Davies Review of Issuer Liability

Liability for misstatements to the market:

A discussion paper by Professor Paul Davies QC

March 2007

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Invitation to comment

March 2007

Dear Colleague

The Government has asked me to carry out an independent review of liability in respect of damage or loss suffered as a consequence of inaccurate, false or misleading information disclosed by issuers or their managements to the market (including to their own shareholders) or of failure to disclose relevant information promptly or at all.

Efficient markets depend on the efficient flow of timely, accurate information from companies to market participants. So what incentives are needed to encourage issuers and their managements to disclose meaningful, accurate and timely statements? To what degree should they be liable for losses suffered as a result of investment decisions taken on the basis of inaccurate, false or misleading information? To whom should they be liable? What rights of claim should those who have suffered such damage or loss have? A sensible liability regime must balance the interests of issuers and investors, providing appropriate incentives to make timely and accurate disclosures in compliance with statutory rules, as well as an appropriate right to recover losses.

The Review is examining the law relating to liability for corporate misstatements and considering whether the statutory liability regime currently in place should apply equally to periodic and ad-hoc disclosures, whether it should apply only to issuers on a regulated market or also to those on alternative markets, what the standard of liability should be, against whom should a right be enforceable, who should be able to sue for damages and how should such damages be measured.

Having reviewed in more depth the issues raised by respondents to the Government's consultation last year (on extending the scope of the statutory damages regime for disclosures required under the Transparency Directive) and having had the benefit of informal discussions with a number of interested parties, this discussion paper sets out my analysis of the problem and further issues arising. I invite you or your organisation to submit comments and views on the questions raised. Please also comment on other related issues if you wish.

I want to ensure that the Review is an open process that takes full account of the views of a wide range of stakeholders. The paper is therefore being sent out to broad cross-section of interested parties – main market and alternative market listed issuers, the legal and accountancy professions, financial advisers and intermediaries, relevant industry associations, investor groups, regulatory bodies and economic and academic experts in the field. Your input will be of great value in helping to shape the direction of my final report and recommendations to the Government.

I would be grateful if you could send your submission to the Review Secretariat by Friday 27 April 2007. I look forward to hearing from you and thank you in advance for your input into this important work.

Yours faithfully

Professor Paul Davies QC

BACKGROUND

In October 2006, the Economic Secretary to the Treasury invited Professor Paul Davies QC, the Cassel Professor of Commercial Law at the London School of Economics to carry out a review of the liability of issuers in respect of damage or loss suffered as a consequence of inaccurate, false or misleading information disclosed by issuers or their managements to the market or of failure to disclosure relevant information promptly or at all.

The Davies Review follows a Government consultation last year on extending the scope of the statutory damages regime for disclosures required under the FSA disclosure rules implementing the Transparency Directive (2004/109/EC). Responses to that consultation confirmed that this was a complex area in which it is vital to get the policy right, but were not conclusive. The Government therefore decided to include a power to amend, limit or extend the scope of the new liability regime introduced by Section 1270 of the Companies Act 2006 (as new Sections 90A and 90B to the Financial Services & Markets Act 2000). The aim of the Davies Review is to make recommendations to the Government on whether to exercise this power and, if so how.

If the Review recommends that the Government should introduce further provisions about liability for published information or that changes should be made to the existing statutory regime, the Government will, when it publishes its response to the Review:

- consult fully on the Government's response to the review's proposals;
- publish a full regulatory impact assessment of these proposals; and, subsequently
- bring forward legislation for the new regime.

The Government's previous consultation documents, together with current information on the Davies Review can be found at the following web address:
www.hm-treasury.gov.uk/davies

How to respond

The deadline for responses to the Review is Friday 27 April 2007.

We would prefer electronic submissions where possible. Please state clearly on the covering note in the body of your submission if you do not want your response to be posted on the Davies Review website.

Responses should be sent by email to: **davies.review@hm-treasury.gov.uk**

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EXECUTIVE SUMMARY

- The central questions this discussion paper seeks to address are: What incentives are appropriate to encourage issuers to disclose meaningful, accurate and timely statements? Should companies, managers or advisers be liable to investors for losses suffered as a result of investment decisions taken on the basis of inaccurate information? To whom should they be liable? If there is to be liability, should the basis of that liability be negligence (carelessness) or deceit (making a statement without an honest belief in its truth)? Are statutory provisions needed to bring about the appropriate liability regime or can that task be left to the common law by way of judicial development of the relevant rules? What is an appropriate balance between public and private enforcement of companies' disclosure obligations?

- It is clear that neither the current state of the law in relation to liability nor its policy rationale are easy to state simply. The paper therefore first sets out the background to the problem: outlining main types of disclosure obligations to which issuers are subject (paras 9-22); evaluating the civil sanctions for breaches of those disclosure obligations (paras 23-57); before turning to public enforcement of the disclosure rules and the role of the FSA (paras 58-67).

- Until 2006, there was no statutory regime for inaccurate statements other than those contained in prospectuses, where liability was imposed on the basis of negligence. Nor did the common law routinely provide liability for misstatements in periodic or ad hoc statements, though the possibility of liability for deceit (fraudulent misstatements) existed. The Caparo case of 1990 excluded common law negligence liability except where the defendant knows that someone is likely to use the statement for a particular class of transaction. The adoption of the Transparency Directive in 2004, which imposes requirements for periodic disclosures specifically for the purpose of investor protection, raised concerns as to whether the Caparo principle would be undermined. Similar concerns exist in relation to ad hoc disclosures, now regulated by the Market Abuse Directive 2003.

- The Government responded by introducing a statutory liability regime (via a new section 90A to FSMA 2000) for disclosures required by the Transparency Directive and prelim announcements (and via section 463 of the Companies Act 2006 for reporting required under Part 15 of that Act). Section 90A first confirms the prior common law situation of no negligence liability to investors, and second, adopts and adapts the prior common law on deceit applying it only to issuers and in favour of purchasers of shares – in effect changing the law marginally in favour of investors. Section 90A does not deprive investors of previously held common law rights to sue.

- Public enforcement of the disclosure rules is largely in the hands of the FSA, who may exercise various powers of sanction under FSMA 2000. FSA powers under the Disclosure and Transparency Rules in relation to periodic and ad hoc reporting apply only to main market issuers. But FSA powers in relation to market abuse apply also to AIM and Plus Market companies. The main responsibility for supervision of disclosures made by AIM companies lies with a "Nominated Adviser" (nomad), which all AIM companies are required to have.

- The second half of the paper (from para 68) discusses two distinct approaches to solving the problem and the issues arising: the first looks at section 90A as a legal mechanism to preserve the common law position on liability; the other considers what would be an appropriate liability regime in principle. Possible reforms to section 90A cannot be evaluated in the absence of a sense of the appropriate policy balance in this area.

- Key questions on which views are sought include:
    i. Should the trigger for liability be <u>fraud (ie. recklessness or intention) or negligence</u>? Should there be liability for misstatements even if those making the statements honestly (but carelessly) believed them to be true? What is the right standard of liability to incentivise disclosure of timely, accurate and meaningful disclosures without imposing undue cost burdens on issuers? (paras 71-78).

    ii. Should the statutory liability regime currently in place under section 90A be <u>extended to ad hoc disclosures</u>? What is the current position in relation to Market Abuse Directive disclosures? Should there be liability for fraudulent misstatements in ad hoc reports? (paras 79-83).

    iii. Should there be <u>liability for statements that are accurate but late</u>? Or are the FSA's rules sufficient, given that much of their enforcement action has focused on delayed disclosure? What about deliberate delays in withholding information in order to mislead the market? (paras 84-88)

    iv. What <u>counts as an ad hoc statement</u>? Just disclosures of inside information required under MAD? Or also ad hoc disclosures required under the DTR? Other announcements or statements? (paras 89-94)

    v. Should section 90A apply also to <u>non-regulated markets</u>? How would it affect the regimes operated by AIM and Plus markets'? How might the courts apply the principles of the common law to non-regulated market liability anyway? Should there be a level playing field between regulated and non-regulated markets? (paras 95-99)

- If section 90A were to be extended, this raises a number of further issues:
    vi. Should investors' claims be subordinated to those of the other unsecured creditors? (para 100)
    vii. Does section 90A serve as sufficient deterrent on those making fraudulent misstatements? Would imposing liability on directors serve a deterrent purpose? What about other advisers? (paras 101-104)
    viii. Should statutory protection as in section 90A also be extended to sellers and holders of shares? (paras 105-107)
    ix. What should be the measure of damages? Should this be left to courts? Should the deceit or negligence measure of damages be adopted? (paras 108-110)

- Finally, paras 111-123 address some overarching issues about: (i) whether development of fraud-based investor action in the UK would encourage a private securities litigation culture similar to that of the US – concluding probably not; and (ii) the benefits and limitations of private actions to enforce securities – concluding that the arguments for facilitating private litigation outweigh those for excluding it where fraud is involved.

LIABILITY FOR MISSTATEMENTS TO THE MARKET: A DISCUSSION PAPER

I. Introduction

1. It is a widely accepted proposition that the efficiency of the price formation process in a securities market depends in large part upon the mechanisms whereby information is produced, verified and analysed to or in that market.[1] Effective price formation operates so as both to protect investors and, more generally, to promote the efficient allocation of financial resources in the economy as between competing projects. To put the matter another way, a securities market in which the supply of information is slow, inaccurate and poorly analysed is not likely to attract investors, especially where competing markets are available which do not suffer from these defects. Markets which do not attract investors will not attract issuers either.

2. This Discussion Paper is concerned with only one part – albeit an important part – of the mechanism whereby information is produced to the market and, to some degree, by which it is verified. It is concerned with the sanctions for non-compliance with the growing list of requirements on companies to release publicly information which is of use to market participants in the evaluation of securities and in making decisions whether to trade in those securities. Clearly, these rules do not provide a complete machinery for the effective formation of prices in securities markets, even in relation to company-specific information. The information, once released, needs analysis before investment decisions can be taken. Analysis is a process which is left largely to market participants, subject to some controls dealing, for example, with analysts' conflicts of interest. However, the release of information by companies constitutes a crucial initial step in the process of price formation, and so it is important that there should be an appropriate set of inducements for compliance with the disclosure rules.

3. In many cases companies might wish to release the information in question in any event,[2] but the rules which constitute the background of this Discussion Paper require them to make the disclosures, whether they wish to or not. The rules thus operate to reduce the asymmetry of information as between companies and market participants. The imposition of a potentially costly burden on companies to produce information, sometimes to have it verified by persons paid for by the company, and to make it public is an implicit subsidy by companies to analysts working in the securities markets. It can be justified as a more efficient way of making company-specific information available to the market than leaving analysts with the whole burden of information acquisition. That would be likely to result in fewer companies being followed by analysts and thus to a less

[1] Ronald J Gilson and Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindsight Bias* (2003) 28 *Journal of Corporation Law* 715, reprinted in John Armour and Joseph A McCahery (eds), *After Enron* (Oxford: Hart Publishing, 2006). This proposition remains robust despite the recent developments in behavioural finance which focus on the role of 'noise' or irrational traders.

[2] The paper also looks to some extent at the practice of companies of making statements to the market, even when they are not required to do so.

efficient price formation process, especially outside the area of the largest companies.[3]

4. However, the 'subsidy' approach does not tell one how big the subsidy should be: should companies bear only the cost of producing and, to some degree, verifying the information, or should they also be liable to investors for the losses suffered as a result of investment decisions taken on the basis of inaccurate information? This is the central question which the Discussion Paper will address.

5. Many of the disclosure obligations in question derive today from European Community law, as a result of the development and implementation at Community level of the Financial Services Action Plan. This is not to say that Community law has introduced entirely novel disclosure obligations into the laws of the United Kingdom: in most cases the Community rules replace (and sometimes extend) what were previously purely domestic disclosure rules. With regard to sanctions for non-compliance, moreover, the relevant Directives, as is common with Community law, give the Member States considerable freedom of action, though that freedom is not completely unconstrained by Community-level rules. Enforcement of the disclosure obligations by private parties, through litigation in the courts, to secure compensation for disappointed investors is one possible enforcement mechanism. However, since the creation of the Financial Services Authority and the steady expansion of its powers, public enforcement by the Authority has become an important element in securing compliance with companies' disclosure obligations. Those powers include now not only the imposition of financial penalties but also the initiation of criminal proceedings and other regulatory action. An important question for this Discussion Paper is, therefore, how to find an appropriate balance between public and private enforcement of companies' disclosure obligations, and to examine possible linkages between the two.

6. Non-legal market sanctions also play an important role in enforcing disclosure obligations, as was emphasised to me by a number of respondents. A company which is discovered to have put out inaccurate information is likely to suffer, not simply a drop in its share price when the truth comes out, but a continuing scepticism on the part of market participants about the information it discloses in future. If, after the truth is revealed, the company's securities continue to trade at a lower level than would otherwise have been the case, the company's cost of capital will be higher and this will be a penalty on the company, possibly of a significant amount. Equally, the directors' reputations may well suffer and this will reduce their value in the executive job market. Thus, as is common in most walks of life, legal sanctions do not have to carry the full burden of securing compliance with the law.

7. However, as is also common in other areas of social activity, adequate levels of compliance with the disclosure obligations cannot be expected to be secured solely through social sanctions. The future cost to the company (ie the shareholders) or to the directors themselves of the publication of information later discovered to be inaccurate may be outweighed in their minds by the immediate benefits of non- or inaccurate disclosure. It is difficult, perhaps

[3] John C Coffee, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717.

impossible, to quantify the extent to which adequate enforcement fails to be secured by social (or market) sanctions, but clear examples of priority being given to short-term considerations over the need for accurate disclosure can readily be found. Thus, in a prosecution brought by the FSA under section 397 of the Financial Services and Markets Act 2000 ('FSMA 2000'), the defendants were found by the trial court recklessly to have made a statement to the effect that the company had binding contracts for the supply of software programs, even though the contracts had not been concluded, at a time when the revenue from the contracts was needed if the accounts were to show that the company had met its expected turnover and profit. The court later commented that 'the putative contracts were illusory'.[4] Again, in a case involving civil liability for the payment of unlawful dividends, Robert Walker L J stated: 'The judge made a specific finding that the former directors were dishonest in the preparation of the 1991 accounts, in order to deceive the market into the belief that the group was much more profitable than it actually was.'[5]

8. Thus, it seems reasonable to conclude that legal sanctions, of one sort or another, are needed to supplement social sanctions in this area. This brings us back to the central question of the balance between private sanctions through litigation and public sanctions, mainly in the hands of the FSA. There is some international and comparative research which associates the presence of deep and liquid securities markets above all with the presence in those jurisdictions of a vigorous system of private enforcement of obligations under securities law.[6] This thesis would suggest that the present, somewhat restricted, possibilities for civil litigation in the UK for breaches of the disclosure obligations of companies (see below) are in need of substantial expansion. However, later work by Jackson and Roe argues that 'measures of public enforcement are more strongly associated with robust financial markets.'[7] However, the latter authors do not claim that public enforcement can be used to replace private enforcement but rather that 'both play a role in promoting strong capital markets.' Nor do those authors claim to have identified which type of public enforcement activity is most likely to be effective. Perhaps the only safe conclusion to be drawn from this evidence is that it would be unwise for any country to put all its enforcement eggs in either the public or the private basket, but that the balance between the two forms of enforcement remains an open question for discussion.

The main disclosure obligations on issuers

9. As a preliminary to a discussion of the sanctions for non- or inaccurate disclosure, it is perhaps useful to set out at this stage a short description of the main types of disclosure obligation to which issuers are subject. For the purpose of analysis, it is useful to see the rules as requiring disclosure through three main categories of document: prospectuses and other fund-raising documents; periodic corporate reports, whether produced annually, half-yearly or quarterly; and ad hoc corporate announcements. Although those I talked to did not press for

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[4] *Rigby and Bailey v R* [2006] 1 W L R 2067 at [5].

[5] *Bairstow v Queens Moat Houses* [2001] 2 BCLC 531 at [63], CA.

