

Davies Review of Issuer Liability:
Final Report

by Professor Paul Davies QC

June 2007

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Contacts

This document can be found on the Treasury website at:

hm-treasury.gov.uk/davies

For general enquiries about the review, contact:

Davies Review of Issuer Liability
Room 4 / 20
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Email: davies.review@hm-treasury.gov.uk

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Foreword by the Economic Secretary to the Treasury

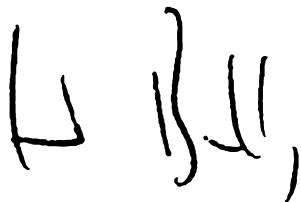
Last summer, in the course of implementing the Transparency Directive through the Companies Bill, I was presented with compelling arguments from a wide range of companies, accountancy firms and from the legal profession, asking that I take action to set out in law the liability of listed companies for the financial statements that they were required to publish by the Transparency Directive.

Accepting these arguments, and taking this policy forward, it became clear that everybody agreed that this was a complex area, in which it is vital that we get the policy right. However, there was no clear agreement on what the right policy was.

Following consultation, I presented to Parliament a framework of legislation that sought to achieve the correct balance between ensuring that investors had the right to take action against companies in respect of financial statements that turned out to be fraudulent, and enabling companies to release accurate, timely and meaningful statements to investors. However, many of those who commented on the proposals argued that they should cover a wider range of financial statements. In recognition of this, and the enormous challenge of striking the balance correctly, I also asked for the power to be able to make amendments to the legislation.

The appointment of Professor Paul Davies QC to conduct this independent review is the crucial component to make sure that in this vital area we get the policy right. When I first met Paul we discussed the effects that his work could have on the efficiency and international competitiveness of the UK's capital markets. The UK's statutory and legal framework is rightly seen across the world as a key competitive advantage.

The thorough analysis and clear explanation that Paul presents in his final report allow the reader to gain a remarkable insight into this difficult policy area, as well as to understand clearly the rationale behind his conclusions.

A handwritten signature in black ink, appearing to read 'Ed Balls'.

Ed Balls MP

Preface by Professor Paul Davies QC

Ed Balls MP
Economic Secretary
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Economic Secretary

You asked me in October last year to carry out a review of issuer liability to investors in respect of misstatements to the market and, in particular, to consider the exercise the powers conferred by the new section 90B of the Financial Services and Markets Act 2000 (inserted by the Companies Act 2006). My appointment followed an earlier consultation carried out in the summer of 2006 by the Treasury, whose results confirmed that this was a complex area in which it is vital to get the policy right but were inconclusive. I issued a Discussion Paper in March 2007 and I now submit my Final Report. The Executive Summary which follows sets out the main conclusions and recommendations of my Report.

I am grateful to all those who gave of their time to discuss the issues with me. They came from a wide range of backgrounds within the securities markets and their users, and I learned something from all of them. I am grateful also to those (often, but not always, the same people) who responded in writing to the Discussion Paper and did so, more or less, within the short time limit set by me for responses. Taken as a whole, the responses were thoughtful and reflective. I refer to some of those responses in this Report. However, reading them through sparked for me trains of thought, whose inspiration I cannot no longer precisely identify. So, I apologise to those unacknowledged respondents, especially where they think my views bear an uncanny resemblance to their own.

I am grateful to four LSE graduate students for research assistance on this project which was provided quickly and flexibly, and with serious detriment to their Christmas vacations: Florian Burnat, Joanna Hemingway, Stefan Papst and Alisa Valderrama.

Above all my thanks go to Anthea Heffernan, Secretary to the Review, without whose organisational and distilling skills this Review would not have been completed in such short order.

Yours sincerely,



Paul Davies

Executive Summary

- Section 90A of the Financial Services and Markets Act 2000 (introduced by section 1270 of the Companies Act 2006) establishes a new statutory liability regime under which issuers will be liable for fraudulent misstatements in periodic disclosures to the market as required under the Transparency Directive (2004/109/EC). However, in response to industry concerns raised last summer about the limited scope of the new statutory liability regime and whether common law rights of shareholders were at risk, the Government appointed Professor Paul Davies QC, the Cassel Professor of Commercial Law at the London School of Economics, to carry out an independent review of liability for corporate misstatements to the market and to recommend whether or not changes should be made to the existing statutory regime.
- Key to the independent Davies Review's inquiry has been striking the right balance between incentives needed to encourage companies to disclose accurate, timely and meaningful information and the rights of investors who rely on misleading statements to make investment decisions to claim damages for losses suffered. The Review has considered both existing regulatory obligations and penalties, including criminal penalties, and the potential for liability in damages under existing common law jurisprudence. It has also looked at the position in other EU member states and more widely in the jurisdictions of other substantial financial services markets.
- The Review's Discussion Paper published in March 2007 invited comments on nine questions relating to liability for corporate misstatements to the market. This Final Report, which takes account of the views of a broad cross-section of over 40 respondents, presents the Review's conclusions and recommendations to the Government, making the case for exercising the powers conferred by the new section 90B of FSMA 2000 to extend the existing statutory liability regime in section 90A in certain ways.
- The first and most difficult question raised by the Review was what should be the basis of liability: fraud or the less demanding standard of negligence? Or is gross negligence a viable middle way? The Review recommends that fraud be maintained as the standard of liability for misstatements to the market, on the grounds that: (a) negligence is a fact dependant standard of liability, with very limited guidance as to how the courts might apply it case by case, and which therefore would encourage defensive and bland reporting; (b) careless reporting will not go unsanctioned because negligence is the standard adopted for FSA penalties and censures; (c) creating a civil liability based on a negligence standard risks generating unmeritorious claims for large sums in a way that fraud-based liability does not; and (d) gross negligence, as a new and untested standard, would create legal uncertainties and risk the same problems of defensive reporting and speculative litigation as simple negligence.
- In response to those concerned that fraud is too restrictive a standard of liability, the final report notes that fraud-based liability does not take away existing investor rights, since negligence will remain open as a basis for investor claims in respect of their rights *as shareholders* in the company. Further, the existing statutory regime makes fraud claims easier to bring than at present at common law, because the claimant need only show that his own reliance on the misstatement was reasonable and not

also that the issuer intended that he should rely on it. The Review recommends that this should continue to be a feature of the extended statutory regime.

- On the basis of maintaining fraud as the standard of liability, the Review recommends the following changes:
 - extend the statutory regime to cover ad hoc disclosures, on the basis that: (a) some ad hoc statements will later appear in periodic disclosures required by the Transparency Directive; (b) it is confusing to have different liability regimes according to whether a disclosure is required under the Transparency or Market Abuse Directives; and (c) issuers and investors alike saw no principled distinction between ad hoc and periodic disclosures in terms of liability;
 - extend the statutory regime to apply to disclosures by issuers with securities traded on exchange-regulated markets, including AIM and Plus Market, and to all ‘multilateral trading facilities’ and other trading platforms for securities, on the grounds that while investors in these markets should accept the risk of different levels of disclosure than on the main market, they should still be protected from dishonest disclosure;
 - apply the statutory regime to all RIS announcements, on the grounds that this is the easiest rule for companies and investors alike to understand, but draft the provisions in such a way so as not to affect the rights of shareholders and others arising out of company circulars addressed to them;
 - extend the statutory regime to encompass liability for dishonest delay in making RIS statements, on the basis that where the purpose of the delay is fraudulent, this should be subject to claims for damages; and
 - extend the statutory regime to confer rights on both buyers and sellers of shares, on the basis that sellers in principle should not be excluded from claiming for losses suffered, but exclude those who continue to hold (or not to buy) shares from suing in respect of misstatements in RIS announcements.
- The areas where the Review recommends no change to the statutory liability regime under section 90A at present are:
 - confine statutory liability to issuers only and not impose statutory liability on directors or other advisers or third parties in respect of misstatements in RIS announcements, on the basis that this is not necessary for deterrent purposes. This is so because: (a) the sanctions and censure of the FSA and market operators themselves provide an alternative source of deterrence on directors; (b) exposing a director personally to large compensation claims will likely induce extreme and undesirable caution in order to avoid liability; (c) D&O insurance may shift the loss from director back to the company; (d) the company has the ability to seek compensation from the director for breach of duty or from advisers or others; and (e) shareholders may bring an action against the director under the new derivative action procedures in the Companies Act 2006;

- leave the assessment of damages to the courts, on the grounds that it is too difficult to formulate effective rules in statute which would not tie the courts' hands in an undesirable way in handling particular cases; and
 - the Government to consider further the issue of subordination of investors' claims to those of unsecured creditors, in part because of the ramifications outside the area of securities litigation.
- Finally, the Review considered the potential for companies to be subject to claims by investors resident in different jurisdictions. The Final Report concludes that it would be best if a single legal regime applied to investor claims, possibly the law of the jurisdiction where the issuer is incorporated or has a primary listing, but this issue cannot be solved through the exercise of the section 90B power and is outside the Review's terms of reference.

