'Supplement to Building the FSRB Administrative Framework (April 2001)' 11 September 2001 at 3; *ASIC Media Release* 01/418 28 November 2001.

6CA[82] that is placed before Chapter 6D on Fundraising and its associated disclosure documents.

In contrast, the FSA in the now restructured Listing Rules and Disclosure Rules (see 4.2.2 above) has more closely drawn together the prescription to disclose and the prohibition on insider trading by using the 'the language and format' of the Market Abuse Directive.[83] FSA Listing Rule 9, no longer contains the continuous disclosure obligation but refers a company listed on a UK regulated market to 'consider its obligations under Disclosure Rule 2'.[84] FSA DR 2.2.1R requires the issuer to disclose inside information that directly concerns the company as soon as possible but there is no longer a reference to the 'price sensitive information' test (see 2.2 above). DR2.8 also mandates that the listed company must maintain lists of those with such inside information.

The equivalent ASX listing rule 3.1 still retains the price sensitive test in reference to information that would have a material effect on the 'price or value' of the securities. The ASX listing rule 3.1A exemptions or 'carve-outs' to the disclosure rule are simplified in a similar FSA DR 2.5.1R on a company delaying disclosure to not 'prejudice its legitimate interests'.

### *5.3 Continuous Disclosure Penalties*

#### 5.3.1 Statutory Penalties

Intentional or reckless contravention of the continuous disclosure rule by a listed disclosing entity could be deemed an offence.[85] For a failure to disclose, the company could incur primary liability and a corporate penalty under s1312. The general statutory penalty provision, s1311, and Schedule 3 of the *Corporations Act* provide for a fine and imprisonment for up to five years for such an offence.[86] Section 11.2 of the *Criminal Code*[87] extends this

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[82] Financial Services Reform Bill 2001, Schedule 2 Continuous Disclosure at 558.

[83] Financial Services Authority, June 2005, 'List!', *UKLA Publications*, Issue 9: 2.

[84] Financial Services Authority *FSA Handbook*, 1 July 2005, Listing, Prospectus and Disclosure: Listing Rules LR 9.2.5G. http://fsahandbook.info/FSA/index.jsp

[85] Section 674(2) Note 1: Offence see s1311(1).

[86] Schedule 3 Penalties: 200 penalty units or imprisonment for five years or both. Section 1311(1A)(da), (1A)(db) applies Schedule 3 penalties to Chapter 6CA Continuous Disclosure and Chapter 7 Financial Services and Markets. Penalties for bodies corporate are five times the maximum pecuniary penalty for that offence (s1312). A penalty unit is $110 (s4AA(1) of the *Crimes Act* 1914 (Cth)).

criminal liability to any person who was directly or indirectly knowingly concerned with the offence.

Potential criminal liability under the statutory provision is balanced by the insertion of 'carve-outs' or exclusions in ASX listing rule 3.1A. However, the difficulty of successfully mounting a criminal prosecution suggests that the deterrent effect of criminal penalties has been largely wasted and the regulator has been constricted by the criminal standard of proof required for prosecution. In the UK, the FSA has only just achieved its first criminal prosecution for the offence of market misconduct, linked to a failure of disclosure. The charges related to a misleading trading announcement that was made contrary to s397 of FSMA.[88] A similar action, in Australia would more likely be taken under the *Corporations Act*, Part 7.10 Market Misconduct rather than s674.

5.3.2 Civil Penalties

The *Financial Services Reform Act* amended the provisions of the *Corporations Act* to extend the civil penalty regime to s674(2) Note 2,[89] which nominates the subsection as a civil penalty provision. It was anticipated that expansion of the civil penalty regime,[90] with its more attainable civil standard of proof, would be a greater deterrent to non-disclosure.

(a) Southcorp Limited

These new powers were used in the regulator's action against Southcorp Limited. On 26 February 2003, the Australian Securities and Investments Commission (ASIC) filed proceedings in the Federal Court alleging a breach by Southcorp Limited of its continuous disclosure obligations under the ASX Listing Rules and s674 of the *Corporations Act*. The breach concerned selective disclosure to analysts of information relevant to the company's forecast earnings. Chairman of ASIC, David Knott, pointed out that:

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[87] Section 5 of the *Crimes Act* was repealed from the commencement of the *Criminal Code Amendment (Application) Act* 2000 (Cth) on 15 December 2001.[87] The elements of s5 are replicated in s11.2 of the *Criminal Code*.

[88] FSMA, Part XXXVII Offences, s397 Misleading statements and practices.

[89] Financial Services Reform Bill 2001, note 21, Schedule 2 Continuous Disclosure at 558 line 26; Note 2: s1317E Civil penalty provisions apply.