[6] La Porta, Lopez-de-Silanes and Schleifer, 'What Works in Securities Laws?' (2006) 61 *Journal of Finance* 1.

[7] Howell E Jackson and Mark J Roe, 'Public Enforcement of Securities Laws: Preliminary Evidence' (Draft of March 2007, forthcoming on ssrn.com).

change to the civil liability rules in relation to prospectuses, which are in any event outside my terms of reference, the prospectus liability rules provide a useful check on reform proposals for the other classes of document, precisely because the prospectus rules are uncontroversial and, indeed, long-standing. Thus some description of the prospectus rules is required. In light of the tough legal regime applying to prospectuses, however, it should be borne in mind that the prospectus is a 'selling document', produced by the issuer to promote its securities to investors, whereas periodic and ad hoc reports are expressions of routine reporting requirements which do not typically coincide with a selling effort on the part of the company.

(a) Prospectus disclosure rules

10. Subject to certain exceptions, section 85 of FSMA 2000 requires a prospectus to be produced whenever (a) transferable securities are to be offered to the public in the United Kingdom *or* (b) transferable securities are to be admitted to trading on a regulated market situated or operating in the United Kingdom. A 'regulated market' is a concept of European Community law,[8] but it is important to note that the operator of a public market in securities is not obliged to obtain the status of a 'regulated' market in order to operate in the United Kingdom. It may choose to forego the benefits and burdens of regulated status, as both the Alternative Investment Market and the Plus Market have.[9] However, the statutory prospectus requirements will bite if there is a public offering of shares,[10] even if the shares are to be admitted to trading on a non-regulated market, such as AIM. In other words, to avoid the statutory prospectus regime for AIM-listed securities, the fund-raising process must involve a placing which does not amount to a public offer.[11]

11. The detailed requirements of what has to be set out in a prospectus are now to be found in Commission Regulation 809/2004/EC. This is a very extensive and lengthy document made by the European Commission, after consulting the Committee of European Securities Regulators. It is made by the Commission under authority given it by Directive 2003/71/EC of the European Parliament and the Council (the 'Prospectus Directive' or PD). The Commission Regulation (because it is a Regulation rather than a Directive) has become part of the law of the United Kingdom without any need for national legislation to transpose it into domestic law. It is also a maximum harmonisation instrument, ie Member States may not add to its requirements (except where the opportunity to do so is specifically provided within the Regulation).

12. In addition to what is said in the Commission Regulation, the PD contains some supplementary provisions on the content of prospectuses, which, because the PD

[8] The relevant rules are now to be found in Title III of Directive 2004/39/EC on markets in financial instruments.
[9] However, a non-regulated securities market will need to obtain the authorisation of the FSA to operate in the United Kingdom: see FSMA 2000, Part XVIII.
[10] Defined in s. 86.
[11] In the rare case where, without a public offer, securities are introduced to the main market of the LSE and a prospectus is not required (usually because the securities do not fall within the definition of 'transferable securities' – see FSMA 2000, Schedule 11A), the FSA requires the production of listing particulars, which require disclosure of some of the information required for a prospectus. See the FSA's Listing Rules, LR 4.

is a Directive, have required transposing into national legislation. Following the PD, section 87A of FSMA contains a sweeping up provision. Even if the specific requirements of the Commission Regulation have been met, further information may have to be disclosed in the prospectus if it is 'necessary to enable investors to make an informed assessment of' the position of the issuer or the rights attaching to the securities on offer. Further, again following the PD, section 87G requires the production of a supplementary prospectus if significant new information appears or an error is discovered after the initial prospectus was issued. Finally, the FSA has made 'Prospectus Rules' under the powers conferred on it by section 84 of FSMA 2000. The FSA plays an important role in relation to prospectuses, for example, in checking that information is presented under all the headings required by the Commission Regulation and FSMA.

13. Even if an issuer avoids a public offer and secures the admission of its securities to trading on a non-regulated market, this does not mean it escapes prospectus-type disclosure obligations. These obligations are to be found, however, not in statute but in the rules of the relevant exchange and are binding on the issuer by way of contract, as part of the process by which the issuer seeks to have its securities admitted to that market and the operator of the market agrees to accept the issuer. Thus, an issuer seeking admission of its securities to AIM needs to produce an 'admission document' which must disclose significant information of the type required under the statutory regime, but in some respects to a less demanding level.[12]

(b) Periodic disclosure requirements

14. The reports and accounts provisions of British company law are of long standing, dating back to the nineteenth century, though more recently Community law has shaped those requirements.[13] As now formulated, the directors of companies[14] must produce reports and accounts annually, have the financial statements and parts of the reports audited, circulate them to the shareholders and lay them before the shareholders in general meeting, and file them at Companies House, so that they are available to the public. For quoted companies the rules of public securities markets have also long supplemented these Companies Act requirements, notably by requiring the production of more frequent reports and accounts. By virtue of Directive 2004/109/EC on transparency requirements in relation to issuers (the 'Transparency Directive' or 'TD') Community law now lays down the basic reporting requirements (both annual and more frequent) for companies whose securities are traded on *regulated* markets. The TD thus does not apply to issuers whose securities are traded on AIM or Plus, nor is there in the TD an equivalent to the public offer trigger in the PD, which might have an indirect impact on non-regulated markets. Once again, however, the absence of statutory regulation beyond the requirements in the Companies Acts does not mean that companies listed on non-regulated markets are subject to reporting

[12] London Stock Exchange, *AIM Rules for Companies*, February 2007, para. 3 and Schedule 2. See also Plus Market, *Rules for Issuers*, paras. 4-5 and Appendix 1.

[13] Notably the Fourth and Seventh Directives on companies accounts in the company law series of directives, the revised Eighth Directive on auditing, and Commission Regulation 1725/2003/EC adopting international accounting standards.

[14] The requirements are set out in Part VII of the Companies Act 1985 and will be replaced in due course by Parts 15 and 16 of the Companies Act 2006. Small or private companies are exempt from some of these obligations, but the exemptions are not relevant to this Discussion Paper.

requirements only on an annual basis. AIM- and Plus-listed companies are required to produce non-audited half-yearly reports.[15]

15. For issuers on regulated markets, notably the main market of the London Stock Exchange, the TD requires annual financial reports (Article 4), half-yearly reports (Article 5) and interim management statements (Article 6). The annual report is in essence that required by the companies legislation, though now termed an 'annual financial report'. The half-yearly report (which is not required to be audited) must contain a condensed set of financial statements and an interim management report. The interim management report must indicate the important events that have occurred during the first six months of the financial year and their impact on the financial statements and the principal risks and uncertainties for the remaining six months. Article 6 requires the publication of quarterly interim management statements by issuers of shares (but not quarterly financial statements). The issuer is required by Article 21 to disseminate the required information 'in a manner ensuring fast access to such information on a non-discriminatory basis' and to do so 'throughout the Community'. In fact, this requirement is applied not only to information required to be disclosed by the TD, but also to any additional information requirements imposed on issuers by Member States beyond the TD (see para 17 below) and to information required by Article 6 of MAD (see para 19 below). Such information is referred to collectively as 'regulated information'.[16]

16. The TD requires transposition into UK law and this has been done via amendments to FSMA 2000.[17] These amendments confer new rule-making powers on the FSA, which the FSA has exercised so as to produce 'Disclosure and Transparency Rules' (DTR) in place of the previous 'Disclosure Rules' (DR). The TD's periodic reporting requirements are transposed in DTR 4 and (for dissemination) DTR 6. In particular, where the UK is the home state of the issuer, the periodic reports are to be distributed through a Regulated Information Service (RIS)[18] and are to be made available on a website. Again, the RIS is an established feature of the markets and is also the required dissemination channel for the information required to be reported periodically by AIM companies.[19]

17. Because, unlike the PD, the TD is a 'minimum harmonisation' directive, it is open to the Member States to add to its disclosure requirements. The FSA has done so, through what it calls 'super-equivalent requirements'. These are set out in the Listing Rules. LR 9.8 requires certain information relating to the company's financial position to be included in the annual financial report beyond that required by the DTR; certain non-financial items, such as the requirement to comply, or explain non-compliance, with the Combined Code on Corporate Governance; and the provision of a directors' remuneration report.[20] However, the Listing Rules no longer require the publication of a preliminary statement of annual results, though they do regulate how such a preliminary statement is to be

[15] *AIM Rules for Companies*, para. 18 and Plus Market, *Rules for Issuers*, para. 30.
[16] TD, art 2(1)(k).
[17] The changes are set out in Part 43 of the Companies Act 2006 and were brought into force on the date that Act was passed.
[18] A RIS requires the approval of the FSA according to criteria developed by the regulator. The term includes equivalent service providers established in other EEA states, which do not need FSA approval.
[19] *AIM Rules for Companies*, para. 10.
[20] See LR 9.8.4, 9.8.6 and 9.8.8 respectively.

made if the issuer chooses to make one; and a public statement of a board's dividend or other distribution decisions is still required as soon as possible after it has been made.[21] For companies listed on the main market of the LSE, therefore, the periodic disclosure requirements are now mainly in the DTR but still in part in the LR.

(c) Ad hoc disclosure requirements

18. Companies whose securities are traded on public markets are now subject to a range of ad hoc disclosure requirements. Some are relatively routine, such as reporting to the market information which has been provided to the company by others. Examples are notifications which the company has received from its directors or major shareholders as to their acquisition or disposal of voting rights in the company.[22] Some disclosures are not aimed at the market principally, but the company's shareholders, such as disclosure of significant or related-party transactions. In the case of significant transactions of the largest size (Class 1 transactions) a circular to shareholders and shareholder approval is required before the transaction becomes binding on the company.[23] Similar provisions apply to related-party transactions, except for small or routine transactions, and in addition the related party may not vote on the resolution for approval.[24] However, such transactions, including class 2 or 3 transactions, which do not require shareholder approval, must be notified through the RIS as soon as the transaction has been agreed. To this extent, the division between notifications to shareholders and notifications to the market is blurred.

19. The most important of the market-regarding ad hoc disclosure rules is that contained in Article 6 of Directive 2003/6/EC on insider dealing and market manipulation (the 'market abuse directive' or MAD). Article 6(1) requires issuers of financial instruments on *regulated* markets to inform 'the public' as soon as possible of inside information 'which directly concerns' the issuer and to post on their internet sites the publicly disclosed inside information. This is not a new requirement in principle. It can be traced back to Directive 82/121/EEC, though article 6 implements[25] the principle in a particularly rigorous way. Article 6 is transposed into UK law by conferring power on the FSA to make rules (originally the DR, now the DTR). DTR 2 lays down the disclosure obligation and requires that the information be disseminated through a RIS.

20. Again, although Article 6 of MAD applies only to regulated markets and it has not been applied more widely on transposition into domestic law, requirements similar to Article 6(1) are imposed on AIM and Plus companies.[26] The provisions say, in rather similar terms, that (to take the Plus Market version): "An issuer must announce as soon as possible any change in its sphere of activity, financial position, the performance of its business, or its expectation of its performance,

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[21] LR 9.7A.

[22] These provisions were previously in the Companies Act 1985 but have been or will shortly be repealed and be replaced by DTR 3 and 5.

[23] LR 10.5.

[24] LR 11.

[25] Supplemented by Commission Directives 2003/124/EC and 2004/72/EC.

[26] *AIM Rules for Companies*, para 11; Plus Markets, *Rules for Issuers*, para. 20.

which, if made public, would be likely to have a significant effect on the price of its securities."

21. The MAD, of course, is centrally concerned not only with disclosure of inside information but also with penalizing market abuse, including insider dealing. Here, it should be noted that the Directive's provisions sanctioning market abuse, although also confined to regulated markets by the Directive, have been applied more widely in the United Kingdom, so as to cover any prescribed market.[27] Both AIM and Plus are prescribed markets.[28] Cases of inaccurate or non-disclosure of inside information can quite easily become cases of market abuse. This is important because the FSA has regulatory functions in relation to market abuse[29] and these functions are thus exercisable in relation to AIM and Plus companies, even though the DTR rules apply only to regulated markets.

(d) Linking the periodic and ad hoc disclosures

22. Over the course of a year a company might issue a large number of ad hoc statements, of which it might be difficult for investors to keep track. Article 10 of the PD requires companies whose securities are admitted to trading on a regulated market to publish and file with the competent authority of its home Member State an annual statement containing or referring to all the information made public over the previous year, including that made available in other countries. This is translated into domestic law by PR 5.2, which requires only a list of the required statements to be filed with the FSA, rather than their text. Moreover, some matters mentioned in ad hoc statements to the market might be sufficiently important to require repetition in a subsequent periodic report. Both provisions blur the line between periodic and ad hoc disclosure.

Civil sanctions for breaches of the disclosure obligations

23. Having set out the bare bones of the current disclosure obligations, it is now possible to turn to the central issue of this Discussion Paper, ie the sanctions for non- or inadequate disclosure. Here again, however, the question of possible reforms of the current law cannot properly be evaluated without setting out the current law. This will be done in relation to both private and public enforcement of the disclosure rules. Unfortunately, on the civil side at least, a full understanding of the current situation requires a substantial explanation of how we got to where we are. It was clear from my conversations with respondents that neither they nor I found the current state of the law or its policy rationale easy to state simply. In consequence, we found the assessment of reform proposals equally challenging. Since, however, rationale debate of the future requires an understanding of the present, I set out, briefly, my understanding of the development of the law.

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27 FSMA 2000, s. 118.

28 Prescribed markets include 'all markets which are established under the rules of a UK recognised investment exchange': Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2000, art. 4.

29 See Part VIII of FSMA 2000.

24. The civil liability rules for misstatements in the different classes of document discussed above have a rather uneven history. By the end of the nineteenth century the position in relation to prospectuses had become clear, partly as a result of developments in the common law and partly because of the introduction of a statutory liability regime. In relation to liability to investors for misstatements in periodic and ad hoc reports, however, the law remained undeveloped and is still subject to substantial uncertainties – hence the need for this Discussion Paper.

(a) The position up to the decision in Caparo v Dickman (1990)

25. By the third quarter of the nineteenth century the courts had established civil liability in relation to fraudulent prospectuses through development of the common law tort of deceit. In 1889, however, the House of Lords blocked further development of the tort of deceit in the case of *Derry v Peek*.[30] It held that that tort was committed only if the defendant had made a statement which the defendant knew to be untrue or if the defendant had acted recklessly as to its truth, ie had made the statement not caring if the statement were true or false. The tort of deceit could not be committed by a defendant who believed the statement to be true, and this would be so no matter how unreasonable the defendant's belief was. In other words, an honest belief in the truth of the statement would protect the defendant, even if the defendant had acted carelessly in the way that belief had been arrived at (for example, where there had been a failure to take proper steps to check the accuracy of the statement). It is true that showing the belief to be wholly unreasonable might persuade the court that the belief was not genuinely held by the defendant. However, that would be a matter of evidence, not of the substantive test to be met. A wholly unreasonable belief, if honestly held, would not amount to deceit.

26. The tort of deceit required proof of various other elements, beyond the lack of a belief in the truth of the statement made. First, there must actually be a statement. There was no liability at common law for non-disclosure, though the law was sufficiently robust to impose liability for half-truths (ie statements which were true as far as they went but implied something false as a result of what was omitted). However, there could be no liability if the defendant said nothing and merely stood by and let the claimant deceive him or herself, even if such conduct on the part of the defendant were intentional. Second, the defendant must intend the claimant to rely on the untrue statement, or at least intend a class of persons, of whom the claimant was a member, to rely on it. Hence, a company could be said to intend a subscriber for shares to rely on the prospectus, even if it did not know the identity of the subscriber when it issued the prospectus. Third, the claimant must in fact rely on the statement, as part of which requirement the claimant would have to be aware of the statement. This requirement is taken to rule out the theory of 'fraud on the market,' whereby a misstatement which has an effect on the market price can be said to cause an investor loss, even though that particular investor was not aware of the misstatement. And, of course, the claimant must suffer loss. Provided these and the other elements of the tort of deceit are satisfied, the common law regards the defendant as having acted fraudulently. There is no need to show that the defendant had any particular

[30] (1889) 14 App Cas 337.

dishonest intention: even a 'white lie' intended to be and in fact acted on which causes the claimant loss constitutes the tort of deceit. Normally, of course, the maker of a fraudulent statement is also dishonest.