FINAL REPORT

1. The Discussion Paper (DP) issued in March 2007 set out the regulatory framework for continuing disclosure by issuers (both periodic and episodic or ad hoc); analysed the development of the common law and the extreme reluctance of common law to impose liability for negligent misstatements where this would result in ‘liability in an indeterminate amount for an indeterminate time to an indeterminate class’;¹ and discussed the circumstances which led to the insertion of section 90A into the Financial Services and Markets Act 2000 by the Companies Act 2006. I shall not repeat that material in this Report, though I refer to specific parts of the DP from time to time and it constitutes the background to this Report. I begin with two responses which raised issues not falling within the specific question I asked in the DP, though the issues were considered towards the end of the DP under ‘overarching issues’ (paras. 110ff of the DP).
2. The law firm, Clifford Chance, argued in its response that there should be no civil liability on the part of companies to investors even for fraudulent misstatements.² One of its points was put on the following basis: “Unlike many fraudulent misstatements, therefore, the benefit of the misstatement [to the market] does not accrue to the issuer. Instead, investors who have not sold their securities are penalised twice - through the fraud and through the subsequent payment of compensation.” This is an important argument of principle which is worth dealing with at the outset. I do not find it persuasive. First, I am not clear how it can be said that investors in the company who do not rely on the fraudulent statement can be said to be ‘penalised’. Their loss appears only to be a result of the company subsequently paying compensation to those who did rely on the statement. Second, I think that fraudulent statements are often made in what the directors conceive (or misconceive) to be the interests of the issuer, for example, deceiving the market so as to keep the company’s business alive for a while longer, in the hope that things will turn around.³ This may be a foolish policy which ultimately inflicts harm on the company and thus on its shareholders, except those who are fortunate enough to sell out before the mistake emerges. However, in this respect it is no different from any other ill-advised or illegal policy adopted on behalf of the company by its directors, the company (ie the shareholders) being required, by law or for reputational reasons, to compensate those harmed by it. The nub of the objection, I suspect, is rather to the compensation of one group of investors, who have suffered from the fraud, by the company (ie the other investors). That, however, is not a novel proposition: the law has provided for such liability for more than a century in relation to fraudulent and even negligent prospectuses,⁴ and clearly does so in the case of investors dealing directly with the company to whom the management makes fraudulent statements. I also take the view that it would not be good for the reputation of the British capital

¹ Per Cardozo C J in *Ultramares Corp v Touche* (1931) 255 NY 170, 179, an American decision but much cited in the relevant British cases.

² The implication, presumably, though it was not expressly drawn, is that section 90A of FSMA, discussed below, should be repealed.

³ See the case of *R v Bailey and Rigby* [2006] 2 Cr. App. Rep. (S) 36, discussed in the DP at para. 65.

⁴ A liability which, on the better view, extends to purchasers in the after market and not just to those who take the securities directly from the company: see J Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (London: Sweet and Maxwell, 2007) para. 7.52.

markets to have them operate under a regime in which investors were not entitled to compensation for fraudulent statements made by issuers.⁵

3. A similar argument was put in the Minority Response of the Law Society's Company Law Committee, but with the conclusion, in this case, that there should be no liability on the issuer but there should be liability on the directors (in the case of fraudulent misstatements). They say: "it would be more appropriate for the liability to fall exclusively on those persons discharging managerial responsibilities who are responsible for the statement or omission which gives rise to the loss."⁶ It is unclear to me why it would be appropriate to exclude corporate liability. The proposition seems to fly in the face of the principles underlying the general law of vicarious liability, ie the liability of companies and other principals for wrongs committed by their agents (including directors) or employees. Here it is established that there will be liability on the principal if what the agent does, even if dishonest, is sufficiently closely connected with the class of acts the agent has been appointed to perform, and this will be so even if what the agent has done can be characterised as performing his or her duties in an improper manner, for an improper purpose or by improper means.⁷ Thus, I think the exemption of the company from liability for the actions of its agent would be contrary to the general principles of our civil law. In the absence of much fuller argument as to why it would be 'appropriate' to disapply the principal in this area, I cannot recommend it. However, there clearly is an important and in some ways analogous issue as to whether directors' liability should be retained in addition to the liability of the company, which I address below when dealing with the responses to Question 7.
4. I am thus less troubled than these respondents by the principle of requiring the company to compensate investors whom it has misled. Indeed, specifically to enact that there should be no liability on the part of issuers to investors in the case of fraudulent misstatements would be to remove rights which investors have at common law, even if the precise scope of those rights is unclear. However, this does not mean that I think that liability for misstatements to the capital markets should be freely and extensively imposed. There seem to me to be strong reasons for proceeding cautiously (but not good reasons for not proceeding at all). As indicated in the DP (Introduction), it is important that any liability regime should not provide incentives for companies to become more cautious in their disclosures to the market. The compensation regime for investors should not be at the expense of a free flow of accurate, timely and helpful information to them from issuers. Rather, if possible, the liability regime should contribute to the incentives for accurate disclosure by issuers. Thus, I share the reservations expressed by a number of respondents about the possible disutility of increased securities litigation.⁸ I set out below a set of

⁵ Clifford Chance acknowledged in their response that it was difficult to identify a principled reason for not imposing liability for fraudulent misstatements.

⁶ Although they put the point as a response to Question 2 (see below at para 31), it is clear that theirs is a more fundamental objection than just to the extension of section 90A of FSMA to ad hoc statements, for they say that they 'question the logic of section 90A'.

⁷ *Dubai Aluminium Co Ltd. v Salaam* [2003] 2 A C 366, HL – solicitors' firm liable to a third party when one of its partners had dishonestly participated in a scheme to defraud the third party, even though neither the partner nor the firm received any of the proceeds of the fraud.

⁸ Clifford Chance say and I agree: "We do not believe that it would be beneficial for the UK financial markets for private securities litigation in the UK to follow the course that has been followed in the US, with extensive private securities actions." I also use a slightly different version of their argument about one

proposals, which build on the existing but partial statutory regime imposing liability on issuers for fraudulent misstatements and which, I believe, will meet the legitimate interests of investors but not hamper the flow of information to the market.

5. Section 90A imposes liability (i) for fraudulent misstatements (ii) upon issuers (only) (iii) in favour of acquirers of securities (only) (iv) in respect of statements made in response to the requirements of the Transparency Directive (TD) or in preliminary announcements of results, and thus (v) the section applies only to issuers with securities traded on a regulated market (notably, the Main Market of the London Stock Exchange but not AIM or Plus Markets) and (vi) it does not impose liability for delay in making announcements. Each of these limits on the scope of section 90A can be seen as raising an issue of principle which needs to be addressed in considering a more general statutory regime. However, it is clear that one cannot take a ‘pick and mix’ approach in discussing these issues. In particular, the answer to the first question (fraud or some version of negligence as the basis for liability) raises the fundamental question in this area, and many respondents made it clear, explicitly or implicitly, that their answers to at least some of the further questions were dependent upon this initial issue having been settled in the way they favoured. I therefore begin with this question, then proceed to the others indicated above, and finally consider a couple of further issues which are not expressly dealt with in section 90A but which emerged from my discussions and researches in this area.

Question 1: Fraud, negligence and gross negligence

(a) Fraud or ‘simple’ negligence

6. The first issue was presented in the DP (at paras. 70–77) principally as a choice between a fraud basis of liability and a negligence basis. There were thirty responses to the Question 1, which posed this issue, and since only one respondent, the UK Shareholders Association, was in favour of negligence as the standard of liability, it might be thought that this issue needs no further elaboration in this Report. However, the matter does deserve detailed consideration because of the need to be clear about the meaning of ‘fraud’ and because of the positive responses on the part of two further experienced investor groups (Association of British Insurers (ABI) and the Investment Management Association (IMA))⁹ to the question also posed in the DP as to whether a ‘gross’ negligence standard constituted an available half-way house between fraud and ‘simple’ negligence. The arguments for and against the gross negligence standard cannot be fully understood before one has seen how they play out in relation to the ‘simple’ negligence standard.
7. In order to present the issue as sharply as possible, the DP based the competing approaches on the existing concepts elaborated by the common law in the torts of negligence, on the one hand, and deceit, on the other. My understanding is that section 90A adopts the fraud definition from the common law of deceit. In negligence, the standard of conduct required is that of the reasonable person in the position of the defendant. This is a highly flexible standard of liability. The tort of

investor group compensating another below in discussing the advantages and disadvantages of liability based on negligence.

