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News Bulletin

August 27, 2008

Extension of the UK Statutory Regime for Liability of Issuers of Securities

In January 2007, in response to the Transparency Directive, the UK's Financial Services and Markets Act 2000 (FSMA) was amended by the insertion of section 90A so as to introduce a statutory civil liability regime for untrue or misleading statements in all periodic disclosures made to the market by issuers of securities. This regime enables investors who acquire securities and suffer losses as a result of a fraudulent misstatement, or the omission of material information from such disclosure, to be compensated by the issuer pursuant to a civil statutory action.

As part of the same package of legislative amendments, section 90B was introduced to enable the Treasury to extend the section 90A regime to make further provisions about liability for published information. The Treasury is currently considering exercising the powers granted to it by section 90B to iron out certain inconsistencies in the liability regime in relation to disclosures which were highlighted by the interplay between section 90A and the Disclosure and Transparency Rules (DTR).

Provisions of section 90A of FSMA

By way of introduction, section 90A of FSMA applies to: (a) issuers with securities admitted to trading on a UK regulated market (such as securities traded on the Main Market of the London Stock Exchange but not AIM) and (b) issuers with securities that are traded on a regulated market outside the UK and issued by a company whose home member state is the UK.

Under section 90A of FSMA, subject to the knowledge and reliance requirements described below, an issuer is liable to pay damages to any person who has acquired securities and suffered loss as a consequence of any untrue or misleading statement in, or omission of any information required to be disclosed in any of the disclosures required by the DTR, including: (a) an annual report, (b) a half yearly report, (c) an interim management statement, and (d) any voluntary preliminary statement published in advance of a report or statement published pursuant to the DTR. However, no liability attaches to the issuer for a delay in making an announcement.

However, the issuer is not liable unless:

- a "person discharging managerial responsibilities" (such as a director, an issuer's member managing the issuer's affairs or a senior executive) in relation to the publication knew that the statement was untrue or misleading, was reckless as to whether it was, or knew the omission was a dishonest concealment of a material fact; and
- the investor acquired securities in reliance on the information and at a time when, and in circumstances in which, it was reasonable for him to rely on that information.

Therefore, the issuer will not be liable if the person discharging managerial responsibilities was merely negligent.

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Criminal and common law liability regime

When it was implemented in 2007, the statutory civil liability regime introduced by section 90A of FSMA supplemented the pre-existing criminal liability regime under section 397 of FSMA whereby a person commits a criminal offence if he knowingly or recklessly makes misleading statements, dishonestly conceals material facts or engages in a misleading course of conduct so as to induce, or to the effect that he does induce, another person to enter into or refrain from entering into an agreement to buy or sell securities or to exercise any rights related to a particular security. Although the criminal liability regime is far-reaching in scope, a high standard of proof is required to secure a conviction under section 397 of FSMA and for that reason, it is infrequently invoked and in practice, it has to date been used successfully only once in criminal proceedings.

Alongside these statutory regimes, a common law liability in the tort of negligence or deceit may arise if a person makes a negligent or fraudulent misstatement which a third party relies on and suffers a detriment or loss as a result.

Treasury proposals

In 2007, the Treasury commissioned Professor Paul Davies QC to review the scope of the statutory civil liability regime. In June 2007, he submitted a report setting out his analysis of the existing regime and proposing ways in which it could be enhanced. The report was duly considered by the Treasury which in July 2008 went on to publish a consultation paper setting out its proposals to extend the civil statutory regime and inviting stakeholders to air their views on the proposals.

In line with Professor Davies' recommendations, the Treasury proposes in the consultation paper that the statutory civil liability regime should be extended to cover the following circumstances:

- disclosures made by issuers with securities admitted to trading on all UK multilateral trading facilities (MTFs) such as JP Morgan Cazenove, Reuters Transaction Services Ltd, the AIM and the PLUS-quoted markets as well as the regulated markets, which include EDX London Limited, the Main Market of the London Stock Exchange, SWX Europe Limited, LIFFE Administration and Management, London Metal Exchange, ICE Futures Europe, PLUS Markets plc (formerly known as OFEX).
- issuers with securities admitted to trading on an EEA regulated market or MTF where the UK is the issuer's home member state under the Transparency Directive or the issuer has a registered office in the UK.
- information published by the issuer via a recognised information service (RIS) and all other information where the availability of that information has been announced by the issuer via an RIS. For the purposes of this proposal, RIS announcements are deemed to include not only the disclosures which are prescribed by the Transparency Directive but also all ad hoc statements under the Market Abuse Directive. Additionally, the Treasury proposes that the issuer be liable in damages, irrespective of whether the person claiming damages obtains the relevant information from an RIS or other sources, provided that the information was published on a recognised RIS.
- where the issuer acts dishonestly in delaying publication of an RIS announcement and by the delay intends to enable a gain to be made or to cause loss to another or expose another to the risk of loss.
- liability should attach irrespective of whether the relevant transaction takes place on or off market.
- both buyers and sellers should be covered by the regime but not holders of securities. The argument against the inclusion of holders of securities is predicated on the difficulty in determining that the holder of the securities relied on a misstatement in the absence of a transaction.

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The Treasury proposes that no changes be made to the following provisions:

- The statutory regime only applies to "transferable securities" as defined in section 102A(3) of FSMA, other than money market instruments which have a maturity of less than 12 months. The regime will cover disclosures by issuers to the market that can potentially influence the value of the traded securities admitted to the market but is not intended to cover issuers of derivatives who typically do not make public disclosures.
- In the case of depositary receipts and other secondary securities giving a right to acquire or sell other transferable securities, the issuer liable to pay compensation shall be the issuer of the underlying securities, provided that the secondary securities concerned have been admitted to trading by or with its consent. For depositary receipts and other secondary securities admitted to trading without the consent of the issuer of the underlying securities, and for all other derivative instruments, the issuer of the depositary receipts, other secondary securities or derivative instruments shall be liable to pay compensation under the regime.
- The current basis of liability, which is fraud, will remain unchanged. The fraud basis of liability is construed in the same manner as the standard common law tort of deceit. At common law, "fraud" implies that the maker of the statement knew that the statement was false or was reckless as to whether the statement was true or false and additionally, that the maker of the statement intended the recipient of the statement to rely on it. However, unlike the common law tort of deceit where the maker of a fraudulent statement is liable to the recipient only if he intended the recipient to rely on it, under the statutory civil liability regime, the recipient need only show that its reliance on the issuer's statement was reasonable. Furthermore, the fraud basis of liability enables courts to strike out unmeritorious claims at an early stage of the judicial process and sets a high tightly defined standard of proof which is likely to discourage speculative litigation.

Negligence and gross negligence were put forward as alternative bases of liability but they were dismissed after a more careful analysis. The common perception is that the legal standard of the "reasonable person" involved in the definition of "negligence" under English law is difficult for the issuer to ascertain at the time of making the statement and that such an uncertain standard of liability would encourage issuers of securities to engage in bland and defensive reporting to protect themselves from speculative litigation, driven by economic opportunism. In addition, "gross negligence" was also deemed not to be a viable standard due to the fact that it is a relatively new, uncertain concept under English law and would similarly encourage speculative litigation. In any event, negligent reporting will not go unpunished under the statutory regime given that the FSA applies a "negligence" standard of liability in its enforcement actions against issuers under FSMA.

- The statutory liability regime should not be extended to directors and advisers. The rationale for this is that directors are liable to their company for negligence and may be sued by the company or by a shareholder on behalf of the company through a derivative action under the Companies Act 2006. In addition, directors are subject to the FSA's penalty regime if they are "knowingly concerned" in the contravention by the issuer.
- The assessment of damages will continue to be a responsibility of the courts which will determine the appropriate measure after they have conducted a detailed examination of the facts of each case.
- Investors' claims will continue to be subordinated to those of other unsecured creditors and ahead of shareholders' claims. The consultation paper states that this issue will be deferred for further consideration.

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Comments on the consultation paper can be submitted to the Treasury by 9 October 2008 and a copy of the consultation paper can be found on the Treasury's website.[1]

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[1] http://www.hm-treasury.gov.uk/media/2/5/issuerliability_170708.pdf