27. Parliament did not think the result in *Derry v Peek* an acceptable one in relation to prospectuses, and so it passed the Directors' Liability Act the following year.[31] That imposed liability for negligent misstatements in prospectuses, ie the defendant would be liable even if belief in the truth of the statement were honestly held, if that belief had been arrived at carelessly (negligently). The present version of the liability imposed by the 1890 Act is to be found in section 90 of FSMA 2000. It is now a very wide-ranging provision. Any person may sue who 'acquires' securities to which the prospectus applies and suffers loss as a result of any untrue or misleading statement in the prospectus or of any omission from the prospectus of a matter which ought to have been included. The use of the verb 'acquires' indicates that the possible range of claimants includes those who buy shares in the after-market as well as those who subscribe for shares from the company. The absence of a requirement that the claimant should have 'relied' on the misstatement (the section requires simply that the claimant should have suffered loss as a result of it) indicates that, provided the misstatement affects the market price of the security, it does not matter that the claimant was unaware of it. And the section covers omissions.

28. The range of defendants is any person responsible for the prospectus or a part of it. Those persons are identified in the FSA's Prospectus Rule 5.5, so as to include the issuer, its directors, and any person who is stated in the prospectus as accepting responsibility for any part of it or who, whether this is stated or not, has authorised its contents. Consequently, the principal advisers will often be within the range of defendants. Finally, the standard for liability is negligence and in fact a strong version of negligence liability. Schedule 10 to FSMA 2000 requires the defendant to prove that he or she was not negligent rather than the claimant to prove that he or she was.[32]

29. The Directors' Liability Act 1890 on prospectus liability was a remarkable development of its day. It influenced the US reforms of the 1930s, when sections 11 and 12 of the Securities Act 1933 were modelled upon it. However, in the Securities Exchange Act 1934 the Congress moved further to introduce a full-scale legislative scheme for the regulation of securities markets of a type not seen in the United Kingdom until the passing of the Financial Services Act 1986. Included in the 1934 Act were continuing disclosure obligations for issuers, both periodical and ad hoc (section 13), the latter by way of a requirement to up-date the company's initial registration statement. Section 18 of the 1934 Act imposed civil liability for misstatements in the continuing disclosure documents to any person 'who, in reliance on such a statement, shall have purchased or sold a security at a price which was affected by such statement.' Unlike in the 1933 Act,

[31] The title reveals that directors were the most common targets of liability suits at this time. The accounting profession had not yet developed so as to make itself the target of choice that it now is; and the decision in *Houldsworth v City of Glasgow Bank* (1880) 5 App Cas 317 prevented shareholders from suing their own company (but see now Companies Act 1985 s 111A (Companies Act 2006, s 655) apparently reversing this decision).
[32] There are some complex provisions dealing with the interrelationship of experts and non-experts as far as liability is concerned.

liability was imposed only if the person making the statement knew the statement was false or misleading (the burden of disproving this being on the defendant). Thus, when moving beyond the prospectus, Congress adopted a standard for liability which was modelled on the tort of deceit. In fact, however, much more important for civil liability in the United States has turned out to be section 10b of the 1934 Act (and Rule 10b-5 made by the Securities Exchange Commission) which prohibits 'any manipulative or deceptive device or contrivance' in connection with the purchase or sale of any security. Although not on their face providing for a civil remedy, the US courts have interpreted them as so doing. I shall look at these provisions further below.

30. In the United Kingdom, by contrast, the question of the liability of issuers (and others) to those who traded on the basis of misstatements in the company's continuing disclosures was not addressed at this time. This was despite the fact that there has long existed a statutory obligation upon companies to produce annual reports and accounts. However, perhaps because that obligation was located in the Companies Acts in the UK, rather than in securities laws, as in the US, that statutory regime did not address the question of liability to investors for misstatements.

31. It might have been thought that, even if statute ignored the issue of liability for misstatements in periodic and ad hoc corporate disclosures, that question could arise by way of common law. If a company made inaccurate statements in its continuing disclosure documents, could not the rules the courts had developed for prospectuses be applied? However, the tort of deceit did not give rise to liability for misstatements in companies' periodic reports as easily as it did for those in prospectuses, because of the requirement for liability that the maker of the statement should have intended that the recipient of the statement rely on it. This was a requirement easy enough to satisfy in the case of a prospectus (which was after all a selling document), but more difficult in the case of an annual report, which was primarily a report to shareholders on the directors' stewardship and not obviously intended to induce reliance by way of securities trading.

32. Alternatively, the common law might have approached the issue via the tort of negligence. This is the most wide-ranging of the torts and covers many types of conduct which fall below the standard set by the law and cause harm to others. The tort was already under development in the nineteenth century, initially to provide compensation for those suffering physical harm as a result of negligent acts, for example in factories or on railways. However, about the time of *Derry v Peek*, the courts decided that the tort of negligence did not apply in principle to negligent statements causing purely economic loss.[33] Not until the 1960s did the common law move away from this 'in principle' denial of liability based on negligence in this class of case.[34] Only at this point was it possible for the common law to confront the question of whether a company, its directors or advisers were liable in negligence for statements in the company's periodic or ad hoc reports upon which investors relied and suffered loss in consequence. An understanding of the answer which was given to this question by the House of

[33] *Le Lievre v Gould* [1893] 1 Q B 491,
[34] In *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] A C 465.

Lords in *Caparo Industries plc v Dickman*[35] is absolutely central to understanding the issues at the heart of this Discussion Paper.

33. By way of summary, therefore, it can be said that before the 1960s the common law imposed liability for intentionally or recklessly inaccurate statements in prospectuses and the statute for negligently inaccurate statements in them,[36] whilst neither statute nor common law routinely provided liability for misstatements in periodic or ad hoc statements.

(b) Caparo

34. Once the courts had accepted that there might be liability for purely economic loss resulting from misstatements, they had to go further and define the circumstances in which such liability would be imposed. This was the question raised in the *Caparo* case. Like many of the cases decided around this period, the factual background of *Caparo* involved the purchase of a company whose economic prospects were discovered after the purchase to be less promising than the purchaser had thought beforehand. Such purchasers then looked around for someone to sue in respect of what was alleged to be the misleading information about the company which had been made available. In *Caparo* the purchase was of a target company listed on the London Stock Exchange by another such company through a takeover offer preceded by share purchases in the market. The action was brought initially against both the directors and the auditors of the purchased company,[37] but proceeded only against the auditors. The target company had issued a profit-warning in March 1984, which caused its share price to halve. In May 1984 the directors of the target made a preliminary announcement in its annual results for the year to March 1984, which confirmed that profits were well short of expectations. This caused a further, though less dramatic, fall in the share price. In June the annual accounts were issued to the shareholders. Shortly before that, Caparo, which had previously owned no shares in the target, began acquiring shares in tranches until it reached a shareholding of 29.9%, at which point it made a general offer for the remaining shares, as the City Code required it to do if it was to acquire any more of the target's shares. Caparo asserted that the 1984 accounts, although gloomy, in fact overvalued the company and that the auditors had been negligent in not detecting the irregularities or fraud which had led to the overstatements in the accounts and in certifying the accounts as representing a true and fair view of the company's financial position.

35. The trial judge held that the auditors owed Caparo no duty of care in negligence, ie that liability did not arise even if the auditors had been negligent.[38] The Court

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[35] [1990] 1 All E R 568, HL.

[36] In the normal case, the statutory liability would trump the common law one, for why would a claimant assume the burden of proving intention where the statute required the defendant to show that he or she believed on reasonable grounds in the truth of the statement? However, where the statute did not reach, the common law might still fulfil a useful gap-filling role: *Possfund Custodian Trustees Ltd v Diamond* [1996] 1 W L R 1351.

[37] Suing the purchased company itself would obviously be irrational, since it was now owned by the claimant.

[38] It was assumed for the purposes of the decision that the auditors had been negligent; whether they had been or not was never determined. It was unnecessary to do so, since they were not liable even if they had been negligent.

of Appeal by a majority held that no duty was owed to Caparo in respect of the purchases made before Caparo was registered as a shareholder in the target but was owed thereafter. The House of Lords unanimously upheld the trial judge. Three points can be made about the House of Lords' ruling. First, the court was prepared to accept that the events described above were foreseeable, ie, if the target's auditors had thought about it, they would have realised that the accounts might be used by a bidder as in fact they were used by Caparo. However, in this area of the tort of negligence, the court rejected foreseeability as the touchstone for liability, in spite of its importance in other areas of that tort.

36. Second, the court rejected the narrower version of the claimants' argument which had been accepted by the Court of Appeal, namely, that the provisions in the Companies Acts relating to the accounts and their audit formed the basis for the creation at common law of a duty of care owed by the auditors to the existing shareholders of the company in relation to their purchase of further shares - but not in relation to purchases by non-shareholders. The effect of accepting this argument would probably have been to give Caparo substantially what it sought by way of damages, since only the shares purchased when it was not a shareholder in the target would fall out of consideration in calculating the damages, assuming it could make out the other elements of the tort of negligence.[39] Whilst accepting that the statutory provisions on accounts and audit did form the basis for the recognition of a duty of care owed by the auditors to the shareholders, it was still necessary, the House of Lords said, to ask what was the nature of the duty thus to be recognised at common law. There was no such thing as 'a duty to take care in the abstract but [only] a duty to avoid causing to the particular plaintiff damage of the particular kind which he has in fact sustained.'[40] It is at this point that the judges needed to embark on their famous analysis of the purpose of the statutory accounts provisions, in order to establish the appropriate scope of the duty of care at common law which could be based on the statute. The view of the House of Lords was that the purpose of the statutory accounts provisions, as far as the shareholders were concerned,[41] was to put them in a position where they could effectively exercise their governance rights over the board (for example, by replacing ineffective management)[42] not to enable them to take investment decisions. Accordingly, a duty of care did not exist in relation to purchases of shares in the company, whether by existing shareholders or non-shareholders.[43]

[39] There is some unclarity in the judgment of the Court of Appeal ([1989] 1 All E R 798) as to the time at which the claimant would have to be registered as a shareholder to be able to assert a claim, an unclarity perhaps linked to the question of whether the relevant document for the claim was the annual accounts as circulated to the shareholders or the preliminary announcement of the results.

[40] Lord Oliver at p 599.

[41] Another purpose of the accounts and their audit was also to protect the company itself, for example, by enabling its management to take timely action to stamp out fraud (Lord Oliver at p 583). For this reason, the duty to shareholders would rarely expose the auditors to substantial damages actions by the shareholders, because their loss would normally be reflective of the loss suffered by the company and the company's recovery would take priority. However, if, for example, the accounts negligently undervalued the company, shareholders might be able to recover from the auditors monies expended in convening a meeting of the company and securing the passing of a resolution to remove the existing board.

[42] Lord Bridge at p 580; Lord Oliver at p 583; Lord Jauncey at p 607.

[43] The judges left open the question of whether sales of shares (for example, where the accounts negligently undervalued the company) were within the scope of the duty, on the grounds that only shareholders could sell shares so that sales were necessarily a shareholder activity. However, the judges

37. Third, however, the House of Lords confirmed earlier cases holding auditors liable when they had assumed responsibility for the accuracy of the accounts in relation to a particular person and in the context of a known transaction. Where the auditor makes a statement knowing that it is going to be made available to a particular person who is likely to rely on it for the purpose of a particular type transaction which is also known or ought to be known to the maker of the statement, a duty of care will normally be found by the court.[44] Most of the post-*Caparo* litigation has been about applying this test to the varying circumstances in which the claimant has sought to get the auditors to stand by or to confirm their audit for the purposes of the particular transaction in respect of which the claimant now wants to sue. Thus, in *Galoo v Bright Grahame Murray*[45], Hillsdown Holdings plc intended to buy a controlling shareholding in companies whose annual statements had overvalued them. Hillsdown sued the companies' auditors and the Court of Appeal held that auditors owed Hillsdown a duty of care. This was because, unlike in *Caparo*, the auditors had sent the accounts to Hillsdown in the knowledge that Hillsdown and the auditors' clients intended to use the financial statements to calculate the purchase price of the shares. On the other hand, no duty of care was owed in respect of loans later made by Hillsdown to the companies, because the auditors did not know Hillsdown intended to use the reports for that purpose[46].

38. The decision in *Caparo* was reasonably controversial at the time, but more among specialists in the law of torts (because of the court's downgrading of foreseeability as a test for the duty of care) than among company lawyers. It does not seem to have produced pressure at that time from the investment community for a change in the law. This may have been because the effect of the decision was to confirm the existing understanding of the law that auditors (and, by extension, directors and the company itself) were not liable to investors at large (including investors who were existing shareholders in the company) in respect of negligent misstatements in companies' annual reports. On the other hand, the court also made it clear that liability could arise for auditors (and presumably others) where the financial statements were given to a known recipient for a specific purpose of which the auditors were aware and upon which the recipient had relied and acted to his detriment. The decision thus distinguished between liability to the market at large and liability in the context of a particular transaction to a particular claimant. In the former case the imposition of liability ran the risk, as was said by a US court many years ago, of 'liability in an indeterminate amount for an indeterminate time to an indeterminate class.'[47] In the latter case, where the auditors were asked to stand by the accounts in the context of a particular, known transaction, they could refuse to do so, negotiate terms for so doing, give the undertaking but disclaim any legal liability for it or

showed little enthusiasm for this argument; and a thorough-going governance analysis would seem to exclude sales as well as purchases on the grounds that both are investment, not governance, decisions.

44 This proposition is set out more fully in the judgment of Lord Oliver in *Caparo* (above) at p. 589.

45 [1994] 2 BCLC 492, CA.

46 The outer limits of this type of argument are represented by the decision in *Morgan Crucible Co plc v Hill Samuel Bank & Co Ltd* [1991] Ch 295, CA, where the Court of Appeal refused to strike out a claim by a bidder, where the misstatement was alleged to be contained in a defence document issued by the target company in a hostile takeover, which, the court found, was intended to induce the bidder to raise its offer. The defendants were the target's then directors, auditors and investment bank advisers.

47 *Per* Cardozo C J in *Ultramares Corp v Touch* (1931) 255 N Y 170, 179.

accept liability. It is also to be noted that the *Caparo* decision has been followed, though not its precise reasoning, by both the High Court of Australia[48] and the Supreme Court of Canada[49].

39. Summary: the effect of the decision in *Caparo* was to leave undisturbed the law as summarised in paragraph 33 above, except where the defendant knew that a particular person was likely to use the statement in the context of a particular class of transaction of which the defendant was aware or ought to have been.

(c) The Impact of the Transparency Directive

40. In 2004 the European Community adopted Directive 2004/109/EC, the Transparency Directive, whose provisions we outlined in paragraphs 14ff. The periodic disclosures required were annual financial reports, half-yearly reports and interim management statements. Despite the fact that these reports were not selling documents, a concern was raised by some corporate lawyers in major law firms that the Directive would undermine the principle laid down in the *Caparo* case. This fear was not based on any explicit provision in the Directive which required Member States to make issuers or directors or advisers liable to investors in respect of losses suffered as a result of trading decisions taken on the basis of negligent misstatements in periodical reports, because the Directive contains no such explicit requirement. On liability, Article 7 of the Directive requires Member States to apply their existing liability regimes to misstatements in the disclosures required by it, rather than to create new ones. The fear was that the British courts (influenced, perhaps, by the European Court of Justice) would interpret the common law in the future differently from the way it had been interpreted in *Caparo* because of the rationale which appeared to underlie the Directive's mandatory disclosure requirements.