⁹ The Investor Relations Society was in favour of gross negligence but only if the problems of definition, which I think are insuperable (see para 25 below) could be overcome.

negligence needs such flexibility because it applies across a very wide range of activities in society, many of which are far removed from making statements to the capital markets, for example, driving a motor vehicle, operating a railway or factory, carrying out a medical procedure. As with all standards, the degree of guidance as to what the law requires, which can be obtained from the wording of the standard itself by those contemplating undertaking an activity to which the standard applies, is very limited. It is the application of the standard by the courts to the facts of particular cases which reveals its requirements, but that is a revelation which comes only after the event. Of course, examining a run of prior court decisions in a particular area enables the reader to deduce some prior guidance about the law's requirements. Nevertheless the application of the standard is always a fact-specific exercise, since what a reasonable person would do in the circumstances in which the defendant was placed can often not be determined without detailed examination of the facts of the case and debate about how the hypothetical reasonable person would have reacted in those circumstances. Thus, the scope for arguing that any particular set of facts giving rise to a potential claim is different in some significant respect from those of the previously decided cases is always large (though not unlimited).

8. By contrast, the tort of deceit is a form of wrongdoing developed by the common law specifically to deal with misstatements. It is formulated in much more precise terms. As laid down by the House of Lords over a century ago in the case of *Derry v Peek*,¹⁰ a person is liable in this tort only if he or she knew the statement being made was false or did not care whether it was true or false (and it was in fact false). A genuine belief in the truth of the statement will protect one from liability, no matter how easily the falsity of the statement might have been discovered. The tort of deceit contains something much closer to a rule than a standard:¹¹ do not make a statement unless you believe it to be true. It is therefore much easier for someone contemplating speech to know in advance what the tort of deceit requires than in the case of a negligence standard. In addition, since the enquiry in a deceit case is only as to what the defendant knew or believed (rather than what a reasonable person would have done in the same situation), the range of facts upon which liability is dependent is much narrower.
9. The main reason put forward for rejecting a simple negligence standard (by both the majority who wanted fraud only as the basis of liability and those few who would add gross negligence as a basis of liability) was that a negligence standard would not promote comprehensive and timely disclosure but would rather encourage defensive and bland reporting. Alternatively, issuers might report more slowly (taking more time, and incurring more expense, to check the accuracy of what was said). However, given the insistence in the FSA's rules (see below) on speedy reporting, less informative rather than less speedy information disclosures is, in my view, the more likely response to the imposition of negligence liability in respect of episodic reporting requirements. Even though most of the disclosures with which this Review is concerned are mandatory, nevertheless the rules cannot specify comprehensively the content of announcements which issuers are required to make. A negligence standard for civil liability would push issuers towards the less helpful and less forthcoming end of the spectrum of possible approaches to the discharge of the disclosure obligations. In other words, there was agreement, at least as far as simple

¹⁰ (1889) 14 App. Cas. 337. For a detailed analysis see J Cartwright, above n. 4, para. 5.13ff.

¹¹ On the distinction between rules and standards see L Kaplow, 'Rules vs Standards: an Economic Analysis' (1992) 42 *Duke Law Review* 557.

negligence was concerned, that the gain in terms of accuracy from the imposition of negligence liability was likely to be outweighed by the loss in terms of the content of what would be disclosed.

10. A number of respondents favouring the fraud rule acknowledged that it would constitute a narrow basis for liability, and, seeking to reduce the force of this argument, pointed out that the standard for liability under FSA's rules is negligence: '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.'¹² Thus, there was, it was said, sufficient incentive, in the shape of the FSA's rules and enforcement powers, to ensure that issuers did take proper care over disclosures to the market. However, this argument generates something of a conundrum: if the FSA's rules do not generate an adverse impact on the quality of disclosures to the market, even if they are based on a simple negligence standard, why should one expect civil liability rules based on the same standard to do so? And if the FSA's rules do have this adverse impact, what is the point of confining civil liability to the fraud standard, since this pass has been sold already?
11. These points lead me to the view that it is better to reformulate the question slightly differently and more broadly. The question is not whether there should be a negligence standard of liability for disclosures to the market but whether that negligence standard should be enforced solely by the FSA, primarily through its penalty-imposing powers, or whether civil litigation by investors seeking damages should also play a role in enforcing the negligence standard. The virtually unanimous response in favour of excluding civil liability based on simple negligence in this field reflected in my view three considerations. One was that the extent of the liability in civil litigation is measured by the loss suffered by the claimants, which in the case of a heavily traded stock could be very substantial. In principle, it is the loss caused to those who acquired securities during the period between the making of the false statement and the emergence of the truth (known in the US as the 'class period'), provided the securities were still held at the end of the period. Such losses would not necessarily be related (perhaps typically would not be) to the degree of fault on the part of the issuer in making the inaccurate misstatement. The prospect of a very large liability for only a very minor deviation from the standard of conduct of the reasonable person is likely to induce potential defendants to stay well on the non-liability side of the line, and, as part of that, to engage in 'defensive' and unhelpful disclosure. By contrast, the FSA is required by statute to have regard to the seriousness of the contravention in fixing its penalty,¹³ so that a minor departure from the required standard will not necessarily trigger a large penalty. The FSA is thus in a position to relate its penalties to the degree of fault involved and thus not trigger excessively defensive reporting.
12. The second concern was a fear that private litigation would lead to over-enforcement of a negligence standard, coupled with the view that enforcement of the negligence standard by the FSA did not and would not suffer from the same defects. Third, at least in terms of issuer liability, where the costs of litigation fall on the current shareholders in the company, there was scepticism about the overall social utility of a

¹² DTR 1.3.4 and 1A.3.2.

¹³ FSMA 2000, s. 93(2)(a). ENF 13.3.3(3) makes it clear that the FSA will take into account, among other things, the financial resources of the firm, when fixing the amount of the penalty. To like effect is LSE, *AIM Disciplinary Procedures and Appeals Handbook*, February 1007, p. 2.

mechanism which shifted investment losses from one group of investors to another. I now look at each the second and third arguments in a little more detail.

13. The fear that private litigation, especially collective private litigation, will lead to over-enforcement of the negligence standard results from an analysis which concludes that the civil litigation process permits the bringing of unmeritorious or speculative litigation (ie litigation based upon only weak arguments that the negligence standard has been breached) but which the defendant will prefer to settle rather than litigate to trial. The problem would be exacerbated if lawyers or other third party funders of litigation had an incentive to bring such litigation because, for example, a substantial proportion of such settlements would go to them. Respondents were influenced by the system of securities class actions in the United States and by analyses of that system to the effect that private enforcement of securities laws operates in that country so as to distort the securities markets and to make them less attractive to issuers.¹⁴ If, it was said, the civil litigation system could develop in this way in a country where the basis of liability was ‘fraud’ (albeit fraud interpreted so as to mean ‘gross negligence’ – see below), the risk would be even greater for a system where liability was based on ‘simple’ negligence. How realistic are such fears in the United Kingdom?
14. It should not be thought that speculative litigation is in some way a cultural phenomenon of the United States, rather than one associated with the structure of the civil litigation process. Where the structure of the civil procedure rules permits such litigation in the United Kingdom, it certainly does occur. In the DP I quoted a description of such speculative litigation by Laddie J., to be found in his decision in *BCCI v Price Waterhouse*,¹⁵ which was a case brought *by* a company (through its liquidator) against its auditors. It is perhaps worth repeating it here.

“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.”

Thus, the question is not whether speculative litigation can occur in this country – it clearly can – but whether the civil procedure rules would encourage or discourage it in respect of the enforcement of securities laws by investors against issuers.

¹⁴ See Committee on Capital Markets Regulation, Interim Report, December 2006 (available on: <http://www.capmksreg.org/index.html>).

¹⁵ [1999] BCC 351.

