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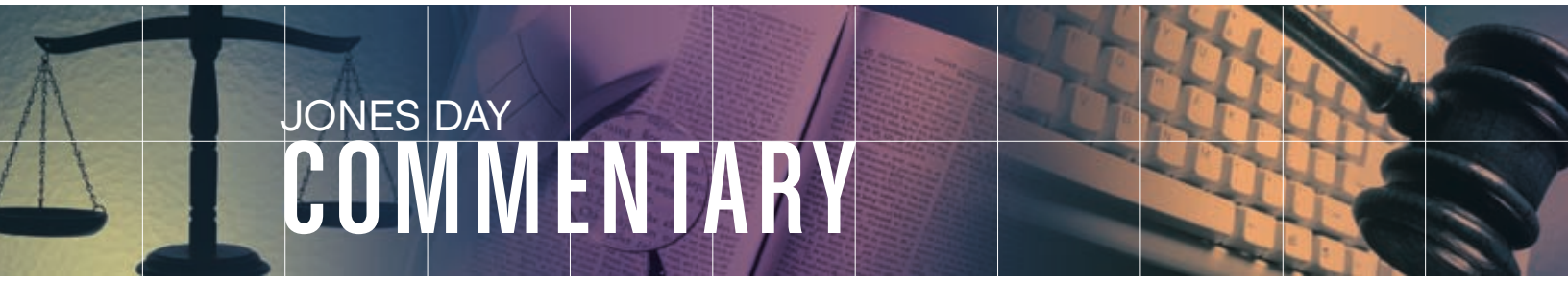

RECENT AUSTRALIAN CONTINUOUS DISCLOSURE DEVELOPMENTS

Further light is gradually being shed on the approach of the Australian Securities & Investments Commission ("ASIC") to enforcing the continuous disclosure laws and on the judicial view of factors that are relevant to imposing civil penalties for breaches of the laws. While ASIC has recently launched legal proceedings against several individuals and companies it alleges have engaged in serious contraventions of the continuous disclosure laws, these cases must still proceed to hearing. In the meantime, most of the recent developments in relation to Australia's continuous disclosure laws have occurred as a result of ASIC's use of its relatively new civil penalty powers for contraventions of the law.

LAW IN RELATION TO CONTINUOUS DISCLOSURE

The Australian Stock Exchange ("ASX") Listing Rules require a listed entity to immediately inform ASX once it is aware of any information concerning itself that could be reasonably expected to have a material effect on the price or value of the entity's securities.[1] This Listing Rules requirement is supported by the Corporations Act, which makes it an offense for an ASX-listed entity not to notify ASX of any information it has that is not generally available or, if generally available, could be reasonably expected to have a material effect on the price or value of the entity's securities.[2]

1. Listing Rule 3.1.
2. Section 674(2).

Since the changes proposed by the ninth Corporate Law Economic Reform Program ("CLERP 9") came into force in July 2004, ASIC has had the power to issue infringement notices to listed entities that it reasonably believes have contravened the continuous disclosure laws.[3] An infringement notice allows ASIC to impose a fine on an entity (based on a tiered level of market capitalization) for an alleged contravention of the continuous disclosure laws within 12 months of the contravention occurring. The entity against which an infringement notice is issued can then choose—without any admission of liability—to comply with the infringement notice by paying the fine or to refute it, in which case ASIC may then bring civil proceedings against the entity in relation to the contravention seeking a declaration of the contravention and a pecuniary penalty order.

The introduction of the infringement notice mechanism was intended to supplement existing criminal and civil court procedures already available to ASIC for breaches of the continuous disclosure laws and to provide ASIC with a "fast and effective remedy" for continuous disclosure breaches so that regulatory redress was "proportionate and proximate to the alleged breach."[4]

THE ENFORCEMENT RECORD ON CIVIL FINES

Notwithstanding the rush of publicity that surrounded the introduction of ASIC's power to fine companies for breaches of the continuous disclosure laws, the Commission has used its powers sparingly thus far and limited itself to targeting small-cap companies. This is consistent with a somewhat forgotten purposive statement in the explanatory memorandum that accompanied the CLERP 9 changes, in which the legislature made clear that the civil penalty powers would be used in relation to "relatively minor" and "less serious" contraventions of the continuous disclosure laws that would otherwise not be pursued through the courts.[5]

Interestingly, ASIC has not yet announced that it has issued any infringement notices that relate to the nondisclosure or inaccurate disclosure of material changes to a company's financial performance (such as may result from a surprise profit downgrade). It is impossible to tell whether this is because ASIC considers these kinds of continuous disclosure contraventions unsuited to the issue of civil penalty notices, to be pursued instead through formal legal proceedings, or because there is already a general high level of compliance with the continuous disclosure laws in respect of updating the market regarding changes in a company's financial position. Instead, ASIC has chosen to focus on issuing infringement notices in respect of a range of disclosures and nondisclosures to the market about issues as diverse as construction costs, intellectual property value, and underwriting arrangements for capital raisings. In some of these cases, ASIC has challenged the factual accuracy of statements made by listed entities to ASX, while in others, it has alleged that disclosure to the market should have occurred but did not.