41. More precisely, it was said that the Directive's disclosure requirements seemed to be animated by a theory of investor protection, not a theory of directors giving a stewardship report to their shareholders. This was deduced from the broad statements in the Directive's recitals about its animating purpose. If the courts did come to accept that the purpose of periodical disclosures was investor protection, the narrower version of the claimants' argument, set out in paragraph 36 above, might be accepted by the courts, thus ushering in issuer and director liability to shareholders in respect of their investment decisions.[50] Indeed, by the same token, the wider version of the claimants' argument might be accepted, ie that the periodic disclosure documents created a link between issuer and investors, whether they were shareholders or not.

42. It is difficult to estimate the size of the risk to the *Caparo* decision which the Transparency Directive represented. The drafting of the Directive, especially of its Article 7, was altered to some extent as a result of British representations during the Community legislative process, but the broad language in the recitals remained. Thus, recital 1 says that 'the disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence

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[48] *Esanda Finance Corp Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241.
[49] *Hercules Managements Ltd v Ernst & Young* (1997) 146 DLR (4th) 577.
[50] The arguments are set out in House of Lords, European Union Committee, 15th Report of Session 2003-04, *Directors' and Auditors' Liability*, HL Paper 89, May 2004.

and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency.'[51] Those who feared for the future of *Caparo* argued in essence that the common law had so firmly tied itself to the notion that the purpose of the disclosures determines the availability of a civil action that a change in the purpose of the disclosures (by the Directive) would enlarge the scope of liability at common law, even though the Directive did not intend to bring this change about.[52]

43. The contrary argument would be that the policy arguments against imposing liability in negligence to investors at large (for example, the indeterminate liability point) would remain as strong as they had previously been regarded, despite the change in the purpose of the disclosures. The purpose of the disclosure may be to inform investors but it is a separate question whether that purpose is to be sanctioned by private actions in damages in addition to public enforcement. Mr Justice Hoffmann (Lord Hoffman as he now is) – a distinguished company law judge - has expressed the view that discussing whether a duty of care exists 'solely in terms of the knowledge, intentions and purposes of the parties' constitutes recourse to 'an impoverished set of concepts.'[53] The Canadian Supreme Court in *Hercules Managements*,[54] whilst coming to the same result as in the *Caparo* case, put most of its emphasis on the policy arguments against imposing liability and only lightly referred to the 'purpose' argument.

44. On the other hand, it is arguably unfair to present the arguments of those who see a risk to *Caparo* as based on a narrow and technical interpretation of the word 'purpose'. One effect, it can be said, of the Financial Services Action Plan is to place company disclosures in an entirely new context, ie a securities market in addition to a corporate governance context. This involves a strategic shift in the role of corporate disclosures to which, over time, the courts are likely to respond. The force of this argument can be seen particularly in relation to those ad hoc disclosures where there is no internal corporate equivalent, for example, disclosures of inside information. The immediate release of inside information by the company seems to be based wholly on a market-protecting rationale rather than one linked to the company's corporate governance. It can also be argued that the requirement for periodic reporting more frequently than annually – and especially the requirement for quarterly interim statements – makes less sense from a governance perspective, because there is no necessary link to a shareholder meeting, than from a market-protecting perspective.

45. <u>The best conclusion</u> about the danger to the common law rule from the Directive is probably that arrived at by the House of Lords' European Committee: that the arguments of those worried about the impact of the Directive on the common law were not 'without foundation.'[55]

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51 See also recitals 2, 5, 6 and 7. The argument is set out persuasively by Lachlan Burn, 'Only connect--the importance of considering disclosure requirements in the light of their legal consequences' (2007) 2 *Capital Markets Law Journal* 41.

52 On the use of recitals to interpret a Directive see the Opinion of Advocate General Mazak in Case C-411/05, *Félix Palacios de la Villa v Cortefiel Servicios SA* (not yet reported) and *R (Amicus) v Secretary of State for Trade and Industry* [2004] IRLR 430 at [158] (Richards J).

53 *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] 1 BCLC 18 at 21. His actual decision in the case was overruled by the Court of Appeal.

54 Above n 49.

55 Above n 50 at para. 22.

(d) The Government's response: section 90A of FSMA 2000

46. The Government took the opportunity of using the Companies Act 2006, Part 43 which transposes the Directive into domestic law, to address the fears that had arisen about the common law. This was done in what is now section 90A of FSMA 2000, inserted by section 1270 of the Companies Act 2006 – see Annex A. This section introduces a statutory regime for liability in respect of 'any reports and statements published in response to a requirement imposed by a provision implementing Articles 4, 5 or 6 of the transparency obligations directive and any preliminary statement made in advance of' the annual report, in so far as the preliminary announcement contains information intended to appear in substantially the same form in the annual report.[56] Since the section is bounded by the scope of the Transparency Directive, it applies only to securities traded on a regulated market (and so not to AIM companies). Within its scope, this statutory liability regime replaces common law liability. However, the concepts it uses to define liability are clearly drawn from the common law.

47. It is crucial to note that that the section has two objectives, one of which relates to the prior common law of negligence and the other to the prior common law of deceit. As far as negligence liability is concerned, the statute confirms the prior common law situation of no liability. As far as deceit is concerned, the approach of the statute is also essentially confirmatory, but it makes some adjustments to the prior law so as to make it effective in the context of periodic disclosures.

(i) Negligent statements

48. The section imposes liability on the issuer for fraudulent misstatements but then provides that, apart from this, no one is liable for loss resulting from reliance by any person (including therefore investors, whether shareholders or not) on an untrue or misleading statement in or the omission of information from the documents to which the section applies.[57] Amongst other things, this excludes liability for negligence on the part of the issuer, its directors or advisers. In this way, the section can be said to confirm the *Caparo* decision and so, as far as the law of negligence is concerned, it does not seek to alter the prior law.

49. Three limitations on this exclusion of negligence liability should be noted. First, despite views apparently held in some circles to the contrary, I do not read the section as intended to take away liability where statements accepting responsibility for the accuracy of a document are made outside the company's reporting processes. In the case discussed in paragraph 37 it is suggested that Hillsdown would be able to rely under the statutory regime on the explicit or implicit statement made to it by the auditors that the financial statements were accurate. This would be a statement outside the scope of the section which applies only to misstatements or omissions in the reports required to be produced by the Transparency Directive or in the prelims. Since the risk to which the section is addressed is that investors at large could sue in negligence and that none of the policy issues against such liability apply where the defendant assumes responsibility for the accuracy of the statements to the particular claimant in

[56] S.90A(1).
[57] S.90A(6).

respect of a particular transaction, it would be surprising if the courts accepted that the section had a broader effect.

50. If this view is correct, common law liability in negligence might have some marginal relevance for discussions between company representatives and analysts in the wake of annual reports. However, it should be made clear that merely repeating what is said in the annual reports, even with some gloss, to a group of people is far from accepting legal responsibility for what those people may subsequently do with the information. There are many cases in which auditors have talked to particular parties about proposed transactions without being found by the court to have accepted responsibility for the accuracy of the financial reports for the purpose of the transactions which are subsequently effected.[58]

51. Second, the section preserves liability at common law *to* the issuer.[59] So, advisers will continue to be liable in contract or tort to the issuer for the negligent performance of their duties, subject, however, to the terms of their contract, including whatever limits on liability auditors may negotiate under the new provisions of the Companies Act 2006. However, the liability of directors in negligence to their companies in respect of the directors' report and the directors' remuneration report (and any summary financial statement derived from them) is excluded by section 463 of the 2006 Act, in order to encourage more open, meaningful and forward-looking narrative reporting. Unlike section 90A of FSMA, section 463 of the CA 2006 does represent a change in the law, so far as the negligence liability of directors to their companies is concerned.[60]

52. Third, section 90A applies only to civil liability under the general law, but not to liability to penalties imposed by the FSA, to criminal liability or liability under a restitution order made under sections 382 and 384 of FSMA. In short, the public enforcement regime is left untouched by the section.[61]

(ii) Intentional or reckless statements

53. The major exception to the principle of non-liability stated in section 90A(6) is that the issuer can be liable if it makes a statement in the documents to which the section applies which it knows to be untrue or misleading or is reckless whether that is the case or, in the case of an omission of a required matter, if it knew the omission was 'a dishonest concealment of a material fact.'[62] Only the issuer can be liable to investors under this provision, not directors or advisers. However, a company can only know things if the knowledge of human beings is attributed to it, and the section treats those 'discharging managerial responsibilities' as the relevant persons. Normally, this will be the directors.[63] Thus, the section will normally focus on the knowledge, recklessness or dishonesty of the directors, but

[58] See, for example, *Peach Publishing Ltd v Slater & Co* [1998] BCC 139, CA.; *James McNaugthon Papers Group Ltd v Hicks, Anderson & Co* [1991] BCLC 163, CA.
[59] S.90A(6)(b).
[60] For an account of the development of the Directive's liability provisions during the Community legislative process see E Ferran, *Building an EU Securities Market* (Cambridge: CUP, 2004) pp. 188-193.
[61] See Case C-97/96, *Daihatsu Deutschland* ([1998] E C R I-6843), holding that the purpose of the requirement in the First Company Law Directive that companies' accounts be publicly available was broader than the protection of members' and creditors' interests and was to enable any 'interested person' to inform themselves about the company's financial information.
[62] S. 90A(4).
[63] S. 90A(9).

for the purposes of making the issuer liable to investors, not the directors. Directors, however, will be liable to the company. Section 463 of the Companies Act 2006 does not protect the director from this liability where the director knows of the untruth of the statement or is reckless with regard to its truth or acts dishonestly in relation to an omission. Thus, the director might have to reimburse the company for the loss suffered by the company in compensating the investor, but the decision to seek recovery from the director would be a decision to be taken by or on behalf of the company.

54. The liability on the part of the issuer is to anyone (so, to any investor, whether already a shareholder or not) who acquires securities and suffers loss as a result of the misstatement or omission, where that person relied on the information at a time when it was reasonable for him to do so. This statutory liability is clearly modelled on the common law tort of deceit. In two ways it goes beyond the common law, however. First, although the claimant will recover only if he in fact relied on the publication and that reliance must be reasonable, it is not required that the issuer should have intended the claimant to rely on the publication. The requirement of intention on the part of the issuer as to the reliance by the claimant on the publication made the common law tort of deceit of only marginal relevance to misstatements in periodic reports, as contrasted with prospectuses, where such intention was easy to show. Second, the liability of the issuer is applied to pure omissions from the publication, whereas the common law applied only to omissions which rendered what was said misleading. However, it is to be noted that in the case of omissions, it is not enough that the omission was intentional or reckless, it must amount to a 'dishonest concealment.' Without these two changes from the common law of deceit, it is arguable that the liability for intentional misstatements created by the section would have been meaningless in practice. For that reason, it can be argued that, without these changes, the United Kingdom would have been in breach of its obligation under Article 7 of the Directive and under the general requirements of Community law to have an effective civil liability regime in place for Transparency Directive disclosures. Although Article 7 merely requires Member States to extend their civil liability regimes to the disclosures required by the Directive, it is strongly arguable that this does require the Member State to have some liability regime to be extended. On this basis, it would not constitute compliance with Community law for a Member State to say that it had no liability regime or a liability regime which in practice was wholly ineffective.[64]

55. On the other hand, the statutory regime retains two features of the common law of deceit which restrict its impact. First, and most important, the claimant can succeed only if it relied on the publication. As we have seen above in para 27, the statutory prospectus liability regime does not require reliance. It adopts a 'fraud on the market' theory. If the misstatement in the prospectus affected the market price of the securities, that is enough, even though the claimant may not have known of the misstatement. Section 90A by contrast, by requiring reliance, seems to require a claimant to have been aware of the statement which subsequently turned out to be misleading and for that knowledge to have played a part in inducing the action which was later taken. Second, the defendant's reliance on the publication is required to have been reasonable. Thus, a claimant might not

[64] *Cf* Cases C-382/92 and C-383/92, *Commission v United Kingdom* [1994] ICR 664.

succeed under the section if it had some available way of checking the publication but chose not to use it.

56. Finally, it should be noted that the regime based on intentional or reckless misstatements operates only in respect of those who acquire securities, and not in favour of those who sell or hold securities.[65] This restriction was criticised by many to whom I talked.

57. Summary: Within its scope of operation, the statutory regime introduced by section 90A of FSMA adopted the prior common law by excluding liability in negligence to investors at large. It also adopted the prior common law on deceit and applied it to issuers (but only them) and in favour of acquirers of securities (but only them). The deceit rules are adopted under the statutory regime with two extensions: to bring in pure omissions and to remove the need to prove the issuer intended the claimant to rely on the publication. Overall, the new statutory regime confirms the prior law and, where it does change it, does so in favour of investors (though the changes can be argued to be marginal). What appears clearly to be the case is that section 90A did not deprive investors of rights to sue on grounds of negligence which they previously held at common law.

Sanctions for misstatements in the hands of public bodies

58. Public enforcement of the disclosure rules is largely, though not wholly, in the hands of the FSA.[66] It is probably not necessary to deal specifically with the FSA's sanctions for breach of the prospectus rules and so attention will focus on the periodic and ad hoc disclosure rules.

59. As we have seen, the FSA has been given the power under Part VI of the FSMA 2000 (as amended) to make rules – the Disclosure and Transparency Rules (DTR) – to implement the MAD and TD, and the rules so made constitute an important element in the FSA's 'Part 6 rules.' As far as both the Disclosure and the Transparency Rules are concerned, 'an issuer must take all reasonable care to ensure that any information it notifies to a RIS is not misleading, false or deceptive and does not omit anything likely to affect the import of the information.'[67] Thus, the DTR adopt a negligence standard for compliance with their requirements. An issuer which fails to comply with any obligation imposed on it by the DTR (including the due care requirements) is liable to a penalty to be imposed by the FSA.[68] Although the due care obligation is imposed only on the issuer, section 91(2) of FSMA 2000 also makes liable to a penalty a director of the issuer 'who was knowingly concerned in the contravention' of the DTR. This appears to mean that if a director knows that the issuer has failed to take due care to establish the accuracy of the statement, he or she will be liable to a penalty as well. Instead of a penalty, the FSA may issue a statement of censure. Action for breach of the DTR is subject to a limitation period of two years.

[65] S 90A(3).
[66] The Financial Reporting Review Panel plays an important and recently expanded role in monitoring companies' compliance with reporting standards.
[67] See DTR 1.3.4 for the Disclosure Rules and DTR 1A.3.2 for the Transparency Rules.
[68] FSMA 2000, s. 91(1ZA) for the disclosure rules and s. 91(1B) for the Transparency Rules.

60. In addition to the civil penalty regime, the FSA possesses powers to apply to the High Court (or Court of Session in Scotland) for an order in respect of a person who has infringed the Part VI rules and has made a profit as a result of the contravention or where the contravention has caused other persons' loss. The court order will require an amount it considers just (having regard to the profit made or loss suffered) to be paid to the FSA, for distribution to persons who appear to the court to have suffered loss or to whom the profits are attributable.[69] The FSA also has the power to apply to the court for an injunction to restrain anticipated or repeated breaches of the requirements.[70]

61. Finally, it should be noted that disclosure of misleading information or non-disclosure of information may constitute market abuse under section 118 of FSMA 2000, notably market abuse in the shape of behaviour 'likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.' Conduct constituting market abuse triggers independent penalty-imposing powers,[71] but a penalty may not be imposed by the FSA on a person who believed on reasonable grounds that his behaviour did not constitute market abuse or who took 'all reasonable precautions and exercised all due diligence' to avoid acting in a way which constituted market abuse. Since the market abuse prohibition applies to 'any person', it is not confined to issuers. It also carries with it restitution and injunctive relief powers.[72]

62. Finally, the FSA has the power to bring criminal prosecutions for some offences, of which the most important for our purposes is that contained in section 387(1) and (2) of FSMA 2000. Under this section an offence is committed by a person who makes a statement (broadly defined) which he knows to be misleading, false or deceptive in a material particular or is reckless as to whether it is so, and does so for the purpose of inducing another to take an investment decision (broadly put) or is reckless whether it has that effect. The section also applies to dishonest concealment of material facts.[73]

63. Turning to the FSA's exercise of its powers, it is clearly reluctant to use its restitution seeking powers other than in relation to consumers. In its enforcement Handbook the FSA states: 'The number of instances in which the FSA might consider using its powers to obtain restitution for market counterparties are likely to be limited.'[74] I could find no case in which the FSA had used its restitution powers in the class of case being considered in the Review. This may well represent an appropriate allocation by the FSA of its limited resources. However, this policy on the part of the FSA does have significance for the view put forward by some respondents, namely, that compensatory actions brought at the initiative of the public authority might (a) solve the funding problems of private litigation and (b) provide a filter, so that

[69] S. 382 of FSMA. Under s. 384 the FSA may make such an order itself in relation to authorised persons, but that is not likely to be relevant in the situations we are discussing.
[70] S. 380.
[71] FSMA 2000, s. 123.
[72] Ss. 381 and 383.
[73] S 397(3) creates a criminal liability for market abuse.
[74] ENF 9.3.2.

unmeritorious claims were not brought. This is not a realistic possibility on the FSA's current view of how best to deploy its efforts.