15. I discussed this issue in relation to fraud-based litigation in the DP (at paras. 110 – 118) and remain convinced of the conclusion there arrived at that fraud-based liability does not give rise to a serious threat of speculative litigation. However, there are certainly grounds for thinking otherwise in relation to negligence-based liability. In relation to fraud-based liability I pointed to three contrasts with the United States. The first was the absence of jury trials in this area in the United Kingdom.¹⁶ That point applies equally to negligence actions. Second, I pointed to the relative ease with which a defendant could obtain an early dismissal (strike out) of a fraud case if the claimant had no evidence of fraud; and difficulties in the way of the claimant simply alleging fraud in order to get past the strike-out stage.¹⁷ Third, I pointed to the lesser incentives to law firms and others to finance speculative litigation in this country, both because funding in exchange for a share of the recoveries was not clearly permitted outside the area of the enforcement of claims by (rather than against) companies in insolvency and because of the British costs rule under which the loser normally pays at least a proportion of the winner's legal costs.¹⁸
16. In relation to this last point on financial incentives to litigation the DP stated at para. 117: 'it is clear that 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.' Subsequent events have served to underline this reservation, at least as far as England is concerned. The Office of Fair Trading has produced a consultation document on the subject of collective private actions to enforce the competition laws which envisages a raising of the cap on the additional fees which lawyers can charge if the litigation is successful (currently set at 100% of the normal fee) and some capping of the liability for the other party's costs if the action is unsuccessful.¹⁹ More significant, the Civil Justice Council, whose earlier work was referred to in the DP, is about to produce a report on the funding of civil litigation generally, which, I understand, is likely to recommend that third party funding should be recognised as an acceptable option for mainstream litigation;²⁰ that research should be undertaken into the acceptability of contingent fee arrangements whereby lawyers' rewards are expressed as a percentage of the recoveries in a particular case (rather than, as at present, as a multiple of the fee normally charged); and some modification in appropriate cases of the rule that the loser pays the

¹⁶ The English rules are dealt with in the DP. The view there expressed that the position was for these purposes similar in Scotland still obtains but I add some more detail on the Scottish provisions. For the use of juries in Scotland see Court of Session Act 1988, s. 11.

¹⁷ On allegations of fraud in Scotland see *Drummond's Trustees v Melville* (1861) 23 D 450 at 462, per Lord President McNeil and *Leslie v Lumsden* (1856) 18 D 1046 at 1070, per Lord Ardmillan). As regards the Code of Conduct applying to advocates in Scotland, there does not seem to be an equivalent rule of conduct in relation to the drafting of pleadings in cases of fraud. There is, however, a rule which provides that "an advocate may not put to a witness any question suggesting that the witness has been guilty of a crime, fraud or other illegal or improper conduct unless he has personally satisfied himself that there is evidence which could, if necessary, be led in support of the suggestion". As such a line of questioning in a case alleging fraud would already be outlined in the written pleadings, this rule appears to achieve largely the same result as the rule for barristers in England.

¹⁸ The distinction between conditional and contingent fees obtains in Scotland: section 61A(3) and (4) of the Solicitors (Scotland) Act 1980 and the Act of Sederunt (Fees of Solicitors in Speculative Actions) 1992 SI 1992/1879). The Courts and Legal Services Act 1990 does not apply in Scotland, in particular its s 58B contemplating third-party funding.

¹⁹ OFT, *Private Actions in Competition Law: Effective Redress for Consumers and Business* (Discussion Paper, April 2007, OFT 916).

²⁰ At the moment it is restricted. See para 118 of the DP.

winner's costs. At the time of writing the precise nature of the recommendations which will emerge from the CJC is unclear as is, of course, the Government's ultimate response to them.²¹

17. I am grateful to Dr Christopher Hodges, of the Centre for Socio-Legal Studies of the University of Oxford, for his response dealing with this issue and for a highly useful subsequent discussion of the likely trends in the funding of civil litigation under these and analogous proposals. If one assumes that the financial incentives to law firms and others to fund litigation are likely to change significantly in the UK, then more weight falls on the other two factors mentioned above to discourage speculative litigation in the securities field. In particular, basing liability on fraud gives defendants scope to secure the strike out of unmeritorious cases at an early stage, in a way which is not likely to be possible in negligence cases because of their fact-specific nature.²² Disputes over facts can be resolved only at trial but before that the incentives to settle, as described by Laddie J, will have begun to operate.
18. I share the view that there is a real risk, even without changes in the system of funding litigation in this country, that creating a liability to investors based on a negligence standard could generate unmeritorious claims for large sums of money which, for the reasons given by Laddie J, issuers would be under pressure to settle, no doubt for much less than their face value, but nevertheless for significant sums. Future developments in the funding of large-scale commercial litigation, if difficult to identify precisely at this point, seem likely only to exacerbate this problem. By contrast, FSA enforcement of the negligence standard through its penalty-imposing powers is likely to be more measured. It will not be distorted by the financial incentives noted above, which do not apply to it. Moreover, given its statutory obligation to promote 'market confidence' and to have regard to 'the desirability of maintaining the competitive position of the United Kingdom', it can be expected that the FSA will be guided in its enforcement of the negligence standard by the objective of promoting the efficient operation of the capital markets through prompt and informative reporting on the part of issuers. Overall, I am persuaded by the arguments which put the weight of the enforcement burden on public rather than private actors and confine private enforcement to the area of fraudulent claims.²³
19. My assessment of how best to deal with the frequent lack of fit in civil litigation between the damages payable and the degree of fault involved and with the risk of unmeritorious litigation might well be different if FSA enforcement were not available. If private litigation were the only means for enforcing the negligence or due care standard, then one might want to accept these disadvantages of civil litigation in order to have effective enforcement in meritorious cases. The strategy I recommend thus relies on the continuing availability of public enforcement by the FSA. The primary role in securing the exercise of due care on the part of issuers in meeting their continuous disclosure obligations will continue to fall on the FSA. Those I discussed the issue with took the view that FSA enforcement was currently effective; certainly, no specific proposals for a different approach to its penalty-imposing

²¹ Some reference to this work is to be found in CJC, *Annual Report 2006*, p. 12.

²² It is not normally proper for the judge to try to resolve disputes of fact at this stage: *Electra Private Equity Partners v KPMG Peat Marwick* [2001] 1 BCLC 589, CA.

²³ In discussion Dr Hodges confirmed his view that the threat of speculative litigation arose principally in relation to negligence liability and that it was not a significant worry in cases of liability based on fraud, provided, of course, that the deceit definition of fraud was adopted.

powers emerged. Nevertheless, discussants were clearly assuming that the FSA would not reduce its enforcement effort in this area in the future. Further, if there were to be a deterioration in the quality of company disclosure, for example, in a market down-turn, the immediate pressures for a response in that situation would be felt by the regulator, which would not be able to respond that a remedy lay in investors' own hands.

20. One or two discussants wondered whether the FSA could make greater use of its restitution powers to obtain recompense for investors in appropriate cases where they have suffered losses as a result of negligent misstatements to the market.²⁴ This is an issue upon which the FSA itself has recently consulted. In its Consultation Paper 07/02 (*Review of the Enforcement and Decision-making Manuals*) it said:

5.31 We are not proposing to make any substantive changes to our current policy on the use of the powers given to us by the Act to apply to court for restitution and to make an administrative order for restitution, as set out in ENF 9. However, this proposed chapter includes a sentence that does not appear in ENF 9 which confirms that we expect to exercise these formal restitution powers on rare occasions only. This reflects the fact that when deciding whether to use the powers, we will consider other ways that persons might obtain redress, and any proposals by the person concerned to offer redress to any consumers or other persons who have suffered loss. We have also added text which clarifies that in deciding whether to use the powers, we will consider whether this would be the best use of the FSA's limited resources taking into account, for example, the likely amount of any recovery and the costs of achieving and distributing any sums.

This statement reaffirms the FSA's cautious approach to its use of the restitution power, though the absence of an alternative remedy for investors in the case of negligent misstatements to the market would be a factor in favour of its use. Nevertheless, the factors referred to in the final sentence of paragraph 5.31 would continue to operate in favour of a cautious approach. Indeed, to take the opposite extreme, routine use by the FSA of its powers to recover on behalf of investors full negligently-inflicted losses would be open to the same objection, in terms of the impact upon the free flow of information to the market, as would private litigation.

21. The third general consideration supporting excluding liability for simple negligence was the disutility of shifting losses between groups of investors. In a crude form this argument has been around since the emergence of the modern company. In some nineteenth century cases it was said that shareholders should not be able to sue the company because they would be suing themselves. Doctrinally, this makes no sense since the company is a separate legal entity and so shareholders do not sue themselves by suing the company. However, the argument is more persuasive when put in functional terms. A widely dispersed, long-term investor may find that it holds similar proportions of the shares whose acquisition was affected by the misstatement and of the shares which were not traded at the time. If so, there is little reason for it to want to move the loss from where it lies. This situation is particularly likely to obtain if one considers, not a single piece of litigation, but securities litigation over a period of time. As pointed out in para. 121 of the DP, unless an investor thinks that

²⁴ FSMA 2000, ss. 382 and 383; DP paras. 60-63.

there is some reason it will systematically be on one side rather than the other in the litigation, then it may be rational for that investor to support a system of letting the losses lie where they fall, thus saving the transaction costs (lawyers' and court fees) required to shift the loss. It may thus be the case that securities litigation is less attractive to long-term investors than to short-term ones. Hermes put the point in this way in their response to the Discussion Paper: "From a simple public policy perspective, it is hard to see why short-term traders of stock should be advantaged by a liability regime to the detriment of long-term shareowners. If this were to take place, it would seem to run counter to the government's intent to encourage a longer-term outlook on the part of the UK investment industry."