[90] Civil penalties were unavailable under s1001A but the amended continuous disclosure provision, s674(2), is a civil penalty provision under the extended s1317E(1)(ja). Civil penalties replace s1041I civil liability and provide an alternative to criminal liability and Schedule 3 penalties. Section 1317E was amended effective 11 March 2002.

> 'This is the first case of its type commenced by ASIC and will test the operation of both the ASX listing rules and the relevant provisions of the *Corporations Act*.'[91]

ASIC sought a Court declaration and pecuniary penalty of $200,000 under ss1317E and 1317G of the Corporations Act. These civil penalty provisions had only applied to a breach of the continuous disclosure obligation since 11 March 2002, approximately a month prior to the occasion of Southcorp's selective disclosure on 18 April 2002. The case was settled on 27 November 2003 when the Federal Court ordered Southcorp to pay a pecuniary penalty of $100,000 plus ASIC's costs.[92]

5.3.3 Infringement Notices and Penalties

The regulator believed that the Southcorp case focused attention on the need for a 'more streamlined process for dealing with disclosure matters.'[93] This was achieved by granting ASIC the power to impose administrative penalties. Such amendments were proposed in the Government's CLERP 9 agenda and commenced on 1 July 2004.[94] The continuous disclosure provision was now followed by Note 3, which stated that an infringement notice could be issued under s1317DAC for an alleged contravention of s674(2). The infringement notice and penalty was provided for in Chapter 9.4AA. ASIC had attained the right, similar to that of the UK regulator, to impose fines on companies for market offences.[95] Through s674(2A), and in a similar fashion to FSMA s91(2) in the UK, the penalty could include a person involved in the infringement.

(a) Solbec Pharmaceuticals Limited

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[91] *ASIC Media Release* 03/070 26 February 2003: *ASIC News* Issue 58 March 2003 at 1.

[92] *ASIC Media Release* 'Southcorp Settles with ASIC over Market Disclosure' 03/376 27 November 2003. *Australian Securities and Investments Commission v Southcorp Limited* (No 2) [2003] FCA 1369 (27 November 2003). http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/federal%5fct/2003/1369.html?query=southcorp

[93] *ASIC Media Release* 03/070 26 February 2003.

[94] CLERP 9 '*Corporate Disclosure: Strengthening the Financial Reporting Framework*' Commonwealth of Australia, The Treasury, Canberra 18 September 2002 1-194 at 147-149; Australian Securities and Investments Commission 'Submission on CLERP 9 *Corporate Disclosure: Strengthening the Financial Reporting Framework*' November 2002 1-51 Proposal 22 at 34; *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act* 2004 : Schedule 6 Continuous Disclosure.

[95] *ASIC Media Release* 01/283 13 August 2001; Knott D 'Launch of the Australasian Investor Relations Association' Speech by the Chairman, ASIC 13 August 2001 at 3 and 4; CLERP 9 above at 147; UK Listing Authority *Listing Rules* 1 December 2001 Chapter 1 pars 1.8, 1.9; *Financial Services and Markets Act* 2000 (UK) ss123(1)(a), 123(1)(b).

This power was exercised for the first time when ASIC issued a notice to Solbec Pharmaceuticals Limited (Solbec)[96] for the company's breach of s674(2) on 23 November 2004. Solbeck failed to notify the ASX about the structure, size and limited nature of the results of an animal study relating to its cancer drug. Solbec elected to comply with the notice and on 1 August 2005 it paid a $33,000 penalty to comply with the infringement notice. As provided under s1317DAJ(3)(b), compliance with the notice was not an admission of guilt or civil or criminal liability, and Solbec was not regarded as having contravened s674(2) of the Act.

**6. Implications of the Research for Agency Costs**

*6.1 Research Findings*

A summary of the analysis (see 3.3 above and Appendix 1) of the UK penalties imposed for contraventions of the Listing Rules demonstrate that the FSA will use the full range of penalties allocated to it under the legislation. The imposition of the penalties to date has been focused and, on occasion, liability has been apportioned between the company and the individual. A failure of continuous disclosure, in the broader sense, can invoke the penalties for insider trading and misleading the market (see 3.2.2 and 3.2.3 above). The full implementation of the Market Abuse Directive has meant that the FSA has adopted 'disclosure of insider information' as the primary obligation in overcoming information asymmetry and improving communications between the 'agent' and the stakeholder.

From 1 December 2001, the FSA had access to the wider range of listing rule and market abuse penalties under FSMA ss91 and 123. In the Sportsworld Media case, this flexibility enabled the regulator for the first time to financially penalise the person 'knowingly concerned', the Chief Executive Geoffrey Brown, rather than the company (see 3.1.2(b) and 3.2.1(a)). The FSA still chose to censure the company as an indicator that it did not think that the board of Sportsworld Media was entirely without liability. In the subsequent case of Universal Salvage, the FSA chose to apportion the financial liability to both the board of the company and the Chief Executive, Martin Hynes (see 3.2.1(b) and (c)).