64. As for the FSA's use of its penalty and censure powers, as far as I could establish the recent history of their use is as set out in Table 1 (see Appendices) in respect of the disclosures with which I am concerned. It should be remembered that the TD powers were acquired by the FSA only at the beginning of 2007 and so were not available in the period covered by the table, but, of course, there were periodic disclosure requirements in the Listing Rules before they were transferred to the Transparency Rules.

65. ***Table 1:*** Two points perhaps emerge from the table. First, the focus of the FSA has been on delayed announcements. Six of the nine cases were based on this complaint alone or together with some other complaint. Under the then applicable version of the FSA's rules the requirements for disclosure 'without delay' of developments or information relating to the company which were likely to have a substantial impact on the price of its securities were contained in LR 9.1 and 9.2. The equivalent today is to be found in DTR 2.2.[75] Second, this is a relatively modest level of public enforcement activity. That the FSA should have made little use of its criminal enforcement powers is not surprising, given the difficulty of proving the elements of intention or recklessness to the required criminal standard of proof.[76] Even so, eight sets of penalties or censures imposed over a period of four years might not seem a high level of enforcement, even though the penalty imposed in the case of Shell was very large in absolute terms – though perhaps less so in comparison with the turnover of that issuer.

66. The FSA's powers under the DTR in relation to periodic and ad hoc reporting apply only to issuers whose shares are admitted to trading on a *regulated* market. Thus, they do not apply to AIM or Plus-listed companies. However, the FSA's powers in relation to market abuse apply to securities admitted to trading on a *prescribed* market,[77] thus including AIM and Plus, whilst the criminal prohibitions in section 397 of FSMA 2000 also apply beyond regulated markets.[78] Through its market abuse powers in particular, the FSA has some supervisory jurisdiction over misleading ad hoc statements issued by AIM-listed companies. However, the main responsibility for supervision in relation to all types of statement made to the market by AIM companies lies with the London Stock Exchange, which has delegated that responsibility on a day-to-day basis to the 'Nominated Adviser'

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[75] LR 9.3A required reasonable care to avoid misleading, false or deceptive statements being put out through a RIS. For the current requirements to take care as at present see n. 65.

[76] However, its one prosecution under s 397 of FSMA 2000 was reasonably successful. In the prosecutions of Rigby and Bailey, directors of AIT, the FSA secured custodial sentences and also compensation orders against the defendants, the compensation orders apparently being made under the Powers of the Criminal Courts Act 1973. About £340,000 was ordered to be paid by way of compensation to investors who had bought shares on the basis of the misleading statements, about £120,000 being payable to Standard Life and £200,000 to Morley Fund Management. The Court of Appeal took some of the shine off the FSA's initial success, first by reducing the length of the directors' sentences – though it did uphold custodial sentences (*R v Bailey and Rigby* [2006] 2 Cr App Rep (S) 36) - and, second, by defeating the FSA's attempted use of the confiscation powers under Part VI of Criminal Justice Act 1988 (*Rigby and Bailey v R* [2006] 1 W L R 3067) to deprive the directors of the gains they had made from the misleading statements as well as requiring them to pay compensation those investors who had been harmed. For the FSA's summary of this case see: http://www.fsa.gov.uk/pages/Library/Communication/PR/2005/120.shtml.

[77] FSMA 2000, s 118(1).

[78] Financial Services and Markets Act 2000 (Misleading Statements and Practices) Order 2001/3645.

(Nomad), which all AIM-listed companies are required to have at all times. Indeed, if an AIM-listed company ceases for whatever reason any longer to have a Nomad, its shares will suspended; and if a fresh Nomad is not appointed within a further month, its AIM listing is cancelled.[79] The LSE supervision system clearly places considerable weight on the proper discharge of their functions by the Nomad; and Nomads translate the obligations laid upon them into their contracts with their companies. During the course of the review there was some public discussion of the overall quality of the supervision provided by Nomads, which was triggered by the LSE's proposal, now implemented, to produce for the first time a rulebook for Nomads, as a way of setting out best practice.[80] Rule 17 of that rulebook states in general terms: 'The nominated adviser is responsible to the Exchange for advising and guiding an AIM company on its responsibilities under the AIM Rules for Companies both in respect of its admission and its continuing obligations on an ongoing basis. A nominated adviser must be available to advise and guide AIM companies for which it acts at all times.'

II. The nature of the problem

67. As will be clear from the lengthy discussion above, one very substantial difficulty in discussing the possible extension of section 90A of FSMA is that it is not a section which can be understood as a free-standing provision. Its significance can be evaluated only in the context of the prior common law, whose future development is itself the subject of uncertainty and debate. Very few incontrovertible statements can be made about it. However, among the people to whom I talked, there were two distinct approaches to the issues which could be identified.

68. One approach was to start from the axiom that the prior common law expressed an appropriate policy stance – essentially one of very limited liability in damages to investors – and that the objective should be to preserve that position. The majority of people taking this stance were of the view (a) that section 90A was necessary to preserve the common law position but (b) that it did not do enough to secure that result and ought to be extended so as to cover misstatements made in other classes of document. Some, however, were sceptical as to whether the common law was at risk from developments in Community law and so thought section 90A unnecessary or opposed its further extension.

69. A second set of respondents (which included some from the first set) were more at ease in discussing an appropriate liability regime in principle rather than the intricacies of section 90A or the common law. For them, the legal mechanism whereby the appropriate result was to be achieved was less important than defining that result. They accepted that the substantial extension of corporate disclosure requirements to the market had given rise to a serious issue which needed to be addressed. However, a range of views was expressed as to what the balance should be. Whilst it would be far beyond my terms of reference to devise a comprehensive liability regime for market disclosures, I agree with these

[79] London Stock Exchange, *AIM Rules for Companies*, February 2007, Rule 1.
[80] London Stock Exchange, *AIM Rules for Nominated Advisers*, February 2007.

respondents that possible reforms to section 90A cannot be evaluated in the absence of a sense of the appropriate policy balance in this area.

Negligence or fraud?

70. Irrespective of the range of documents covered by any statutory liability regime, a central question is whether the trigger for liability should be negligence or fraud (meaning intention or recklessness). Should there be liability for misstatements in corporate disclosures even if those making the statements honestly (but carelessly) believed them to be true? As we have seen, historically this has been the central question for the common law, and section 90A confirms the current common law position of no liability to investors for honestly held, even if negligent, statements.

71. There was a widespread (but not unanimous) agreement amongst those I talked to about the desirability of excluding liability for negligence. Even investor groups were generally cautious about the wisdom of imposing liability for negligence, though they were naturally amongst those who were more open to persuasion as to the potential advantages of such liability. An argument in favour of negligence liability for periodic and ad hoc statements can be made from the fact that, for over a century, such a rule has operated for prospectuses, in an apparently acceptable way. The overwhelming response of respondents to the notion that the prospectus standard should be applied to other disclosures, however, was that it would be very costly and in some cases impracticable. It was accepted that the standard of accuracy in prospectuses was high and that this could be attributed in part to the imposition of a negligence standard. However, it was pointed out that the verification process to which prospectuses are subject is both costly and time-consuming. It was not thought that the benefits of imposing this standard for civil liability beyond prospectuses would outweigh the costs. As for annual statements PwC, which was already investigating this issue, provided me with an estimate that a prospectus-type verification approach to annual statements would increase the audit costs by a fifth and that a similar further increase would be generated by additional legal work which would be involved.

72. However, respondents did not view the costs of a negligence regime solely or even mainly in terms of financial costs to the issuer of providing a higher degree of verification. They were concerned that a negligence standard might reduce the incentives to timely and full disclosure of information to the market, even if the level of accuracy of the information actually disclosed improved. In the case of ad hoc disclosures, it was thought that there would be a cost in slowing down information release (contrary to the thrust of the MAD), even if the negligence standard (of *reasonable* care) might be expected to be less demanding for an ad hoc disclosure than a prospectus or periodic disclosure, which could be planned for in advance to some extent. Whilst some theories might hold that a reasonable care standard would cause the maker of a statement to spend resources on checking the statement up to the point where the cost of the checking exceeded the expected benefits from reduced liability resulting from the checks, this assumes that the maker of the statement has no control over what is said, only over the amount of checking which occurs before the statement is made. Whilst this might be true of some corporate disclosures, in respect of many corporate

disclosures the law can require that a statement be made but not determine how detailed it should be. Respondents, including investor groups, were concerned that liability to the market for negligent misstatement might induce less useful disclosures, so that the overall benefit to investors of such a rule might be slight or negative. Investors in some circumstances would be able to recover losses suffered as a result of relying on inaccurate disclosures, but investors as a whole would suffer from having less information in the market.

73. On the other hand, when faced explicitly with the question whether they thought the reputation of public securities markets in the United Kingdom would be enhanced if there were no realistic possibility for investors who had been misled by intentionally or recklessly misleading corporate statements to obtain recovery for their losses, no respondent was prepared to give a positive answer. To permit fraudulent statements, it was generally agreed, would have a particularly corrosive effect on market confidence. Moreover, many of the costs of negligence liability do not arise in relation to statements not honestly believed to be true. A person does not have to engage in extensive verification to know whether he or she honestly believes something to be true (as opposed to checking whether it is actually true), whilst it is easy to avoid saying things not believed to be true, without this caution spilling over into statements honestly believed to be true. Some respondents were concerned that the meaning of 'reckless' should be tightly defined, as it is in the current tort of deceit, but all those with whom I discussed the proposition accepted, hardly surprisingly, that a market in which losses caused by fraud could not be recovered would not be attractive to investors or, in turn, to issuers.

74. It is also worth noting the experience of other countries. In both the United States and Germany legislators have refrained from introducing liability to investors based on the simple negligence of issuers and others. It is particularly important to note this feature of the US federal law, given the prominence which that law has achieved in recent public debates about securities markets. As we noted in para 29, when it imposed civil liabilities for disclosures outside the area of prospectuses, the US legislator retreated to a test of intention: the maker of the statement would escape liability if he could show that he had no knowledge that the statement was false or misleading – usually referred to as the 'scienter' requirement.[81] In fact, private civil actions tend to be brought in the US under section 10(b) of the 1934 Act and Rule 10(b)(5) made under it, although this section appears to give rise to no private right of action. When the courts interpreted the section so as to provide this right, they too adopted a scienter standard.[82] In fact, the standard adopted was more than the making of a knowingly false statement with intention that it be relied upon: there was required to be an intention to 'deceive, manipulate or defraud.' However, later cases have relaxed this standard so as to embrace 'recklessness'; and have then given recklessness a broader meaning than in the United Kingdom, so as to embrace 'an extreme departure from the standards of ordinary care.'[83]

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[81] Securities Exchange Act 1934, sec. 18(a).
[82] *Ernst & Ernst v Hochfelder* 425 US 185 (1976).
[83] L. Loss and J. Seligman, *Fundamentals of Securities Regulation* (New York, NY: Aspen Publishers, 5th ed, 2004) at p. 1025.

75. In 2002 Germany reformed its Securities Trading Act (Wertpapierhandelsgesetz – WpHG) in the light of the collapse of companies quoted on the Neuer Markt, Germany's secondary market, launched in 1997 but closed in 2002. The aim was to introduce civil liability for ad hoc statements, the publication of inaccurate ad hoc reports by companies being perceived as having been a significant contributing factor to the collapse and investor losses. Section 37c (see WpHG in Annex B), which applies to all domestic German stock exchanges, imposes such civil liability (though only on issuers) but provides that: 'Those issuers who can prove that they were not aware of the inaccuracy of the inside information and that such lack of awareness does not constitute an act of gross negligence shall not be liable for damages pursuant to subsection (1).'[84] The recent German law thus tracks the modern understanding of the scienter requirement in US law.

76. It might thus be concluded that to introduce liability to investors for ordinary negligence would be a step further than either the US legislator and courts or the German legislator have been prepared to contemplate. On the other hand, both systems are prepared to contemplate a meaning for 'recklessness' which includes some cases of negligence, ie where the belief is honestly held but on very unreasonable grounds. By contrast, in the English law of deceit an honest belief in the truth of a statement defeats a claim of recklessness, no matter how unreasonable the belief.[85] Consquently, a half-way house between liability for fraud and liability for negligence might be liabilty for gross negligence. However, it is difficult to know what legislating for such a standard in the UK would involve, since 'gross negligence' is not an established term in English civil law, though it is used in some parts of the criminal law.

77. Despite the general caution about introducing liability to investors for negligent misstatement – a view which is supportive of this aspect of section 90A – there was one view put to me which went in the other direction. This was that uncertainty as to what impact the TD had on the *Caparo* decision was actually desirable. On the one hand, because issuers and directors thought they might be liable, they would take care over announcements. On the other, because it was not clear that they were, there would be a disincentive to investors to litigate. This situation represented the best of all possible worlds. Consequently, the common law operated satisfactorily and section 90A should not have been adopted and should certainly not be extended. This is a particularly sophisticated analysis. Two points can be made about it. First, it is far from clear that it is sustainable in the long run or even the medium term, since at some point the legal position at common law would be tested in the courts and the beneficial consequences of uncertainty, if such they are, destroyed. Second, it is not clear that the costs of negligence liability referred to above depend heavily on the level of litigation. The costs referred to by respondents were the costs of the steps needed to be taken to avoid litigation, whether by way of extra verification or less useful disclosure. Either issuers and directors believe that such liability is a significant risk, in which case those costs will be incurred, or they do not, in which case the possibility of liability in negligence has no purchase on their actions. My impression is that the advice being tendered by the leading

[84] Articles 37b and c are set out in the Annex.
[85] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (London: Sweet & Maxwell, 2nd ed., 2007) para. 5.14.

commercial firms is that the risk exists and so the costs of negligence liability are being incurred.

Question 1:
What should be the basis of liability? Should the basis of liability be simple negligence? Would gross negligence be available as a possible basis for liaiblity in the British context? Is fraud an appropriate basis for liability?

The range of disclosures to be covered

78. The current statutory regime in section 90A of FSMA 2000 applies only to 'statements published in response to requirement imposed by' Articles 4 to 6 of the TD or to material in prelims which will appear in the annual financial report in substantially the same form. Thus, it does not apply to ad hoc disclosures, in particular to disclosures of inside information required by Article 6 of MAD. A central issue for the Review is whether the statutory regime should be extended to ad hoc disclosures.

79. A number of respondents were of the view that there should be no extension. However, those who took this view were generally sceptical of the need for having section 90A in any event and who therefore thought that there was no need to extend it and some disadvantage in doing so, since a new statutory provision inevitably created some uncertainty as people worked out its implications for them.