22. Of course, it could be said that the argument put forward in the preceding paragraph amounts to an argument against fraud as a basis for liability as well. However, it can be said that fraud is so corrosive of the basic trust on which the market operates that civil liability for such statements performs a valuable public function in deterring fraud; and that the absence of liability in damages for fraudulent misstatements would fail to meet the legitimate expectations of investors, as the current common law recognises. Moreover, fraud being less prevalent than negligence, even long-term investors may not think that, over a reasonable period of time, their gains from fraudulent statements will outweigh their losses.
23. My conclusion is, along with most respondents, that simple negligence should not be adopted as the basis for private litigation in this area. This is because I think respondents are right to fear that a negligence standard would generate defensive reporting, especially defensive ad hoc reporting, even where such reporting was mandatory. This is not so much because negligence is not an appropriate standard for liability in this area as because it is an inappropriate standard for civil liability in damages, in the light of the three considerations analysed above.

(b) Fraud or 'gross' negligence

24. The definition of 'fraud' adopted in the DP was a restrictive one: the maker of the statement must either know it was untrue or not care whether it was true or not. The latter form of misstatement is usually referred to as 'reckless misstatement'. Belief in the truth of the statement made would mean that there was no liability, even under the heading of recklessness. Whilst no respondent proposed liability based on 'simple' negligence, a minority of respondents (three out of thirty) wished to have a basis for liability in damages which went beyond fraud as defined above. The DP raised the possibility of a gross negligence standard as a half-way house. It is explicitly used in the German legislation (see Annex B to the DP) and in practice the term 'fraud' is interpreted in this way in US securities legislation (see para. 74 of the DP). Not surprisingly the respondents in favour of a gross negligence standard were investor groups. However, the investor groups were not unanimously in favour of a gross negligence standard: both the National Association of Pension Funds (NAPF) and Hermes supported a fraud-only standard.
25. The question is whether 'gross negligence' is a viable middle way. After much thought, I have concluded that it is not. In the common law of negligence (unlike the German civil law) the term 'gross negligence' has no clearly defined meaning because it has not been developed by the courts as a concept distinct from negligence. As

Millett L J said in *Armitage v Nurse*,²⁵ speaking of the difference between common law and civil law systems: “While we regard the difference between fraud on the one hand and mere negligence, however gross, on the other as a difference in kind, we regard the difference between negligence and gross negligence as merely one of degree. English lawyers have always had a healthy disrespect for the latter distinction.” More than one respondent quoted the famous quip of Willes J that ‘gross negligence is ordinary negligence with a vituperative epithet.’²⁶ There is therefore a serious problem about adopting in legislation²⁷ a term whose meaning is so unclear. The first danger is that cautious lawyers would advise clients to act as if the term used were simple negligence, and thus trigger the defensive reporting which it is the aim of the law to avoid. Further, issuers would have a strong incentive to accept this advice because of the potential size of the damages award. Although the standard of care required by the law would now be set at a higher level than under simple negligence, every potential defendant would have a strong incentive not to contribute to the litigation in which the height of the gross negligence hurdle was considered by the courts. It might be said that the legislation could give the concept a firm meaning rather than simply adopt the term and leave the courts to make of it what they will. However, I am unconvinced that this could be done. Negligence, whether gross or simple, is a standard designed to apply flexibly in a wide range of situations. It is difficult to see what further specification could be given in the statute which would not involve the use of general phrases, to which the interpretative problem would simply be transferred.

26. Further, the danger of speculative litigation would remain. The gross negligence standard, just like the simple negligence standard, requires the courts to establish the facts of the particular case and then to apply the standard to those facts. The striking out of negligence claims is notoriously difficult where the issue is compliance with the standard of care, and that would remain the case no matter where the standard of care was pitched. The risk is therefore that the strike-out would not act as an effective filter of unmeritorious claims and that the incentives to settlement of even unmeritorious claims, noted above, would operate.

(c) The definition of fraud

27. The argument developed above has been that liability should be based on ‘fraud’ as defined in the tort of deceit. The maker of the statement must either know that the statement is false or not care whether it is true or false; and a genuine belief in the truth of the statement would be a defence to liability. It would be important that this definition should be clearly embodied within an extended statutory regime. ‘Recklessness’ in particular is a potentially slippery concept. It would be important that it should be clear that a genuine belief in the truth of the statement made did not amount to recklessness. In other words, and contrary to developments in the United States, the proposed regime would make a firm distinction between recklessness (potentially leading to liability in damages) and gross negligence (which would not); and the dividing line between them would be the presence or absence of a genuine belief in the truth of what was said.

²⁵ [1998] Ch. 241, CA.

²⁶ *Grill v General Iron Screw Collier Co* (1866) 35 LJCP 321, 330.

²⁷ It is clear that the imposition of liability for gross negligence would require legislative action, given that it is not a concept the common law has deployed in this area.

28. However, it is important not to exaggerate the limitations of the fraud basis of liability. In particular, the maker of a statement would not necessarily escape liability by stating in the witness box that he or she believed the statement to have been true at the time the statement was made. This is because the court might not believe the witness. In other words, the statement of belief in the truth of the statement must be a credible one. A person who could very easily have checked the truth of a statement which he or she had a strong interest in making may not subsequently be believed when asserting a belief in the truth of what was said. Given the ability of human beings to delude themselves about what they did think in the past, the court may well be right to take a sceptical approach. Although this is only a matter of evidence (if the person did genuinely hold the belief, no matter how irrational it was, there should be no liability), this point does dispose of the argument that a fraud basis of liability permits persons to escape liability where belief in the truth of the statement was not genuinely held. The risk of being disbelieved also means that, at the margin, fraud liability generates some incentive to check the facts before speaking.
29. Some of those arguing in favour of a gross negligence standard were fearful that the explicit adoption of a fraud standard could, in the words of the IMA, ‘result in a lessening of the standards of care currently exercised and weaken a key link in the chain of accountability.’ I am less concerned by this point than the IMA. As explained in the DP (at paras. 34-39), the current (common) law is liability to investors only on the basis of fraud. There is no case in the UK of which I am aware, outside the area of prospectuses, in which investors have succeeded against an issuer on the basis of negligence. Since this is an area where the central players seem to be well advised legally, it is difficult to see why the transference of such a rule from common law to statute should have by itself a significant impact upon standards of behaviour, assuming current levels of public enforcement.
30. In fact, there is one limited, but significant, way in which the current partial statutory liability scheme (set out in section 90A of FSMA), whose extension I recommend, makes the bringing of a fraud claim easier than it is at common law. At common law, besides knowing that the statement is false or being reckless in this regard, the maker of the statement is liable only if he or she intended the recipient for the statement (or a class of person of whom the recipient was one) to rely on it.²⁸ This requirement creates a potential obstacle to liability in the case of statements to the market, even if the maker of the statement knew it was false. Section 90A(5) substitutes for ‘intended reliance’ a requirement that the recipient’s reliance should be reasonable in the circumstances. This change facilitates the bringing of fraud actions. If an issuer makes a statement which it knows to be false, liability can follow under the section if the investor’s reliance on the statement is reasonable in circumstances, without investigation of the issuer’s intentions in making the statement. I recommend that this relaxation of the common law’s requirements continue to be part of any extended statutory liability regime.

²⁸ See Cartwright, above n 4, at para. 5.19.