BACKGROUND TO THE *CHEMEQ* CASE

Since 2004, ASIC has issued only three infringement notices. ASIC's most recent infringement notice was issued against Chemeq Ltd ("Chemeq") in respect of two breaches of the continuous disclosure rules. The *Chemeq* case is notable for two reasons: not only did it result in the largest fine ever paid in response to an infringement notice, but it also led to a judicial decision that provides further guidance on the factors that will be taken into account by courts in determining civil penalties for breaches of the continuous disclosure laws that are the subject of an infringement notice.[6]

Chemeq is an ASX-listed company that owns intellectual property associated with an antimicrobial product which could be developed as an alternative to antibiotics used to treat infections in livestock and which could be used for other possible applications including sunscreens, cosmetics preservatives, and human pharmaceuticals.

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3. Section 1317DAC(1), Corporations Act.
4. ASIC Guide, "Continuous disclosure obligations: infringement notices," May 2004, para. 6, page 4.
5. Paragraphs 5.457 and 5.458, CLERP 9 Explanatory Memorandum.
6. *Australian Securities & Investments Commission v Chemeq Limited* [2006] FCA 936.

In 2002, Chemeq informed the market—through an ASX announcement—that following a capital raising, it had begun construction of a manufacturing plant that was needed to produce commercial quantities of the product it was developing. Market announcements made by Chemeq in 2003 anticipated the construction cost of the plant to be A$25 million. However, by year-end, the company's board of directors was aware that the anticipated plant-construction cost had materially increased. ASIC alleged that the company had failed to inform ASX of the increase in the anticipated construction cost.

2003 was also significant for Chemeq because it made an announcement to ASX towards the end of the year that it had received approval for a U.S. patent for antimicrobials. This was followed by an announcement in 2004 that stated the grant of the U.S. patent meant that it kept competitors from manufacturing or marketing polymeric antimicrobials in the U.S. market. The granting of the patent was given prominence in other documents issued by Chemeq throughout 2004, including a prospectus for a nonrenounceable rights issue, and in a press story that attributed certain statements to Chemeq. ASIC alleged that Chemeq's management knew at the time of the ASX release that the patent was not material to the company's commercial position because it protected only a particular method of formulating the antimicrobial product being developed by Chemeq, rather than the product itself.

ASIC brought legal proceedings seeking declarations and penalties against Chemeq, alleging that it had contravened the continuous disclosure laws by failing to disclose to ASX information about the cost overruns on the construction of the plant and by failing to disclose that the U.S. patent it had been granted had no commercial significance—information material to the price of the company's shares. Chemeq subsequently admitted the contraventions of the continuous disclosure laws. The issue for the court then became approving the civil penalties proposed by ASIC for the contraventions.

RELEVANCE OF CORPORATE CULTURE TO THE DETERMINATION OF PENALTIES

In line with other relevant decisions, the court confirmed that the character of the pecuniary penalties in the Corporations Act—including those that apply to the continuous disclosure laws—is punitive and that the object of the penalties is both general (in the sense of deterring those who may be tempted not to comply with the law) and specific (in terms of deterring the particular contravener who might be tempted to reoffend). Relevant to the issue of specific deterrence is the question, not so much of intention or recklessness, but of whether the contravening company's conduct was deliberate and therefore increased the risk of the company reoffending. The court said that when a company takes a calculated risk by intentionally or recklessly failing to disclose material information to the market, it could be inferred that there was a corporate culture that encouraged, tolerated, or permitted decision making that weighed the benefit of noncompliance against the risk of noncompliance being detected. Where there was deliberate conduct, the risk associated with reoffending would be considered high by a court, and accordingly a higher penalty should be set for the contravention than would otherwise be the case.

In assessing whether a company had an effective corporate culture of compliance, the court noted that what was important was not only the form and content of relevant policies and procedures, but also the measures the company adopted to ensure that they were understood and applied. These measures include the company's approach to ensuring that officers and directors are provided with training in respect of applicable continuous disclosure policies and procedures, as well as with refresher training.

Given that the continuous disclosure obligations could be triggered not only by the occurrence of a new event, but also by a shift in circumstances (such as was the case with the construction cost overruns on Chemeq's plant), the

court noted that to ensure that the risk of nondisclosure by oversight was minimized, it was important that a company's continuous disclosure policies and procedures allowed for a monitoring system whereby changes in circumstances or information that had already been released to the market could be re-assessed. This would then allow the company to determine whether any changes in the base information already announced to the market triggered the need for further disclosures under the continuous disclosure laws.

