

how CAN you know ... what you DON'T (or CAN'T) know?

In January 2010 the Government introduced a continuous disclosure regime for New Zealand's nine largest state-owned enterprises (SOEs). But what's the purpose of continuous disclosure for firms with no tradable ownership interests? And will the regime achieve its objectives? Talosaga Talosaga and Dave Heatley investigate.¹

Inherent in the separation of ownership and control in publicly listed companies (PLCs) is the problem of asymmetric information: the board and managers of a firm have better information about the firm than do the shareholders. In particular, as they exercise day-to-day control, they know what they intend to do with the company's assets in the future – something that the shareholders cannot know unless the board and managers specifically inform them. Such asymmetric information creates three types of risk for shareholders: insider trading; trading on the basis of out-of-date information; and managerial opportunism.

The three risks of asymmetry

Insider trading occurs when a person (an 'insider') who has material information that's not widely available about a PLC uses that information to profit from trading shares with someone who does not have the same information (an 'outsider'). Outsiders, fearing that the counter-party in any trade may be better informed, will discount the price they are willing to pay or will expend resources trying to acquire the inside information. Continuous disclosure reduces this information-asymmetry risk by requiring the information be released as soon as it becomes known to the firm's managers.

Even if no insider trades occur, asymmetric information creates a risk for investors of making trades based on out-of-date information. Fearing that their information is stale, investors may lower the price they are willing to pay. Once again, continuous disclosure reduces this risk by ensuring that everyone is trading on the basis of up-to-date information.

The third risk from asymmetric information arises because managers do not always act in the interests of shareholders, who consequently need effective mechanisms to incentivise and monitor management performance. These mechanisms enable shareholders to sanction poor – and reward good – performance; but their effectiveness is constrained by the quality and timeliness of the relevant information. For example, managers can delay bad news in the expectation (or hope) of being able to blunt it with subsequent good news. Such actions give shareholders a misleading picture of management performance, and undermine their ability to select and retain a management team that maximises

¹ This article is based on: T Talosaga, D Heatley & B Howell (2011) 'Can continuous disclosure improve the performance of state-owned enterprises?' (available at www.iscr.org.nz/f648,18373/18373_Continuous_disclosure_Final.pdf).

returns. When managers are required to release information that they would rather withhold (including evidence of managerial opportunism) shareholders are better able to constrain management.

Continuous disclosure must be credible

A continuous disclosure regime will only be able to reduce these risks if the regime itself, as well as the information provided, is credible. If investors believe the regime is not being fully complied with, then the investor risks remain. Full compliance requires the effective deterrence of non-compliance – and effective deterrence requires identification, detection, and punishment.

Identification in this context means that it must be possible to evaluate whether or not a particular piece of information is subject to the disclosure regime or not. The ‘material effect on the share price’ criterion is helpful here, as share price responses to new information (however released) are readily observable.

Detection means it must be possible to identify when a specific instance of non-disclosure has occurred. After all, if there is no possibility of a non-disclosure being detected, then withholding will likely occur – even when a disclosure obligation exists. Those who monitor and enforce disclosure agreements ‘can never know what they cannot discover’. An act of insider trading actually aids enforcement of a disclosure regime, as a significant share-price change otherwise unexplained by information releases would indicate that investigation of non-disclosure is warranted.

Punishment refers to the consequences of non-compliance. To ensure compliance, severe sanctions for non-compliance are required. A verbal warning or proverbial slap with a wet fish will not suffice. By way of comparison, insurance contracts often include terms to address non-disclosure of information that may have a material effect on the risk associated with cover – and (typically) the lower the probability of detection, the higher the penalty. Thus non-disclosure of a criminal record may lead to the whole policy being declared void. Stiff penalties imposed on those caught not disclosing become a strong deterrent for other potential non-disclosers.

In the case of NZX-listed companies, the Financial Markets Authority can issue a disclosure order (which carries a maximum penalty of \$30,000 if not obeyed) and the courts can impose fines of up to \$1,000,000 per defendant.