Question 2: Extension of the statutory regime to ad hoc statements

31. At present the statutory regime in section 90A of FSMA applies only to disclosures made by companies in response to the requirements of the Transparency Directive (TD) and to prelims. The TD applies only to companies with securities traded on regulated markets. Thus, two questions arise: should the statutory regime apply to ad hoc or episodic statements, required by the Market Abuse Directive (MAD) and should it apply to statements, periodic or ad hoc, made by companies whose securities are traded on exchange-regulated markets. I deal with the first issue here and the second issue in the next section.
32. Overwhelmingly, respondents thought the statutory regime should be extended to ad hoc statements made by companies with securities traded on regulated markets. Only two out of 30 respondents were against this extension, plus the two respondents not in favour of imposing statutory liability even for periodic reporting. The reasons in support of the extension were three-fold. First, some ad hoc statements would later appear in disclosures required by the TD, and it was thought to be odd to have a different disclosure regime according to which disclosure the investor relied on. Second, and more broadly, it was thought that those subject to the rules would find it confusing to have different liability regimes according to whether the disclosure was required by the TD or MAD, whether there was overlap or not. Third, it was thought that there was no principled distinction between ad hoc and periodic disclosures as far as the appropriate liability regime was concerned.
33. In some cases those in support of the extension of the statutory regime to ad hoc statements made their support conditional on the their preferred answer to the first question (fraud or gross negligence as the basis for liability) being adopted in the statute. In the case of those in favour of fraud as the only basis of liability this makes sense. Not extending the statute would leave the common law rules in operation in relation to ad hoc statements, and, as explained in the DP and mentioned above, the common law imposes liability only for fraud. For those preferring gross negligence as the basis for liability, this argument for not extending the statute seems less compelling, since the common law does not adopt their preferred basis of liability either. In fact, as explained in para 30, the effect of not extending the statutory regime would be to make the fraud claim less easy to bring.
34. Those opposed to the extension as such, rather than to the principle of statutory liability, were Grant Thornton and Price Waterhouse Coopers (both accountants). The objection of both sets of accountants seemed on a fair reading to be to having a statutory liability based on negligence extended to ad hoc statements and to the undermining of the decision in *Caparo*.²⁹ Since the recommendation above is for liability based on fraud alone, thus confirming the absence of negligence liability, this objection falls by the way.
35. I therefore recommend that the statutory regime be extended to ad hoc statements made by companies with securities traded on regulated markets.

²⁹ [1990] 2 A C 605, CA.

Question 5: Extension to exchange-regulated markets

36. There was widespread support for the extension of the statutory regime to exchange-regulated markets. In fact, only two respondents rejected the idea, though many respondents made it clear that their support for the proposition was on the basis that the liability regime should be based on fraud alone. No principled reasons were put forward for not making this extension. It needs to be borne in mind that this is a proposal for a common liability regime across regulated and exchange-regulated markets, not a proposal for common disclosure standards across both types of market. As the Institute of Chartered Secretaries and Administrators (ICSA) said in their response: “The investors in these markets know that companies do not have to disclose the level of detail of those in the main market and they expect a higher level of risk. However, we believe that these investors should still be protected from dishonest disclosure.”
37. Significantly, those most closely connected with the exchange-regulated markets supported the extension of the statutory regime: AIM, Plus Market and the Quoted Companies Alliance (QCA). AIM thought that different liability regimes would create confusion for both issuers and investors; QCA thought such a move would protect exchange-regulated markets from uninformed criticism; and Plus Market were concerned simply that the extension of the statutory regime should not impede the market authorities themselves from taking disciplinary action (though they did not suggest any reason why it should). I myself am aware of no basis upon which extension of the civil liability regime would have the effect feared by Plus Market.
38. I therefore recommend the extension of the statutory regime to exchange-regulated markets. In fact, I think it is necessary to go further than the inclusion of exchange-regulated markets. In terms of the concepts used in the Markets in Financial Instruments Directive (2004/39/EC), from November 1 2007 markets will be either regulated or ‘multilateral trading facilities’. Although many of the latter will be exchange-regulated markets, as we currently understand them, this may not always be the case. I therefore recommend that all trading platforms for securities be brought within the extended statutory regime.
39. However, it needs to be recognised that in the case of exchange-regulated markets the burden of ‘public’ enforcement lies on the market operator, not the FSA. Thus, the AIM rules require companies (with the help of the their nominated advisers) to take reasonable care to ensure that information required to be put out on a RIS is accurate and complete, but disciplinary action against the issuer or nomad is a matter for the LSE.³⁰ The Disclosure and Transparency Rules of the FSA do not apply to exchange-regulated markets. However, the market abuse provisions of FSMA³¹ do extend beyond regulated markets to embrace ‘prescribed’ markets (including any market operated by a Recognised Investment Exchange, such as the LSE). The market abuse rules do catch some types of inaccurate disclosure. Thus, in the Shell case, the penalty of £17 million was imposed for market abuse, although breaches of what are now the DTR were found as well. The FSA found that Shell’s failure to correct the false or misleading information it had given to the market about the size

³⁰ AIM Rules for Companies 10, 42 and 43. To similar effect are the Plus Rules for Issuers 22 and 56.

³¹ S 118ff.

of its reserves, despite warnings from a number of sources that the information was false, amounted to market abuse.³²

Question 4: How are the relevant disclosures to be identified?

40. Once the decision is taken to extend the statutory regime to ad hoc announcements and exchange-regulated markets, a crucial issue arises about the precise definition of the disclosures to which the statutory regime should apply. The overwhelming majority of respondents (twenty-two out of twenty-five)³³ favoured all RIS announcements, on the grounds that it would be the easiest rule for companies to apply and for investors to follow. In particular, it would be problematic to have different regimes for announcements required to be put out through a RIS and those which were not so required but which companies had chosen so to disseminate because it was not clear to them whether the RIS route was needed. This situation might arise where there were doubts about whether a particular piece of information was inside information or not. More broadly, it was thought it would be confusing for investors and companies to have different liability regimes for different categories of RIS statements, according to the legal basis of the disclosure requirement. This would have been the consequence of adopting either of the alternatives put forward, ie only disclosures required by MAD or disclosures required by the FSA's Disclosure and Transparency Rules (DTR) but not those required by the Listing Rules (LR).
41. Those favouring a narrower approach (Hermes, Association of Corporate Treasurers (ACT)) were concerned that the broader approach would or could reduce the rights which shareholders have as shareholders as against their companies. This is because the RIS system is required to be used to disclose to the market certain circulars which the companies are required to send to their shareholders, for example, in relation to significant transactions (LR 10) or related-party transactions (LR 11). I think it vital that the statutory regime for investors should not reduce shareholder rights. On the other hand, I think the arguments in favour of extending the statutory regime to all RIS announcements is compelling. Thus, the question becomes whether an 'all RIS' rule is compatible with the preservation of shareholder rights.
42. I have concluded that it is. I think the way forward was indicated by some of the law firms and lawyers groups which addressed the issue. They were in favour of the 'all RIS' rule but equally concerned, as I am, to preserve shareholder rights. Their argument was that the statutory regime could be applied to the RIS announcement without prejudice to rights which shareholders might have as shareholders arising out of the (virtually identical) circular sent to them. As the City of London Law Society put it: "We do not agree that the purpose of [RIS] announcements is to inform shareholders for *Caparo*³⁴ purposes. Shareholders are informed for the purpose of exercising their governance rights through direct communications addressed to them as shareholders (circular letters prepared in accordance with Chapter 13 of the Listing

³² FSA, Final Notice, 24 August 2004, *The "Shell" Transport and Trading Company plc and The Royal Dutch Petroleum Company N V*. Section 118 has been rewritten subsequently to this FSA action in the light of the transposition of MAD, but not in such a way as to affect the point in the text.

³³ Those not favouring an extension of the statutory regime to ad hoc disclosures (see para 34) said 'none' in answer to question 4 and these responses are not included in the figures given in the text.

³⁴ The *Caparo* case (above n 29), whilst denying liability on the part of the auditors to investors (including shareholders who decided to acquire shares on the basis of the inaccurate information) nevertheless reaffirmed the auditor's liability to the company and to shareholders collectively. See DP para. 36.