For companies already familiar with the governance requirements in respect of continuous disclosure that apply to listed companies under the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations* ("Corporate Governance Principles"), there is little that should be surprising in these judicial comments. Recommendation 5.1 of the Corporate Governance Principles already requires listed companies to establish written policies and procedures designed to ensure compliance with the continuous disclosure requirements in the Listing Rules and to ensure accountability at a senior-management level for that compliance. The Corporate Governance Principles also suggest that companies should implement policies and procedures designed to ensure compliance with the continuous disclosure laws, which address, among other things, promoting understanding of compliance with the continuous disclosure rules and monitoring compliance.

OTHER RELEVANT FACTORS

The court identified 13 other factors that should be taken into account in determining a penalty for breach of the continuous disclosure rules. The more important factors were:

Extent to Which the Information Not Disclosed Could Be Expected to and (If Applicable) Did Affect the Price of the Contravening Company's Shares. In Chemeq's case, the court found that the information about the plant-construction cost overruns would have been expected to significantly affect the price of Chemeq's shares. In relation to the overstatement of the significance of the U.S. patent, the court noted that Chemeq accepted that some trading in its shares may have occurred as a result of its failure to correctly inform the market of the significance of the patent.

Extent to Which the Information, if Not Generally Available, Would Have Been Discoverable by a Third Party. The court found that information about the plant-construction cost overrun was not readily discoverable upon inquiry by a third party or by the type of small investors who made up the majority of Chemeq's shareholders.

Extent (if Any) to Which Acquirers or Disposers of the Company's Shares Were Prejudiced by the Nondisclosure. Even though the court was not satisfied that the risk could be quantified, it concluded that there was a "reasonable risk" that acquirers of the company's shares were materially prejudiced by the nondisclosure.

Extent to Which (if at All) the Contravention Was the Result of Deliberate or Reckless Conduct by the Corporation. The court found that although the contravention was not the result of deliberate or reckless conduct by Chemeq, the contravention had been brought about by something more than mere carelessness. The court concluded that the plant-construction cost overruns had been known to the directors throughout the relevant period, but it had not occurred to the directors that this was something that required disclosure.

Existence Within the Company of Compliance Systems Relating to Its Disclosure Obligations, Including the Provision for Education and Internal Enforcement of Such Systems. The court examined Chemeq's compliance systems and found that it had no systems in place—at the time the offense occurred—that related to compliance with the continuous disclosure laws. However, the court also took into account expert evidence about compliance systems that the company had subsequently put in place to ensure compliance with the continuous disclosure laws, and it found these to be representative of a new level of commitment by the company to meet its continuous disclosure obligations.

Changes in the Composition of the Board or Senior Managers Since the Contravention. The court noted that there had been significant changes in the composition of the board of directors and executive management of Chemeq since the period in which the continuous disclosure contraventions took place.

LOOKING FOR A TREND

Is it too early to discern a trend in how ASIC has chosen to exercise its continuous disclosure civil penalty powers? Probably yes, although ASIC does appear to be using the powers in line with the legislative intent that they be reserved for less serious contraventions of the continuous disclosure laws. Until further infringement notices are issued, and some of the legal proceedings that ASIC currently has underway in relation to more substantive allegations of continuous disclosure contraventions find their way through the judicial process, the full picture on how Australia's continuous disclosure laws are developing will remain incomplete.

However, there are some governance pointers for companies that emerge from the enforcement action to date, and these may well be reinforced if ASIC is successful in establishing future contraventions of the continuous disclosure laws. Companies need to take as much care in ensuring that material price information released to ASX is factually accurate as in ensuring that material price information is released to ASX and to the market in the first place. The *Chemeq* case shows that particular caution needs to be taken with statements that (perhaps even inadvertently) have the impact of "overstating" a company's achievements or progress towards its business objectives, and which can then have the effect of increasing the price of a company's securities. Attention also needs to be placed by companies on ensuring that if material price information is announced to ASX, any changes to that information that the company becomes aware of are independently assessed to determine whether the market needs to be informed of the changed circumstances. Some companies may need to assess their own governance practices to ensure that appropriate attention is placed on this aspect of continuous disclosure (as opposed to an exclusive emphasis on assessing as a threshold issue whether the company is aware of base information which is material to price and which should be released to the market). Finally, to the extent it needed reinforcement in a post-Sarbanes-Oxley/Enron world, the court's decision in *Chemeq* places further emphasis on companies dealing with their continuous disclosure governance in a substantive and practical way rather than through mere form, and ensuring that policies are backed up by effective practical measures and training that is ongoing rather than merely occasional or introductory in nature.

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