80. The contrary argument was that it was impossible in practice to draw a firm line between ad hoc and periodic disclosures, since some ad hoc disclosures will have to be repeated in periodic statements. To remove the risk of negligence-based liability only for periodic statements whiles leaving open the possibility that the courts might impose negligence liability at common law for ad hoc statements did not constitute a rational way of proceeding.[86] Moreover, it could be argued that the risk to the common law regime as it applies to MAD disclosures is at least as great as that from the TD, because MAD, like the TD, adopts in its recitals a market protecting rationale for its provisions, including the requirement for the disclosure of inside information by issuers. In fact, it can be argued that the risk to the common law regime is somewhat greater for MAD disclosures, since there is no company law equivalent to the MAD requirement that inside information be disclosed. Whereas the periodic reporting requirements have their historical origins in the companies' legislation requirements for reporting to shareholders and are still partly regulated in that legislation, the requirement for ad hoc disclosure of inside information is unrelated to governance by shareholders but rather is linked to informing investors.[87] A court applying the common law of negligent misstatement might still be convinced by policy arguments against imposing liability in damages (especially the point about the indeterminacy of the liability) but it would not have at its disposal the comforting rationale for non-

[86] See in particular Financial Markets Law Committee, *Legal assessment of the proposed statutory liability regime in the Companies Bill in relation to Transparency Obligations Directive disclosure*, September 2006.
[87] As the DTR implementing the MAD requirement put it, 'the purpose of this chapter is to promote prompt and fair disclosure of relevant information to the market.' (DTR 2.1.3)

liability that the purpose of the disclosure requirement was to promote shareholder governance.

81. Looking at the matter more broadly, it can be said that it would be undesirable to have a liability regime for ad hoc statements (permitting negligence actions) which was more expansive than that for periodic statements (excluding negligence). This is because periodic statements can be planned for to some degree, whereas the triggers for ad hoc statements are often (though not always) events of which the company has little notice. Given the emphasis in the FSA's rules and practice on immediate disclosure of the information to the market (with only limited reasons for delay being acceptable), the risk of an issuer falling below the required standard of care in relation to an ad hoc statement is higher than in relation to a periodic statement. Whilst it is true that the standard of *reasonable* care would adjust to a degree to take account of the pressures on the issuer to communicate quickly to the market, the risk of a court holding ex post that the issuer should have picked up an inaccuracy in the statement remains greater in relation to ad hoc statements than in relation to periodic statements.

82. The extension of the statutory regime to ad hoc disclosures also needs to be viewed from the standpoint, not only of the protection it would afford against negligence liability, but also of the liability it would impose for fraudulent misstatements. None of the respondents I reported above as being in favour of, or at least not opposed to, the imposition of liability for fraud sought to draw an 'in principle' distinction between fraudulent statements in periodic and ad hoc reports. The anti-fraud argument thus constitutes a reason for extending section 90A to ad hoc statements. If it is bad for the reputation of a share market for investors to be left without compensation for fraudulent misstatements in periodic reports, that must equally be the case for ad hoc statements. Indeed, as the German experience suggests, the risk of misleading statements is greater in the latter case, since the issuer may put out an ad hoc statement at any time.

Question 2:
Should the statutory regime should be extended in principle to ad hoc statements?

Particular issues about liability for fraudulent ad hoc statements

(i) Delay

83. However, respondents, who were in favour of the extension of section 90A, raised a couple of very important issues about the scope of such an extension. One was the question of how section 90A would operate in relation to ad hoc statements which were accurate but late, ie should have been disclosed earlier under the criteria set out in the FSA's DTR rules. This was a significant problem because the FSA's rules were thought to be very demanding about the promptness of the required disclosure and to provide few reasons for non-disclosure.[88] We have also noted that the FSA's public enforcement action has focussed heavily on delayed disclosure. It should be noted, however, that the

[88] See DTR 2.2.9 (inside information to be disclosed as soon as possible) and 2.5 (especially 2.5.5) – unlikely to be circumstances in which delay justified other than in relation to negotiations whose outcome would be jeopardised by public disclosure.

German reforms do impose liability for delay in parallel terms to those used for inaccuracies. See WpHG section 37b in Annex B.

84. Where a disclosure was delayed, it was pointed out, to impose liability only on the basis of intention would be no protection for issuers, because the decision to make the announcement at time t_2 rather than earlier time t_1 would often have been a deliberate one. Moreover, it would always be possible for claimants to argue that the disclosure should have been made somewhat earlier and, in the case of a heavily traded stock, the range of potential claimants could be quite large.

85. Although section 90A goes beyond the common law by imposing liability for omissions, and late disclosure could be analysed as an omission (ie during the period between t_1 and t_2), it seems clear that the section does not cover this type of omission. The section contemplates liability only for omissions from the statement which is made ('omission from any such publication of any matter to be included in it')[89] rather than liability for failure to make any statement at all. Further, it is difficult to see how the section's requirement for reliance 'on the information in the publication'[90] could be satisfied in relation to the period when no statement had been made. There can be such reliance only when the statement is made, but if the statement, when made, is accurate and complete, there can be no liability at that point.

86. Most of those who raised this issue wanted to maintain the regime of no civil liability for late disclosure. It has to be said, however, that it is unattractive not to impose liability where an issuer deliberately withholds information in order to mislead the market and to create a false market in its securities. It is suggested that an appropriately narrow liability could be crafted in such a case. First, it is already the case under section 90A that, in relation to omissions, that a deliberate omission is not enough to lead to liability. There must be 'a dishonest concealment' of a material fact. There must be dishonesty as well as deliberateness, so that this test, applied to late disclosures, would not mean an issuer was liable simply because it decided to delay publication for a short period in order to check the accuracy of its proposed statement. Second, however, there is the issue of reliance. It is difficult to see how that requirement could be retained in the case of liability for late publication. An investor can hardly be said to rely on something of which he or she is not aware. However, a substitute for the reliance requirement in the case of late disclosure could perhaps be found by focussing on the purpose of the delay, ie that the purpose of the delay should be to mislead the market. This approach is adopted by section 397 of FSMA 2000 which imposes criminal liability for dishonest concealment of material facts 'whether in connection with a statement . . . or otherwise' but only where the purpose of the concealment is (under that section) the inducement of, broadly put, an investment decision.

87. However, the criminal law does not have to answer an important question which a civil liability section would have to address: what losses would be subject to compensation in the case of dishonest delay? The core case is one in which the information when published is true, but it is late in arriving. When published, the

89 S. 90A(3).
90 S. 90A(5)(a).

information may contain good news or bad news about the company. The absence of a reliance requirement would suggest that anyone who, in the case of good news, sold securities in the period between the point at which the information should have been disclosed and when it was disclosed should be compensated for the difference between the sale price and price that would have been paid, had the information been in the market. Similarly for purchases in the case of bad news. This rule would yield a large number of potential claimants. However, the frequency with which the rule would apply would be constrained by the requirement of dishonesty rather than just intention to delay.

Question 3:
Should a liability for dishonest delay be imposed in the narrow circumstances identified above or should delay be sanctioned only through public enforcement via the FSA?

(ii) What is an ad hoc statement?

88. Irrespective of whether civil liability is imposed for delay or only for inaccurate ad hoc statements, there is the question of what counts as an 'ad hoc statement'. This apparently innocuous question is in fact a very difficult one to answer precisely. The narrowest approach would be to focus only on the disclosures required by Article 6(1) of MAD, ie the disclosures of inside information. The rationale for this approach would be that it is in relation to this Article that the threat to the common law exclusion of negligence is at its strongest. One objection is that it is often difficult for companies to judge whether a particular piece of information is in fact inside information (normally because of unclarity about whether it price sensitive) and so companies may put out disclosures through a RIS which strictly they are not required to make. However, section 90A, it is suggested, already deals with this point, since it imposes the statutory regime in relation to 'reports and statements published in response to a requirement' imposed by Articles 4 to 6 of the TD. The formulation 'in response to a requirement' does not confine the statutory regime to statements required by the TD but extends it to statements put out where the issuer thinks it is arguable that disclosure is required. The same approach could be applied to disclosures under Article 6 of MAD.

89. However, nearly all non-lawyers and many lawyers did not think it attractive to confine any extended regime to disclosures of inside information under Article 6 of MAD. As is made clear in para 18ff above, there are many types of ad hoc disclosure which companies are now required to make. Article 6 itself is not confined to disclosure of inside information by the issuer. Article 6(4) requires those 'discharging managerial responsibilities' to notify their transactions in the shares (and other related financial instruments) of the issuer. As implemented in the DTR, the notification must be to the issuer which has to inform the market through the RIS of the information received.[91] Following Chapter III, Section 1 of the TD, a similar regime now applies to disclosures of major shareholdings in companies.[92] Both sets of provisions were previously in the companies legislation. There are additional ad hoc disclosure requirements in the Listing Rules, notably in relation to significant or related-party transactions.

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[91] DTR 3.1.
[92] DTR 5.

90. Most respondents thought that it would be unattractive for issuers and their advisers to have different liability regimes applying to different classes of ad hoc disclosures. One popular suggestion, if there was to be an extension of the statutory regime, was to apply it to all announcements put out through a RIS. However, there are two objections to this approach. First, the Listing Rules (LR 10 and 11) require RIS announcements of significant and related-party transactions, but it is clear that the purpose of these announcements is as much to inform shareholders (whose prior consent to the transaction is often needed) as the market. In *Caparo* the court was concerned to preserve the negligence-based rights of shareholders in relation to the governance of the company. The scope of these rights may be unclear and their financial significance not large (in most, though not all, cases, losses to the shareholders will be indistinguishable from the losses to the company and the latter will take precedence) but it seems wrong in principle to reduce these rights. The extension of section 90A, in its present form, to this class of RIS announcement would exclude the liability of directors or the company itself to shareholders in respect of misstatements made to the shareholders in circulars seeking their approval. A slightly more restrictive approach might be to confine the definition of ad hoc statements to statements put out in response to requirements contained in the DTR, thus excluding the shareholder-oriented disclosures required by the LR.

91. Second, it was argued by some people that the content of RIS announcements might be repeated in briefings and that liability might be based on the briefing rather than the RIS announcement. However, it is not clear that this is a good argument. Section 90A(6) imposes its principle of non-liability where there has been reliance on an untrue or misleading statement in a publication etc. Although it is clear that this principle applies where the claimant reads the document in question and relies on it, it would seem also to apply where the claimant obtains knowledge of the statement in some other way, ie where the information is repeated to him or her by someone else.

92. Third, it was pointed out that companies release some types of information through press releases rather than a RIS. In principle, this was not thought to be a problem at present, because where the information is thought likely to be price sensitive, a RIS will be used. However, if a more favourable liability regime (from the issuer's point of view) is established for RIS announcements, there might be thought to be an incentive for issuers to use a RIS where it was inappropriate to do so.

93. There is also a question about whether statements made in the course of takeover bids should be covered by the definition of an ad hoc disclosure. I am inclined to the view that they should not. They are essentially shareholder-regarding rather than market-regarding statements, and the common law, post *Caparo*, has already been applied to them.[93] There is also a hands-on public regulatory system in place in the shape of the Panel on Takeovers and Mergers.

Question 4:
If the statutory regime were to be extended to ad hoc announcements, should it be (a) confined to disclosures of inside information (the most pressing case), (b) applied to all

[93] See *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] 1 BCLC 18, CA and *Partco Group Ltd v Wragg* [2002] 2 BCLC 323, CA.

RIS announcements or (c) confined to announcements made under the FSA's Disclosure and Transparency Rules (ie excluding ad hoc announcements made under the Listing Rules)?

Application of the statutory regime to non-regulated markets

94. Both the TD and the MAD apply only to securities admitted to trading on regulated markets. And section 90A is confined to regulated markets because it applies only to statements made in response to the TD requirements. It might seem, therefore, that the questions discussed in this paper have no relevance to non-regulated markets, such as AIM or Plus. However, as we have seen in paras 14 and 20, the rules of both markets require similar, if less demanding, periodic and ad hoc disclosures. Therefore, on both regulated and non-regulated markets, periodic and ad hoc statements will be made and so the question of the appropriate civil liability regime arises in both cases.

95. Both AIM and Plus pride themselves on their 'light touch' approach to regulation. In their view this has been an important element of the success of both markets, especially of AIM. However, the question of whether section 90A promotes or hinders a 'light touch' regulatory regime remains to be answered and the answer is not obvious. In order to address the question it is important to recall once again the twin effects of section 90A, relating to negligence, on the one hand, and fraud, on the other.

96. As far as negligence is concerned, the section applies the principle of non-liability. One might think that this principle is consistent with the 'light touch' approach. If section 90A continues not to apply to non-regulated markets, then those markets will continue to be regulated by the common law. It might be said that the *Caparo* decision shows that the common law principle is one of non-liability to investors and that the Directives constitute no threat to the common law in relation to non-regulated markets, because they do not apply to them. Consequently, non-regulated markets can continue to rely on the common law to exclude negligence liability in appropriate cases. However, the potential effect of section 90A (whether extended or not) upon the courts' perception of the appropriate liability at common law needs to be considered. A court might take the view that the legislature was prepared to confirm non-liability in negligence for the main market, because of the greater public controls to which it is subject, whilst not being prepared to do that for the non-regulated markets, so that it would be appropriate to modify *Caparo* in its application to the non-regulated markets. It is difficult to assess the weight of this argument about the 'spill over' effect of section 90A on the liability regime for the non-regulated market, but the extension of the statutory regime to non-regulated markets would bring clarity to the liability position.

97. The other effect of the application of section 90A to non-regulated markets is that it would make it clear that there could be civil liability for fraudulent statements. As stated above, no respondent claimed that the absence of liability for fraudulent misstatements would be reputation-enhancing for any securities market, and so it is not apparent that there is any inconsistency between a 'light touch' approach and making liability for fraudulent statements effective. In fact,

making clear that such liability was effective might support steps currently being taken by the London Stock Exchange to increase the effectiveness of its regulation, for example, the introduction of a rulebook for Nomads and the devotion of greater resources on the part of the Exchange to monitoring the quality of Nomads' discharge of their functions.[94] A clear fraud-based liability might be thought to be supportive of the Nomads' work. A number of respondents also made the point that, in relation to deliberate and reckless misstatements, there should be a level playing field as between regulated and non-regulated markets, especially in the light of the movement of issuers between the two markets.

Question 5:
Should section 90A apply to non-regulated markets? Does your answer differ according to whether section 90A is extended to cover ad hoc statements?

Defining the scope of liability for fraudulent misstatements

98. The thrust of this paper has been to propose the extension of the statutory regime in section 90A of FSMA 2000 for the twin purposes of (a) clarifying the absence of liability in damages for negligent statements and (b) modifying the common law liability for fraudulent misstatements so that it applies effectively to periodic and ad hoc disclosures. In respect of the second aim, a number of detailed issues arise, which are now discussed. In fact, those issues can be said to arise in relation to the existing section and so need consideration whether section 90A is extended or not.

(i) Priority as between investors and other unsecured creditors

99. Section 90A imposes liability for fraudulent misstatements only on the issuer. If the company is insolvent, an issue arises as to whether the defrauded investors should be allowed to compete with the other unsecured creditors of the company for a share of the assets or whether the claims of the shareholders as creditors should be subordinated to the claims of the other unsecured creditors (mainly trade creditors). The English position would seem to be that the investors' claims are not subordinated to those of the other creditors. This is the implication of *Soden v British & Commonwealth Holdings plc* (1997),[95] where the court considered the provisions of section 75(2)(f) of the Insolvency Act 1986, which subordinates claims for 'any sum due to a member of the company (in his character of a member) by way of dividend, profits or otherwise' to the claims of the other unsecured creditors. The House of Lords held that this section did not apply to a claim by a shareholder for damages against the company on the basis of a negligent misstatement made to the shareholder by the company, on the faith of which it had acquired shares in the company. Consequently, the investors' claims ranked equally with those to the other unsecured creditors. The same decision was arrived at recently by the High Court of Australia in the *Sons of Gwalia* case,[96] on the basis of similar Australian legislation. The claim in the Australian case

[94] See London Stock Exchange, *AIM Rules for Nominated Advisers*, February 2007.
[95] [1998] A C 298. The question of whether B&C had a good claim against the insolvent company was never determined.
[96] [2007] HCA 1.

arose out of an allegation that the company, in breach of the relevant Australian ad hoc disclosure rules, had failed to notify the Australian Stock Exchange that its gold reserves were insufficient to meet its gold delivery contracts and that it could not continue as a going concern. Although the Australian High Court came to the same conclusion as the House of Lords as to the meaning of the statutory provision, some of the judges expressed regret at the policy outcome. By contrast, the US Bankruptcy Code subordinates securities-based claims to those of other general creditors.