In the three most recent instances, the financial penalties were directed at the companies; Shell Transport, Pace Micro Technology and MyTravel Group (see 3.2.1 (d), (e) and (f)). In Shell Transport the additional market abuse penalties under s123 were also invoked because of the detrimental effect to the market of the non-disclosure. The investigation into the role of

[96] *ASIC Media Release* 05-223 'ASIC Issues First Infringement Notice for Continuous Disclosure Breach' 1 August 2005.

individuals concerned in the breach was only discontinued a year after the penalty was imposed, presumably for lack of evidence. We can assume that it was for the same reason that no individual penalties were imposed in the latter two cases, even after three-year investigations in both instances

In the Australian context, ASIC has considered the disclosing entity to be the proper subject for the financial penalty, by implication placing the responsibility for information asymmetry on the board and management as a whole. This apportions the financial and reputation costs to the company and would increase the difficulty of raising additional funds – a significant agency cost.

*6.2 Future Research*

It is not the purpose of this paper to discuss the penalties or enforcement procedures for continuous disclosure failure in jurisdictions outside the UK. But, as has been discussed above, the Market Abuse Directive has meant that the FSA has adopted the 'disclosure of insider information' as the main continuous disclosure obligation, even though now it is included in separate Disclosure Rules cross-referenced from the Listing Rules.

It will be left to a later study to evaluate the pattern of penalties that emerges from this new regime but it is clear from the previous UK enforcement precedent that the FSA is prepared to impose financial penalties on both the company and the individual associated with the breach and, where required, apply for criminal penalties. A later study could also investigate the ongoing implications of EU Directives for disclosure on the stock markets of non-Member States, for example, stock market regulation in Australian, which shares a common law tradition with the UK but is not a Member State of the EU. Australia has, to date, largely followed the UK model of regulation with some notable differences.

In the Report[97] submitted prior to these CLERP 9 amendments, the Parliamentary Committee recommended that CAMAC review the operation of the infringement notice provisions two years after they came into force. Further, it recommended that in light of comments suggesting that ASIC is not fully or effectively using its current powers to enforce the continuous disclosure provisions, that the review take a broader approach and examine the effectiveness of the enforcement regime for continuous disclosure as a whole including the

[97] Parliamentary Joint Committee on Corporations and Financial Services 'Senator Chapman Tables Part 1 of Report on CLERP 9' *Media Release* 4 June 2004 at 14: Recommendation 17 (6.112) and Recommendation 18 (6.134).

criminal and civil provisions. Even with the full arsenal of deterrents, information asymmetry is still apparent in the Australian stock market and ASX's attitude is:

> 'While there is a case for ASIC to have increased powers to enforce the regime of continuous disclosure, it is equally true that a successful system requires the creation not of a 'culture of compliance' on the part of listed companies, but a 'culture of disclosure'. [98]

*6.3 Future Regulation*

Disclosure regulation is dynamic and the ongoing adoption of further EU Directives will alter the enforcement pattern. The Transparency Directive[99] came into force on 20 January 2005 and, as there is a two-year implementation period, the deadline for its introduction will be 20 January 2007. The implementation of the Transparency Directive in the UK will require further substantial revisions of the FSA Listing Rules, particularly Chapter 9, which sets out some of the issuer's Continuing Obligations relating to financial reporting.[100] These changes are likely to increase the focus on continuous corporate disclosure, as well as extended periodic and special incident disclosure, that should be the responsibility of all directors and senior officers, whether the obligations are outlined in EU Directives, Listing Rules, Disclosure Rules or Codes of Corporate Governance.

Increased periodic reporting is now being used by ASIC and ASX almost as a penalty for a company's failure to comply with continuous disclosure obligations.[101] Full and timely continuous disclosure is always preferable to the more structured and delayed disclosure available in periodic reports. Quarterly reporting could be an effective, if unwelcome, control in reducing the amount of time during which the market remains uninformed. There are also quarterly reporting requirements for companies with mining production and exploration activities.[102]

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[98] Australian Stock Exchange Limited *Continuous Disclosure – The Australian Experience* 20 February 2002 at 1.

[99] Financial Services Authority 'Transparency Directive' Update 22 March 2005 at 1-2.

[100] Financial Services Authority 'The Listing Review and Implementation of the Prospectus Directive' *Consultation Paper* 04/16, October 2004 at 7.

[101] *ASIC Media Release* 98/277 11 September 1998 and 98/343 12 November 1998: Crown Casino agreed to report quarterly.

[102] ASX listing rule 5.1-5.3 states that a mining company must complete a report and give it to ASX within one month after the end of each quarter of its financial year.