Rules). We think it is important that shareholders' *Caparo* rights in respect of these communications should not be restricted but we do not see why applying the statutory liability regime to the RIS announcements relating to the same transaction would have that effect.”³⁵ Herbert Smith made the further point that it is probably not even necessary to confine the preserved shareholders' rights to governance rights, thus giving rise to the need to define governance rights in the statutory regime. Whatever rights the shareholders have vis-à-vis the company as a result of inaccuracies in the circulars distributed to them by the company should remain untouched by the statutory regime and be left to development by the courts applying the common law.³⁶

43. I thus agree with the view put forward by the ABI: “We consider that real time disclosures made under RIS announcements are quintessentially disclosures to the market and not to shareholders though shareholders may subsequently make use of these announcements for governance purposes. What is important, in point of principle (and as per one of the intentions within the *Caparo* judgment), is that accountability through liability by directors to shareholders for governance purposes should not be prejudiced. We see no need or justification for a carve-out of certain RIS announcements because they are thought to be primarily governance related. However, liability in respect of contents of circulars sent to shareholders in their capacity as such for governance purposes must be maintained.” I believe the way to implement this principle is that indicated in the previous paragraph.
44. The same solution can be applied to circulars issued in the course of a take-over bid. These circulars are different from those considered in the previous paragraph, because they may be issued by the offeror to the shareholders of the target company or, when issued by the target to its own shareholders, have sometimes been considered by the courts as addressed also to the bidder company. Such circulars are also issued as announcements via the RIS. However, the policy reasons for preserving shareholder rights in this case seems to me as strong as the cases discussed in paragraph above. I agree with the IMA who, whilst supporting an ‘all RIS’ rule, wished to preserve the possibility of negligence liability in relation to takeover circulars.
45. I therefore recommend that the statutory regime should apply to all RIS announcements but that the statutory regime should be drafted so as not to affect the rights of shareholders and others arising out of company circulars addressed to them.
46. Finally, I stated in paragraph 49 of the DP that I did not believe that section 90A affected the negligence liability arising where, for example, an auditor undertook responsibility for the accuracy of the accounts in the context of a specific, known transaction. This principle should apply to any acceptance of responsibility on the part of any person (for example, the issuer) for any statement in such a specific context. As I explained in the DP, it is easy for the potential defendant in such a case to protect itself either by not accepting the relevant responsibility or by accepting it

³⁵ The Law Society’s (majority) response was to the same effect: “Shareholders should in any event have more extensive rights than market participants in the case of Class 1 transactions by virtue of the shareholder circular required, notwithstanding that the circular would have to be published to the market in full text format and/or via a summary and link to a website.”

³⁶ This is not an area which is dealt with in any detail in the Companies Act 2006.

on terms which are satisfactory to it. I do not think it will be difficult in drafting terms to achieve this result.

Question 3: Liability for dishonest delay

47. The DP asked whether there should be liability for dishonest delay. At common law there is in principle no liability for not speaking (unless it makes something already said misleading) and so delayed speaking would in principle be covered by this rule. However, the statutory regime in section 90A of FSMA, following the long-standing policy in relation to prospectuses, does not accept the principle of no liability for not speaking. It does impose liability for the deliberate or reckless omission in a statement of anything required to be included in it, whether or not it renders anything said misleading (s. 90A(3)(b)(ii)). The question, therefore, is whether the common law principle should be eroded further by imposing liability, not only for failing to disclose fully, but for delay in disclosure. The DP accepted that liability could not be imposed simply for deliberate delay. In most cases the delay will be deliberate and often for good reasons, for example, in order to be able to make a fuller and more helpful disclosure when disclosure is made. There is no public policy reason in my view to create legal pressure on companies to make quick but inadequate disclosure. The DP therefore put forward for discussion the suggestion that *dishonest* delay should be the basis for liability. In relation to inaccurate statements intention or recklessness would be enough; in relation to delay, there would be the additional requirement of dishonesty.
48. The majority of respondents were against this proposal. Nevertheless, a significant minority (seven out of twenty-nine), coming from a spread of relationships with the capital markets, supported it: ABI, ACT, Association of Investment Companies, ICSA, Investor Relations Society, KPMG, QCA. In discussions it became clear that some of those opposing liability for dishonest delay using it as a proxy for opposition to the FSA's rules on the timing of ad hoc disclosures, which they viewed as impractically demanding.³⁷ However, the proposal put forward in the DP was not to attach civil liability whenever there was an unjustifiable delay according to the FSA's rules, but to do so only in the case of dishonest delay. Those supporting the proposal were aware that it was very much in the nature of a back-stop (and so not open to the flood-gates argument); and no one identified a principled reason why dishonest delay should not be the subject of civil litigation. Indeed, many of those opposing the reform recognised that there was a good case in principle for imposing liability but were opposed for pragmatic reasons, which I found unconvincing, or because of uncertainty about the meaning of dishonesty.
49. The need to define dishonesty appropriately is indeed a key requirement of this proposal. In my view the solution to this problem is to focus on the purpose of the delay and to impose civil liability only if the purpose (or predominant purpose) for the delay falls within the prohibited category. One could take an analogy from section 397 of FSMA, imposing criminal liability for dishonest concealment of material facts, whether in connection with a statement of not. Under that section, criminal liability is imposed only if the concealment is for the purpose of inducing someone to take or not to take a certain course of action (broadly to take or not take an investment

³⁷ See DTR 2.2.1 and 2.5. The FSA's decision in the Marconi case seems to have been particularly influential in forming attitudes: FSA, Final Notice, Marconi plc, 11 April 2003.

decision). Translated into the context of this Report, there would be liability only if the person deliberately delayed publication for the purpose of inducing investors to acquire (or possibly dispose of) securities. More narrowly, the prohibited purpose could be defined as making a profit on the part of the defendant or inflicting a loss on the person who acquired the securities during the period of delay.³⁸ In either case, delay in order to obtain the full facts of the situation or even delay in order to permit the company to deal more easily with the situation which had arisen, would not fall within the scope of the civil liability regime, though such delay might constitute a breach of the FSA's rules.³⁹ On the other hand, delayed disclosure of bad news on the part of the issuer in order to enable the directors of the company to exercise their options and sell the shares at a more attractive price would fall within the civil liability regime, at least on the second of the two approaches to dishonesty.

50. I therefore recommend that the statutory regime should encompass liability for dishonest delay in making RIS announcements.

Question 8: Should liability extend to sellers and holders of securities?

51. Only six out of twenty-nine respondents favoured the policy adopted in section 90A of FSMA of giving a right of action to acquirers of securities only. Fifteen would extend the right of action to those who disposed of securities and eight to buyers, sellers and holders. I think it is impossible to draw a principled distinction between acquirers and disposers. Although corporate statements are, no doubt, much more often misleadingly optimistic than misleadingly pessimistic, so that acquirers have in fact more cause to complain than disposers, in principle their complaint is the same. In either case the price paid for the security would have been different if the truth had been known, and so the loss in question is the same, even if its incidence is not. I suspect that the exclusion of sellers from section 90A was due to the fact that the House of Lords in *Caparo* did not have to deal with the position of sellers and left the point open to some degree.⁴⁰ In any event, I can see no reason to exclude disposers of securities from a developed statutory regime.

52. I have found the question of holders a very difficult one. In most cases they will not be able to show that their decision to hold was taken as a result of reliance on the statement made. However, this will not always be the case: paragraph 105 of the DP gave an example of a situation where there seemed to be no problems of proof and the Appendix to Herbert Smith's response provided some more. However, if holders of securities are given a cause of action, it is unclear why non-acquirers should not be given one as well, ie a person who, on the basis of a fraudulent statement by the company, decides not to become invested in it. I am influenced by the fact that neither US nor German law gives rights of action to holders but require a securities transaction as a condition for liability. I think there is a risk of the courts being asked to make very difficult findings of fact in cases where there is no transaction and of their getting it wrong (or not clearly getting it right), thus bringing this new legislation into disrepute. As the CBI suggested, in many cases holders will be protected by their rights as shareholders, for example, in respect of misstatements made in shareholder

³⁸ This is the approach taken in section 3 of the Fraud Act 2006.

³⁹ See DTR 2.5.4G on delay in order to make the handling of the crisis easier.

⁴⁰ See para. 36, n. 43 of the DP.

circulars, which rights, it has been recommended above, should continue have effect outside the statutory regime.

53. I therefore recommend that the statutory regime should confer rights on both acquirers and disposers of shares. In respect of holders (and non-acquirers) I recommend that the statutory regime exclude them from suing in respect of statements contained in RIS announcements. However, the common law rights of holders arising out of misstatements in circulars should, as recommended above, remain in existence for development by the courts.

Question 7: Should liability be confined to issuers or be extended to directors and advisers?

54. Section 90A imposes liability on the issuer. The DP raised the question whether liability should be extended to directors and advisers, on the ground that this would be a deterrent aimed directly at those making the statement on behalf of the issuer. A number of respondents made the point that it is in fact rare, though not unknown, for advisers to make statements on behalf of the company, as opposed to providing reports upon which the directors rely. Accordingly, the discussion will focus on the position of directors.

55. The majority of respondents (twenty-three out of thirty) were opposed to the extension of liability to directors. Those in favour were mainly, though not entirely, investor groups: ABI, AIC, Investor Relations Society (though very cautiously), NAPF, UK Shareholders Association, KPMG. In addition, the Minority View of the Law Society's Company Law Committee was in favour of liability being imposed on directors alone (see paragraph 3 above). Certainly, on normal principles of vicarious liability, the director or other agent remains liable whilst the company or other principal is made vicariously liable for the agent's wrongdoing. The purpose of imposing vicarious liability on the principal is to increase the chances that the claimant will have a financially viable defendant to sue and to give the principal an incentive to control the actions of the agent. In practice, the agent is rarely sued. The issue is thus whether the threat of suit, although in practice not very large, unless the director is insured, is a useful addition to the armoury of weapons available to deter directors from making fraudulent statements.