Question 6:
Should the claims of investors for damages under section 90A or any extension of it be subordinate to the claims of other unsecured creditors?

(ii) Liability of those who make statements on behalf of the company

100. Tort law has not only a compensatory but also a deterrent purpose. Where, as under section 90A, liability is confined to the issuer, it is far from clear that any deterrent purpose of tort law is achieved. This is because the liability, falling on the company, is borne by its shareholders, whereas the makers of the fraudulent statements, normally the directors, carry no liability to the investors (though they may have a liability to the company, as explained in para 53). The shareholders may put pressure on the directors as a consequence of the liability imposed on the company, but such deterrence would operate only indirectly. The question thus arises as to whether, in relation to fraudulent misstatements, there should be liability on those who make the fraudulent misstatement on behalf of the company. Where they meet the requirements of the tort of deceit, for example, where they themselves know that the statement they are making on behalf of the company is false, directors and senior managers are liable at common law. At present, this is the rule that applies to ad hoc disclosures, but section 90A applies a different rule to periodic disclosures.

101. It might be said that imposing liability on the directors would not in fact secure any deterrent purpose, because D&O insurance is likely to transfer the costs of the liability back to the company, even if the law apparently provides otherwise. Even if D&O insurance is generally unavailable to cover fraudulent behaviour, it may be that such cover would extend to directors' liabilities under settlements of claims brought by investors in which the directors do not admit liability. If this is the case, imposing liability on directors might simply add to the incentives for defendants to settle investors' claims out of court. It is also the case that the cost of the misstatements will be transferred back to the company if the company undertakes to provide to the directors an indemnity against liability to third parties, as is now permitted by section 309B of the Companies Act 1985.

102. As to foreign experience on this point, in the United States section 10b of the Securities Act 1934 is not confined to issuers, though in practice the system of D&O insurance operates so that little liability remains with the directors.[97] In Germany the reform of the WpHG in 2002 imposed liability only on issuers. In 2004 there was a further reform proposal which would have extended liability to those who acted on behalf of the company, but this reform was not proceeded

[97] John C Coffee Jr, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, Columbia Law School, Center for Law and Economic Studies, Working Paper No. 293, March 2006.

with after lobbying by German business.[98] In France, there is the general doctrine of the separate legal personality of the company which protects directors from liability whilst they are acting on behalf of the company, at least before the French civil courts, though the criminal courts are more sceptical of this doctrine.

103. This question arises not only in relation to directors and senior managers, but also in relation to advisers. Again, the requirements of the fraud action would have to be satisfied by the adviser in question, ie the adviser would have to know that the statement was false or be reckless as to its truth and reliance by the investor would have to be reasonable in the circumstances. There may be a particular worry about imposing this liability on auditors, because of the particular structure of the international audit market, though that worry exists, I believe, more in relation to negligence-based liability than fraud-based liability. The provisions of Chapter 6 of Part 16 of the Companies Act 2006 would not seem to benefit the auditor in this situation because they apparently deal with the auditor's liability to the company, not to third parties.

Question 7:
Should statutory liability for fraudulent misstatements be extended to those who make the statement on behalf of the company?

(iii) Compensation for sellers and holders?

104. Section 90A provides compensation only to those who acquired securities on the basis of misleading statements and who suffered loss in consequence.[99] Those who sell securities or hold securities on the basis of false misstatements are not entitled to claim. The exclusion of sellers of securities was criticised by all those respondents who commented on the issue. Some respondents also thought holders of securities should be able to claim. I am inclined to view these two classes of potential claimants as raising rather different questions, which their common feature of being excluded from the current version of section 90A rather obscures.

105. The problem with giving a right to compensation to a person who simply continues to hold securities (let alone a person who decides to continue as a non-holder of securities in the issuer) is the difficulty of establishing that, in the absence of the misstatement, they would have sold the securities in question or bought (more of) them, as the case may be. This is a counter-factual which may be very difficult to prove. On the other hand, without proof of the counter-factual it will not be possible to say that the claimant relied on the misstatement, reliance being a pre-requisite of liability under section 90A. It is tempting to say that questions of proof can be left to the courts and only those claimants who can show reliance will succeed in their claims. Thus, if I can prove that I telephoned my broker to instruct him to sell my shares in a company but that he drew my attention to an optimistic statement the company had just put out and I told him not to proceed with the sale, I might succeed in my claim. However, in general such cases will be difficult to prove and there might be thought to be a public interest in not giving to the courts the task of making factual

[98] See for a critical account of this:
http://www.jura.uni-augsburg.de/prof/moellers/aktuelles/kapinhag_gestoppt.html.
[99] Section 90A(3).

determinations for which there will normally be little reliable information. It is interesting to observe that neither the US nor Germany (two countries having statutory liability for misleading disclosures) confers protection on those who simply hold securities or remain as non-investors in the company. In the case of Germany it was an explicit decision to require a market transaction before there could be liability.[100]

106. In the case of a seller of securities, acting in reliance on a false statement put out by the company, the issues of identifying and proving loss might be thought to be the same as with an acquirer of securities. It may be in the nature of things that companies more often put out misleading optimistic statements and so generate purchases of securities than misleadingly pessimistic ones which generate sales. However, in principle it is not clear why reliant sellers should not recover if reliant purchasers do.

Question 8:
Should statutory protection be extended to sellers and holders of securities as well as to buyers?

(iv) The measure of damages

107. Section 90A of FSMA 2000 does not deal with the measure of damages to be awarded if an investor's claim is successful. It seems likely that the courts would apply the same approach as is followed in the case of common law claims for deceit, since the section is closely modelled on the common law tort. In *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd* (1996)[101] the House of Lords used a test which was generous to claimants. In particular, the court held, damages in deceit were not limited to that part of the loss which flowed from the fact that the misrepresentation was false. In this case a vendor of shares (Citibank, through one of its employees) made directly to the claimant (Smith New Court) a fraudulent misstatement in connection with a block of shares in Ferranti which the claimant was proposing to purchase as a long-term holding. The effect of the fraudulent misstatement was that there were other bidders for the shares held by Citibank. After the claimant had purchased the shares, it appeared that an entirely unconnected fraud within Ferranti meant that the price of the shares in the market was overvalued. The claimant eventually sold its holding at a considerable loss and recovered the whole of the difference between the purchase and the sale prices, even though much of that loss represented the effect of the unconnected fraud.

108. The approach in the tort of deceit is in contrast to the measure of damages in negligence, where the recoverable loss is defined by reference to the scope of the duty broken. Thus, in *South Australia Asset Management Corpn v York Montague Ltd* (1996)[102] the same court as in the *Smith New Court* case applied a different test where a surveyor had negligently valued properties for a lender proposing to take security over the properties. In this case, the surveyor's liability was limited to the loss caused to the lender from having a security worth less than it had expected,

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[100] See Ulrike Ehricke 'Deutschland' in Klaus J Hopt and Hans-Christoph Voigt (eds), *Prospekt- und Kapitalmarktinformationshaftung* (Mohr Siebeck, Tübingen, 2005) pp 280-282.
[101] [1997] A C 254, HL.
[102] [1997] A C 191, HL.

but the surveyor was not liable for the loss caused by the subsequent drop of values in the property market generally.

109. As was explained to me by NERA Economic Consulting the focus in private securities litigation in the United States is on identifying the loss caused to the investors by the misstatement, ie the approach is much closer to that for the tort of negligence in the UK than that for the tort of deceit, despite the fraud basis of the US substantive law. NERA, who provide expert evidence to defendants in class actions in the US, have developed a sophisticated methodology for distinguishing the adverse impact on the stock price when the truth emerges from adverse impacts arising from other causes, such as a fall in the overall market which occurs at the same time; and for predicting what the course of the share price would have been if the misstatement had not been made. In the new German rules dealing with misstatements in ad hoc disclosures, it is disputed whether the measure of damages is the loss caused by the misstatement ('Kursdifferenzschaden') or whether the investor can claim to be put in the position he was in before the transaction was entered into ('Vertragsabschlussschaden'), which is in effect the deceit measure in English law. The better view is that it is only the former which can be recovered.[103]

Question 9:
Should the deceit or the negligence measure of damages be adopted in the statutory regime?

III. Some overarching issues

Can super-optimal levels of fraud-based litigation be avoided?

110. During the course of this Review there has been a considerable body of criticism emanating from the United States about the way that private securities litigation, especially private securities class actions, operate in that country. In particular, in December 2006 the Committee on Capital Markets Regulation, directed by Prof Hal S Scott of Harvard Law School, delivered its Interim Report.[104] Although its views are not universally accepted in the US legal and business communities, there is no doubt that the Report reflects a substantial degree of dissatisfaction with private securities class actions in the US, despite the reforms which had been made in that area as recently as 1995 in the Private Securities Litigation Reform Act. The report makes proposals for various reforms of private securities litigation in the United States, though it should be noted that it falls very far short of proposing that the right to bring such litigation should be removed. The question is thus raised as to whether similar problems would occur in the UK if fraud-based actions by investors became generally available.

111. There are strong reasons for thinking that a fraud-based investor action would operate very differently in the UK from the way in which private securities litigation operates in the US. First, as has been pointed out in para 74 above, the

[103] Klaus J Hopt and Hans-Christoph Voigt, 'Grundsatz- und Reformprobleme der Prospekt- und Kapitalmarktinformationshaftung' in Hopt and Voigt (eds), above n 98. pp. 130-133.
[104] Available on: http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

definition of 'fraud' in section 90A and, indeed, in the tort of deceit upon which it is modelled, is narrower than that used by the US courts in 10b litigation. 'Fraud' for the purposes of section 10b of the Securities Act 1934 has been interpreted by the courts as including cases of gross negligence, whereas an honest, even if unreasonable, belief in the truth of the statement prevents a finding of fraud in English law. This point was settled for good by the House of Lords as long ago as 1889 in *Derry v Peek*.[105] As a leading authority has put it: 'The core of the action of deceit is *fraud* on the part of the representor, by which the claimant was *deceived*: this has been clear since the late eighteenth century. During the course of the nineteenth century there was some debate about the exact meaning of "fraud" for the purposes of this tort, but in 1889 this debate was definitively settled by the House of Lords in *Derry v Peek* , and since then the tort has remained in substance unchanged.'[106]

112. Besides this very important difference in the definition of fraud, there are substantial differences in the operation of the civil litigation systems in the two countries, which are probably as important as the differences in the substantive law. These differences in procedural law tend to reinforce the differences in the substantive law, ie to discourage private securities litigation in England[107] and to encourage it in the US.

113. An important procedural issue is how easy it is for a defendant to have the claim against it struck out at an early stage of the litigation, ie at the point when the claimant has simply formulated its claim but there has been no (expensive) pre-trial disclosure, let alone a trial. It is relatively costless (both financially and in terms of management time) to defend an action up to strike-out. If, however, a strike-out is not available, the costs of the litigation begin to mount and so do the pressures on the defendant to settle the claim (and thus avoid the costs and distractions of the litigation), even if the defendant thinks the claim lacks merit. In *BCCI v Price Waterhouse*[108] Laddie J put the significance of the courts taking a robust view of the strike-out as follows:

> "However it is common knowledge that in many cases like this in which enormous sums of damages are sought, the dispute does not reach the stage of a judgment. The sums claimed, the sheer cost of the litigation which in a case like this will be in many tens of millions of pounds, the enormous time which will be needed for the trial and the dislocation that will impose on the parties means that there will be very great pressure on them to settle. That pressure may be felt particularly acutely by the defendants. In fact during another application before me in this action some little while ago, counsel for the plaintiffs (but not the counsel appearing before me on this application) suggested that, no matter how weak the Plaintiffs' claim might appear in a case of this type, the defendants or their insurers would normally succumb to the pressure to offer a settlement. He appeared to suggest that such proceedings therefore justified themselves. I wish to make it clear that I am not suggesting that that is the motive behind these proceedings or that that was being suggested by counsel. But I have little doubt that it reflects what happens in some cases. In a legal system where even success in the litigation leaves the winning party bearing a substantial costs burden, the incentive to do a deal must be significant. Soldiering on as a matter of principle frequently is not a commercially sensible course to adopt. The result is that a significant part of the case law consists of cases concerning applications to strike out."

105 (1889) 14 App. Cas. 337.
106 Cartwright, above n 83 at para. 5.01.
107 These remarks are confined to English civil procedure, though it is not believed that the overall position is significantly different in Scotland. Comments from those familiar with Scottish procedure are invited.
108 [1999] BCC 351.

In spite of some relaxation in the strike out rules in English law in recent years, it remains the case that in the case of fraud the statement of case must allege fraud clearly and that allegation must be supported with particulars, which are capable of supporting the allegation of fraud.[109] Fraud cannot be 'averred generally'. In addition, under the Bar Council's Code of Conduct a barrister may not draft a statement of case making 'any allegation of fraud unless he has clear instructions to make such allegation and has before him reasonably credible material which as it stands establishes a prima facie case of fraud.'[110] Thus, the stricter definition of fraud in the UK combines with the rules on formulating statements of case to make it more difficult for a claimant who does not have evidence of fraud to get past the strike-out stage, in the hope that pre-trial disclosure by the defendant will produce the evidence that was previously lacking – or that the costs of the disclosure process will pressurise the defendant into a settlement. Although the 1995 reforms attempted to move the US system of civil procedure away from general averments of states of mind and towards greater particularity, it appears that this reform has not been uniformly interpreted across the various Circuits of the federal court system.[111] In the US a very small proportion of private securities actions which are commenced actually reach trial, whilst the percentage of claimed losses (which may well be over-inflated) which is actually met in settlements is very low (about 3 per cent currently).[112]

114. In the United States securities class actions are routinely tried by juries, who determine both liability and damages. This is regarded by potential defendants as substantially increasing the chances of claimants obtaining a large damages award and by claimants as adding significantly to the pressures on defendants to settle. A significant recommendation of the Scott committee is that companies should be able to opt for judge trials (not only in relation to securities litigation).[113] Although fraud actions remain one of the areas where jury trials are still in principle to be used in civil actions in England, this requirement does not apply if 'the court is of opinion that the trial requires any prolonged examination of documents or accounts';[114] and it appears that jury trials are rare in the class of case with which this Review is concerned.

115. However, the factor which was mentioned most often by respondents as promoting securities litigation in the United States were the financial incentives for law firms to initiate litigation. These incentives seem to depend on two matters, neither of which is replicated in the United Kingdom. First, class actions in the US operate on an 'opt out' basis, whereas the closest analogy here under the Civil Procedure Rules is the 'group litigation order' which operates on an 'opt in' basis. Under the US system a court will award recovery for all the members of the class (for example, investors who bought securities after the false statement was made and before the truth emerged) unless they choose to take themselves out of the class action at an early stage. The burden is on the investor to do so, not on the claimant's lawyer to seek their consent to be included in the class.

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109 *Three Rivers District Council v Bank of England (No. 3)* [2001] 2 All E R 513, HL.
110 Bar Council, *Code of Conduct*, para. 704(c).
111 Though the Supreme Court this term will address this issue in the case of *Tellabs Inc v Makor Issues & Rights Ltd*.
112 NERA, *Recent Trends in Shareholder Class Action Litigation*, April 2006, pp. 7- 8. The dollar amounts recovered, however, are often substantial.
113 Above n. 102 at p. 11.
114 Supreme Court Act 1981, s. 69.

Under a Group Litigation Order under the CPR[115] the court's judgement will benefit only identified claimants, either those who are on the 'group register' when the judgment is handed down or, if the court so directs, claimants who bring claims in the future. Consequently, to maximise the size of the recovery under the British system, the lawyers must identify the full range of class claimants and seek to obtain the permission of as many of them as possible to join in the litigation and have their claims entered on the register.