Companies may defer releasing information that is discovered in the course of preparing structured disclosure documents until the time of finalisation of those documents. ASX and ASIC have actively promoted awareness about the need for listed companies to be mindful that such deferral is inappropriate if the information is material.

> 'One of the main tensions in administering a continuous disclosure regime is educating companies about the relationship between continuous and 'structured' or periodic disclosure.'[103]

*6.4 Concluding Comment*

However, it does appear for the present, in spite of the severity of some of the recent penalties in the UK that the FSA wishes to foster an environment of compliance to reduce information asymmetry, while still retaining a range of penalties and avenues of legal action:

> 'Where a breach of listing rules occurs, we have the power to issue a public censure or levy a financial penalty. Enforcement action is only one tool that we have to influence market behaviour. Where less serious breaches of listing rules have occurred, we have dealt with these by issuing a warning letter to the company concerned. We have also contacted listed companies where no breaches of listing rules have occurred, but where we thought that behaviour could be improved.'[104]

[103] Australian Stock Exchange Limited *Continuous Disclosure–The Australian Experience* 20 February 2002, 4.1.

[104] Financial Services Authority *Annual Report 2004/05* Section 1 at 24.

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**Appendix 1: Instances of Penalties Imposed for Contravention of Continuous Disclosure Rule**

| | Penalty Imposed Company/ Individual | Date Breach | Date Final | How Penalty Applied | Legislation | Choice |
|---|---|---|---|---|---|---|
| | ***United Kingdom*** | | | | | |
| *3.1* | **Non-financial Penalties against Corporation** | | | | | |
| *3.1.1* | Public Statement of Contraventions by Corporations | | | | | |
| *(a)* | Iceland Group plc | 02/01/2001 | 26/04/2002 | Public statement | FSMA 1/5/2000 | 1 |
| *(b)* | Marconi plc | 04/07/2001 | 11/04/2003 | Public statement | FSMA 1/5/2000 | 1 |
| *3.1.2* | Censures for Breaches by Corporations | | | | | |
| *(a)* | SFI Group plc | 30/07/2002 | 12/12/2003 | Company censure | FSMA 1/12/2001 | 2 |
| *(b)* | Sportsworld Media Goup plc | 24/12/2001 | 29/03/2004 | Company censure | FSMA 1/12/2001 | 2 |
| *3.2* | *Penalties against Corporation/Individual* | | | | | |
| *3.2.1* | Financial Penalties for Listing Rule Breaches | | | | | |
| *(a)* | Geoffrey Brown | 24/12/2001 | 29/03/2004 | Fine £45,000/individual | FSMA 1/12/2001 | 2 |
| *(b)* | Universal Salvage | 16/04/2002 | 19/05/2004 | Fine £90,000/company | FSMA 1/12/2001 | 2 |
| *(c)* | Martin Hynes | 16/04/2002 | 19/05/2004 | Fine £10,000/individual | FSMA 1/12/2001 | 2 |
| *(d)* | Shell Transport* | 19/04/2004 | 24/08/2004 | Fine £17 million/company | FSMA ss91, 123 | 2, 3 |
| *(e)* | Pace Micro Technology plc | 05/03/2002 | 26/01/2005 | Fine £450,000/company | FSMA 1/12/2001 | 2 |
| *(f)* | My Travel Group plc | 31/07/2002 | 14/07/2005 | Fine £240,000/company | FSMA 1/12/2001 | 2 |
| *3.2.2* | Financial Penalties for Market Abuse | | | | | |
| *(a)* | Robert Middlemiss* | 26/04/2002 | 10/02/2004 | Fine £15,000/individual | FSMA s123 | 3 |
| *3.2.3* | Convictions for Misleading Market Statement | | | | | |
| *(a)* | Carl Rigby* | 13/06/2002 | 18/08/2005 | Custodial penalty | FSMA s397 | 4 |
| *(b)* | Gareth Bailey* | 13/06/2002 | 18/08/2005 | Custodial penalty | FSMA s397 | 4 |
| | ***Australia*** | | | | | |
| *5.3* | **Continuous Disclosure Penalties** | | | | | |
| *5.3.2* | Civil Penalties | | | | | |
| *(a)* | Southcorp Ltd | 18/04/2002 | 27/11/2003 | Fine \$100,000/company | s674(2)Note 2 | 5 |
| *5.3.3* | Infringement Notices/Penalties | | | | | |
| *(a)* | Solbec Pharmaceuticals Ltd | 23/11/2004 | 01/08/2005 | Fine \$33,000/company | s674(2)Note 3 | 5 |

*Note:*
1. FSA 1986 private/public censure of issuer or suspend or cancel listing
2. FSMA s91 Penalties for breach of Listing Rules, censure, fine of issuer/individual
3. FSMA s123 Powers to impose penalties in cases of market abuse
4. FSMA s397 Misleading statements and practices
5. Corporations Act s674 Continuous Disclosure