Effect on a firm’s performance

Although the primary focus of continuous disclosure is on reducing investor risk, other stakeholder relationships with the firm can be affected by asymmetric information. Risks for a firm’s suppliers, customers, debt-providers and employees are all reduced by accurate and timely information about the firm’s financial state. As these risks can be expected to be priced into input factors, continuous disclosure thus has wider economic benefits for the firm and also for its owners.

What happens without tradable shares?

So what is the purpose of imposing continuous disclosure on SOEs? As they are fully owned by the government and have no tradable shares, the first two risks from asymmetry (insider trading and out-of-date information) are not applicable. And because government ownership provides an implicit guarantee of the SOE's financial state, risk levels for the SOE's other stakeholders are already low – which reduces increased disclosure's potential benefits for those who trade with the SOE.

However, the risk of managerial opportunism remains. For the continuous disclosure regime to reduce or eliminate this problem it firstly needs to be credible – otherwise observers will assume that at least some relevant information is being withheld. Secondly, those receiving the information must have a mechanism for controlling the selection and retention of the management team. In the PLC case, this control mechanism is tied to share ownership. There is no obvious analogy in the SOE case, except perhaps an extremely weak political accountability: citizens (who bear the ultimate risks of poor financial performance by SOEs) have poor incentives to monitor and little ability to influence the shareholding ministers who exercise control rights over the SOEs.

Is the SOE regime credible?

SOE managerial performance is subject to scrutiny by the Crown Ownership Monitoring Unit (COMU), giving shareholding ministers access to information not normally provided to shareholders of listed firms. However, an additional benefit from an SOE continuous disclosure regime might be the board's and managers' voluntary disclosure of information that is relevant to the SOE's performance but is neither observable from trading activities nor discoverable by COMU in the course of its monitoring activities.

If such a disclosure regime is to be credible, there must be some possibility of non-compliance being discovered *and* severe penalties when it is. But curiously, under the new regime, SOE managers face no formal penalties for non-disclosure: there is simply an expectation from the relevant shareholding ministers that the regime will be complied with. Moreover, no agency has been assigned the responsibility for detecting non-compliance.

SOEs are poor disclosers

In the absence of either a reasonable risk of detection of non-disclosure or meaningful sanctions if it ever was discovered, there would seem to be few incentives for SOE boards and managers to actually disclose any additional information under the SOE continuous disclosure regime – and, almost certainly, less information would be disclosed than if the SOE was listed on the NZX.

Empirical evidence appears to bear this out. We paired up each SOE with a PLC of a similar size from the same industry, and compared the number of price-sensitive disclosures made by each group of nine companies over the first sixteen months of the SOE continuous disclosure regime (see Table 1). The PLCs in our sample made more than three times as many disclosures as their paired SOEs did. As the paired firms are of similar size, it is unlikely that the listed firms had been four times busier than the SOEs. The most likely explanation is that, as predicted, the SOEs failed to make all disclosures that should have been classed as material (and that would have been disclosed, had the firm had a defined ownership interest and been listed on the NZX).

Table 1

Number of disclosures	SOEs	PLCs
Average	4.33	15.11
Highest	11	39
Lowest	1	3

Operation through other mechanisms

Transferring a tool from one institutional environment to another gives no guarantee of success in the new environment. We have shown that, in the case of continuous disclosure, the underlying rationale from the PLC environment does not translate simply into the SOE environment. Key benefits from a continuous disclosure regime rely on a tradable share price. Furthermore, continuous disclosure in listed firms relies on independently verifiable evidence that relevant information has not been fully disclosed and on strong penalties when non-disclosure is detected – neither of which feature in the SOE regime.

If the SOE continuous disclosure regime is to have a positive effect on SOE performance, penalty and monitoring arrangements must change. Alternatively, partial or full listing on the NZX would provide access to the benefits that rely on tradable shares and the credible deterrence of non-disclosure.

Talosaga Talosaga is a undergraduate student in economics and a research assistant at ISCR. **Dave Heatley** is a senior advisor at the New Zealand Productivity Commission.