116. In connection with the formation of the class, it is also important to revert again to the reliance requirement in section 90A (see para 55 above). In the United States a typical class is constituted by those who bought shares after the misleading statement was made and still held the shares at the point the truth emerged. Under the 'fraud on the market' theory, adopted in the US for misleading continuing disclosures as well as for misstatements in prospectuses, it is not necessary for the claimant to show knowledge of and reliance on the misstatement in question. Thus, class formation is easier and classes are larger than where reliance has to be shown.

117. Second, *contingent* fee arrangements in the United States permit lawyers to enter into agreements whereby they take in a successful case a significant proportion of the recovery awarded to the claimants (thus reinforcing the 'opt out' rule from the point of view of the lawyers) but are not remunerated at all if the case is unsuccessful. In the UK section 58 of the Courts and Legal Services Act 1990[116] permits *conditional* fee arrangements, by which lawyers can agree to no payment if the case is unsuccessful and an increase of their normal fee (but *not* a share of the recoveries) if the case is successful. Such agreements may lead to a doubling (but no more) of the fees otherwise payable.[117] The overall effect of the UK provisions is, it would seem, to give law firms a much less powerful incentive to promote private securities litigation than in the US.[118] There seem to be no law firms in the UK, as there are in the US, whose business model is based wholly or mainly on the promotion of private securities litigation, though the arrival in Europe from the US of such a firm was often mentioned as a possibility by respondents. However, it is clear that the issue of the funding of civil litigation in the United Kingdom is still the subject of debate and that the current rules cannot be assumed to represent the situation which will continue in the future.[119]

118. A particular issue about funding of securities litigation which came to the fore during the Review was that of funding by third parties (as opposed to the law firm representing the claimants). Section 58B of the Courts and Legal Services Act 1990[120] permits third-party funding of litigation, on a similar basis to that for conditional fees. Section 58B is not in force and I understand there are no immediate plans to bring it into force. In the area of insolvency litigation, however, recent changes appear to permit a liquidator to assign a cause of action to a third party in exchange for a share of proceeds, if the litigation is

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115 CPR 19.10 ff.

116 As amended by the Access to Justice Act 1999, s. 27.

117 The Conditional Fee Arrangements Order 2000/823.

118 The UK costs shifting rule in the case of unsuccessful litigation is a further factor in discouraging litigation.

119 See, for example, Civil Justice Council, *Improved Access to Justice – Funding Options and Proportionate Costs*, August 2005.

120 Also introduced by the Access to Justice Act 1999 (s 28).

successful,[121] and that third party funders have emerged to take advantage of this possibility.[122] This is a basis for funding litigation which is clearly closer to the US contingent fee model than to the British conditional fee one. However, this facility appears to apply only to claims by companies (brought through the insolvency practitioner), not to claims against them by investors.[123]

The benefits and limitations of private actions to enforce securities law

119. It is traditionally said that the law of tort (of which the law of deceit is part) has two, sometimes conflicting, goals. These are compensating those who have suffered from the wrongful act and deterring the commission of such acts in the future. On deterrence, we have already noted that section 90A of FSMA does not impose liability on the makers of misleading statements on behalf of the company. This does not mean that the private litigation has no deterrent effect on those who make the statements, because they may suffer reputational and other losses as a result of being involved in the litigation. Nevertheless, it does mean that at present direct sanctions on the makers of misleading statements lie in the area of public enforcement of the disclosure rules, notably by the FSA.

120. As for compensation, we have seen that there are two issues here. On the one hand, the measure of damages rule might seem over-generous to claimants. On the other, the US evidence suggests that most private litigation to enforce securities litigation is settled for a relatively small amount of the damage suffered. The former problem could be fixed by altering the measure of damages rules. The latter is more difficult because it may be very near impossible, and probably undesirable, to change the incentives of issuers, and their directors, to settle litigation rather than to go to trial.

121. It can also be argued that, for long-term only investors, the financial benefits of being able to sue for damages may be small, if their position is looked at over time. They are as likely, it might be said, to be among the shareholders in the issuer which has made the misleading statement as among the investors who were misled. They benefit in the latter capacity but lose out in the first. Over time, their financial position may not be significantly different than if they could not sue at all, except that they will have borne the transaction costs of the litigation. Thus, on both the compensation and deterrence fronts, the achievements of private litigation are limited.

122. However, none of the above arguments is a good reason for excluding private litigation entirely where fraud is involved. First, to do so would be exclude almost any possibility of compensation being provided to investors misled by fraud, given the FSA's decision not to allocate its scarce resources to routine use of its restitution powers under FSMA in the case of non-retail investors. Although some investors may appear as often on one side of the litigation equation as on the other, this cannot be guaranteed to be the case for all investors. Those whose

[121] See J Armour and A Walters, 'Funding Liquidation: A Functional View' (2006) 122 *Law Quarterly Review* 303.
[122] Notably IM Litigation Funding. See http://www.insolvencymanagement.co.uk/default.htm.
[123] In Australia, where third-party funding is more generally available, there are a number of such providers and the largest, IMF, is quoted on the Australian Stock Exchange. See http://www.imf.com.au/.

position is asymmetrically on the investor side, will be out of pocket if they have no possibility of suing for fraud. Second, given the adverse effect on market confidence of fraud, it can be said to be unwise from a broader public policy standpoint to rely entirely on public sanctions to combat it. The FSA has a wide range of statutory objectives to fulfil and needs to harbour its resources with care. Private litigation both relieves some of the pressure on those resources and provides an alternative forum within which decisions can be taken about devoting resources to combating fraudulent disclosures by issuers. Third, in the areas covered by EU Directives, it can be argued that making fraud-based liability effectively available would help promote an 'equity culture' which is a subsidiary aim of the EU-level reforms.

IV. Appendices

Table 1: FSA cases[124]

Company	Date	Breach	Sanction
Eurodis	12/09/2005	Delayed announcement LR9.2	Censure
My Travel	14/07/2005	Delayed announcement LR9.2	Fine 240k
Pace Micro	26/01/2005	Omission from interim results and failure to announce: LR9.2 and 9.3A	Fine 450k
Shell	24/08/2004	Market abuse	Fine 17m
Universal Salvage	19/05/2004	Delayed announcement LR9.1	Fine 90k company 10k director
Sportsworld	29/03/2004	Delayed announcement LR9.2	Public censure and 45k on directors
SFI	11/12/2003	Misleading preliminary results LR9.3A	Censure
Marconi	11/04/2003	Delayed announcement LR9.2	Public statement
AIT	2002 onwards	Reckless statement in trading statement FSMA s397 – criminal prosecution	Custodial sentences, disqualification from being a company director, compensation order, confiscation order quashed

[124] Source: www.fsa.gov.uk

Annex A: Sections 90A and 90B of FSMA 2000 (section 1270 of Companies Act 2006)[125]

1270 Liability for false or misleading statements in certain publications

In Part 6 of the Financial Services and Markets Act 2000 (c. 8), after section 90 insert—

"90A Compensation for statements in certain publications

(1) The publications to which this section applies are—
   (a) any reports and statements published in response to a requirement imposed by a provision implementing Article 4, 5 or 6 of the transparency obligations directive, and

   (b) any preliminary statement made in advance of a report or statement to be published in response to a requirement imposed by a provision implementing Article 4 of that directive, to the extent that it contains information that it is intended—
      (i) will appear in the report or statement, and
      (ii) will be presented in the report or statement in substantially the same form as that in which it is presented in the preliminary statement.

(2) The securities to which this section applies are—
   (a) securities that are traded on a regulated market situated or operating in the United Kingdom, and
   (b) securities that—
      (i) are traded on a regulated market situated or operating outside the United Kingdom, and
      (ii) are issued by an issuer for which the United Kingdom is the home Member State within the meaning of Article 2.1(i) of the transparency obligations directive.

(3) The issuer of securities to which this section applies is liable to pay compensation to a person who has—
   (a) acquired such securities issued by it, and
   (b) suffered loss in respect of them as a result of—
      (i) any untrue or misleading statement in a publication to which this section applies, or
      (ii) the omission from any such publication of any matter required to be included in it.

(4) The issuer is so liable only if a person discharging managerial responsibilities within the issuer in relation to the publication—
   (a) knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading, or
   (b) knew the omission to be dishonest concealment of a material fact.

[125] See www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en.pdf

(5) A loss is not regarded as suffered as a result of the statement or omission in the publication unless the person suffering it acquired the relevant securities—
   (a) in reliance on the information in the publication, and
   (b) at a time when, and in circumstances in which, it was reasonable for him to rely on that information.

(6) Except as mentioned in subsection (8)—
   (a) the issuer is not subject to any other liability than that provided for by this section in respect of loss suffered as a result of reliance by any person on—
      (i) an untrue or misleading statement in a publication to which this section applies, or
      (ii) the omission from any such publication of any matter required to be included in it, and
   (b) a person other than the issuer is not subject to any liability, other than to the issuer, in respect of any such loss.

(7) Any reference in subsection (6) to a person being subject to a liability includes a reference to another person being entitled as against him to be granted any civil remedy or to rescind or repudiate an agreement.

(8) This section does not affect—
   (a) the powers conferred by section 382 and 384 (powers of the court to make a restitution order and of the Authority to require restitution);
   (b) liability for a civil penalty;
   (c) liability for a criminal offence.

(9) For the purposes of this section—
   (a) the following are persons "discharging managerial responsibilities" in relation to a publication—
      (i) any director of the issuer (or person occupying the position of director, by whatever name called),
      (ii) in the case of an issuer whose affairs are managed by its members, any member of the issuer,
      (iii) in the case of an issuer that has no persons within sub-paragraph (i) or (ii), any senior executive of the issuer having responsibilities in relation to the publication;
   (b) references to the acquisition by a person of securities include his contracting to acquire them or any interest in them.

90B Power to make further provision about liability for published information

(1) The Treasury may by regulations make provision about the liability of issuers of securities traded on a regulated market, and other persons, in respect of information published to holders of securities, to the market or to the public generally.

(2) Regulations under this section may amend any primary or subordinate legislation, including any provision of, or made under, this Act.".

Annex B: Sections 37b and 37c of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG)[126]

<u>Section 37b</u>
<u>Liability for damages due to failure to immediately publish inside information</u>

(1) If an issuer of financial instruments that are admitted to trading on a German stock exchange fails to immediately publish inside information that directly affects that issuer, it shall be liable to compensate a third party for the damage resulting from the omission if the third party

1. has bought the financial instruments after the omission and still owns the financial instruments upon disclosure of the information or

2. has bought the financial instruments before the existence of the relevant insider fact and sells them after the omission

(2) Those issuers who can prove that the omission was made neither deliberately nor in an act of gross negligence shall not be liable for damages pursuant to subsection (1).

(3) Damage claims pursuant to subsection (1) shall not exist if, in the case of subsection (1) no. 1, the third party knew about the undisclosed fact at the time of purchase and, in the case of subsection (1) no. 2, the third party knew about the undisclosed fact at the time of sale.

(4) Damage claims pursuant to subsection (1) are subject to a limitation period of one year from the date on which the third party learned of the omission, but not more than three years after the omission.

(5) This is without prejudice to further contractual claims or claims in intentional tort which may be raised under the provisions of civil law.

(6) Any agreement which reduces the claims to be brought by an issuer against the members of the board of management based on damage claims against the issuer pursuant to subsection (1) or which relieves the members of the board of management of such claims shall be deemed invalid.

<u>Section 37c</u>
<u>Liability for damages based on the publication of false inside information</u>

(1) If an issuer of financial instruments that are admitted to trading on a domestic stock exchange publishes false inside information that directly affects that issuer in a notification pursuant to section 15, he shall be liable to compensate a third party for the damage resulting from the fact that the third party relied on the accuracy of the inside information, if the third party

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[126] Source: www.bafin.de

1. has bought the financial instruments after publication and still owns the financial instruments at the point in time at which it becomes publicly known that the information was inaccurate or

2. has bought the financial instruments before publication and sells them before it becomes clear that the information was inaccurate.

(2) Those issuers who can prove that they were not aware of the inaccuracy of the inside information and that such lack of awareness does not constitute an act of gross negligence shall not be liable for damages pursuant to subsection (1).

(3) Damage claims pursuant to subsection (1) shall not exist if, in the case of subsection (1) no. 1, the third party knew that the inside information was inaccurate at the time of purchase and, in the case of subsection (1) no. 2, the third party knew that the information was incorrect at the time of sale.

(4) Damage claims pursuant to subsection (1) are subject to a limitation period of one year from the date on which the third party learns of the inaccuracy, but no more than three years after publication.

(5) This is without prejudice to further contractual claims or claims in intentional tort which may be raised under the provisions of civil law.

(6) Any agreement which reduces the claims to be brought by an issuer against the members of the board of management on grounds of damage claims pursuant to subsection (1) or which relieves the members of the board of management of such claims shall be deemed invalid.

LIST OF QUESTIONS FOR RESPONSE

Question 1:
What should be the basis of liability? Should the basis of liability be simple negligence? Would gross negligence be available as a possible basis for liaiblity in the British context? Is fraud an appropriate basis for liability?

Question 2:
Should the statutory regime should be extended in principle to ad hoc statements?

Question 3:
Should a liability for dishonest delay be imposed in the narrow circumstances identified above or should delay be sanctioned only through public enforcement via the FSA?

Question 4:
If the statutory regime were to be extended to ad hoc announcements, should it be (a) confined to disclosures of inside information (the most pressing case), (b) applied to all RIS announcements or (c) confined to announcements made under the FSA's Disclosure and Transparency Rules (ie excluding ad hoc announcements made under the Listing Rules)?

Question 5:
Should section 90A apply to non-regulated markets? Does your answer differ according to whether section 90A is extended to cover ad hoc statements?

Question 6:
Should the claims of investors for damages under section 90A or any extension of it be subordinate to the claims of other unsecured creditors?

Question 7:
Should statutory liability for fraudulent misstatements be extended to those who make the statement on behalf of the company?

Question 8:
Should statutory protection be extended to sellers and holders of securities as well as to buyers?

Question 9:
Should the deceit or the negligence measure of damages be adopted in the statutory regime?

TERMS OF REFERENCE

Section 1270 of the Companies Act 2006 establishes a new statutory regime for liability in damages to third parties in respect of disclosures under the Transparency Directive (2004/109/EC). The Government consulted last year on whether the statutory regime should be extended. Responses to the consultation confirmed that this was a complex area in which it is vital to get the policy right, but were not conclusive.

The Government want to strike the right balance between the interests of investors and issuers, providing appropriate incentives to make timely and accurate disclosures in compliance with statutory rules, and an appropriate – but limited – right to recover losses. Section 1270 of the Companies Act amends the Financial Services and Markets Act 2000, inserting a new section 90B that provides for a power to amend the statutory regime.

The Government appointed Professor Paul Davies, the Cassel Professor of Commercial Law at the London School of Economics in October 2006 to undertake a review of issuer liability. The Davies Review will:

- Consider the law relating to liability in damages of issuers of securities traded on a regulated market or alternative markets (such as AIM or Plus Markets) in respect of statements and publications made to the market and which are incorrect, false or misleading or have not been made promptly;

- Consider how any such liability may be affected by regulatory obligations attaching to issuers and directors;

- Consider the case for providing for a specific right to damages by those relying on such statements and publications in the context of securities market activities, in particular: the circumstances that might give rise to a right, against whom a right might be enforceable and the consistency with the effect of corporate governance and conventions, standards or rules affecting the information that issuers publish to shareholders and others and how they publish it;

- Consider the impacts on:
    - issuers, markets, investors and others;
    - the quantity and quality of information disclosed;
    - the competitiveness of the UK as a good place to do business;

- Take into account the liability of issuers and their managements in other centres of financial services in Europe or more widely including the USA;

- Make recommendations to the Treasury on whether to exercise the section 1270 power and, if so, how.

In making recommendations to the Treasury, the Review will advise on:

- options for a new regime if recommended;
- who might bring actions to sue for damages;
- the kinds of damages that might be awarded and potential effects of paying those damages on issuers, including effects on their business and employees, directors or senior executives, and on the supply of qualified individuals willing to take on director and non-executive director roles in consequence;
- and other related matters.

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