56. I am convinced by the arguments of those who say that the imposition of liability upon directors is unnecessary for deterrent purposes. The main alternative source of deterrence are the FSA's sanctions (public censure and penalties), which can be deployed against directors of companies on regulated markets where the company acts in breach of the DTR, requiring accurate disclosures according to a negligence standard, provided the director was 'knowingly concerned' in the contravention on the part of the issuer.⁴¹ The DTR do not apply to companies with securities traded on an exchange-regulated market, but inaccurate disclosures may amount to market abuse, which again triggers the FSA's censure and penalty powers, even in relation to companies on AIM or Plus.⁴² However, the main burden of policing the accuracy of disclosures on AIM and Plus and imposing sanctions on offenders lies with the market operators themselves (LSE and Plus). The AIM rules make directors

⁴¹ FSMA s. 91(2).

⁴² FSMA ss. 118 and 123.

responsible for compliance by their companies with the disclosure obligations contained in the AIM rules, but seem to contemplate the imposition of disciplinary sanctions only against the company or its nominated adviser. The Plus Market rules are similarly constructed.

57. There is also reason to be concerned about how targeted damages are from a deterrence point of view. If the director is in fact personally exposed to large securities losses (enough to bankrupt him or her), then the threat of liability is likely to be over-detering, ie it will induce extreme and undesirable caution on the part of the director in order to avoid liability. On the other hand, if D&O insurance,⁴³ or some other mechanism, shifts the loss from director to company, it is unlikely that the threat of liability in damages will add the deterrence mechanisms already in place. Whether making the director wholly or partly liable for the loss suffered by investors is a sensible course of action is thus likely to vary from case to case, according to the insurance and indemnity arrangements in place in any particular company and according to the company's view of the utility to the company of proceeding against the director or, on the contrary, protecting him or her from liability. This is not a judgement which investors are well-placed to make or, necessarily, interested in making. The company is better placed to do so and, indeed, can do so as the law stands. If the director's negligent discharge of his or her duties, including the issuance of misleading statements to the market,⁴⁴ has caused loss to the company, the company may in principle seek compensation from the director for breach of duty. Directors may be unwilling to sue one of their number, but may do so under shareholder pressure, and no such inhibitions will apply to a liquidator or a new board, appointed after a take-over, for example. Finally, an individual shareholder may make use of the new derivative action procedure contained in the Companies Act 2006 in order to bring an action on behalf of the company against the director.
58. Furthermore, the company is not restricted to waiting until the director has inflicted harm on investors before it takes action. Over the past fifteen years or so, the internal control structures of large companies, especially listed companies but not only them, have improved enormously. Creating an internal control structure which reduces significantly the opportunities for directors to make fraudulent statements, where such structures do not already exist, is feasible. Overall, the above approach is consonant with the theory of vicarious liability which generates incentives for the principal made liable for the harm to exert control over the actions of its agents, either in advance of the harm being inflicted on the third party or afterwards.
59. I therefore conclude that liability under the statutory regime should continue to be confined to the issuer.

Question 9: Assessment of damages

60. This question asked whether respondents preferred a negligence or a fraud measure of damages. On reflection, I am convinced that this question was posed too sharply in the DP and that it would be difficult to formulate effective rules in the statute which would not tie the courts' hands in an undesirable way in handling of particular

⁴³ D&O insurance could operate in this way, even in the case of fraud. See DP para. 101.

⁴⁴ Section 463 of the CA 2006 restricts the director's liability to the company to a fraud basis in the case of misstatements in the directors' report or directors' remuneration report.

cases. I agree with most of the legal respondents that the matter is best left for decision-making by the courts. However, it should be made clear that the effect of this recommendation is that damages are likely to be assessed by reference to the loss caused by reliance on the statement, not the loss caused by its falsity.

Question 6: Subordination of investors' claims

61. The question here was whether investors' claims should be subordinated to the claims of the other unsecured creditors in the case of the issuer's insolvency, an insolvency possibly brought about by the need to meet the investors' claims. If subordinated, they would rank, presumably, with the claims of the shareholders as shareholders, though they could conceivably rank ahead of pure shareholder claims. If not subordinated, they would compete with the claims of the other unsecured creditors and have priority of the claims of the shareholders as shareholders. There was an almost even split of responses on this issue: fourteen for subordination and thirteen against. I am convinced that this is an important issue. It raises important general issues about the nature of equity investment in companies and about the role of legal capital. A number of those favouring subordination nevertheless put the point very cautiously. As Herbert Smith said: "This issue is however a complex one which would need careful thought. It raises some fundamental questions in relation to insolvency law which would need to be considered further. Also, caution is needed because in some situations subordination would lead to an inequitable result. The wrongdoer, for example the director guilty of deception, could be a substantial creditor of the company. A subordination of the claims of investors would then favour his position as fraudster over theirs as innocent victim."
62. I conclude that this issue needs further work. The issue has potential ramifications outside the area of securities litigation. However, I also agree with the CBI that the point is not so central that the implementation of the above recommendations should await its resolution. I note that in Australia the issue, arising out of the decision of the High Court in the *Sons of Gwalia*⁴⁵ case, has been referred to the (Australian) Corporations and Markets Advisory Committee.⁴⁶ I recommend that the Government should consider its resulting report as part of any future policy developments.

Applicable law

63. Many companies quoted on the British capital markets will have investors resident in a number of different jurisdictions. Which law governs claims brought by such investors is a complex subject, partly because the British rules determining the answer are not entirely clear and partly because courts in other jurisdictions may use different (but equally complex) rules to determine the answer. It is thus not impossible that such companies may be subject to investor claims under as many differing legal regimes as it has investors in different jurisdictions. This seems to me undesirable. A better result would be one in which a single legal regime applied to investor claims, possibly the law of the jurisdiction where the issuer is incorporated or possibly the law of the jurisdiction where the issuer has its primary listing. I have

⁴⁵ [2007] HCA 1. See DP para. 99.

⁴⁶ The terms of reference to the Corporations and Markets Advisory Committee can be found at: [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/\\$file/Ref_Sons_of_Gwalia.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/$file/Ref_Sons_of_Gwalia.pdf).

not explored this question in any detail because it is clear that it cannot be solved through an exercise of the powers contained in section 90B of FSMA, and so is outside my terms of reference. My understanding is that the Government did advance precisely this point in the discussions on the (now agreed) 'Rome II' Regulation on the law applicable to non-contractual obligations, but without success.

Summary of Recommendations

Following the Discussion Paper questions

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 liability in the British context? Is fraud an appropriate basis for liability?

Recommendation: That fraud should be maintained as the basis of liability for the statutory regime and that the relaxation of the common law's requirements – whereby the claimant need only show that his own reliance on the misstatement was reasonable and not also that the issuer intended that he should rely on it – should continue as part of any extended statutory liability regime.

Question 2:

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

Recommendation: Yes, the statutory regime should be extended 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?

Recommendation: That the statutory regime should encompass liability for dishonest delay in making RIS statements.

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)?

Recommendation: That the statutory regime should apply to all RIS announcements but that the statutory regime should be drafted so as not to affect the rights of shareholders and others arising out of company circulars.

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?

Recommendation: That the statutory regime be extended to exchange-regulated markets and that 'multilateral trading facilities' and all trading platforms for securities be brought within the extended statutory regime

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?

Recommendation: That this issue needs further work and that the Government should consider the outcome of the report of the Australian Corporations and Markets Advisory Committee on the [Australian] High Courts decision in the *Sons of Gwalia* case as part of any future policy developments in this area.

Question 7:

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

Recommendation: That liability under the statutory regime should continue to be confined to the issuer.

Question 8:

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

Recommendation: That the statutory regime should confer rights on both acquirers and disposers of shares but exclude holders (and non-acquirers) from suing in respect of statements contained in RIS announcements. The common law rights of holders arising from misstatements in company circulars should remain in existence for development by the courts.

Question 9:

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

Recommendation: That this matter is best left for decision-making by the courts. The effect of this recommendation is that damages are likely to be assessed by reference to the loss caused by reliance on the statement, not the loss caused by the falsity.

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.

List of contributors

The Davies Review is grateful to the numerous organisations and individuals that provided invaluable input throughout the course of its inquiry through informal discussions and supporting information. The following organisations and individuals contributed written responses to the Discussion Paper:

100 Group of Finance Directors
Allen & Overy
Association of British Insurers (ABI)
Association of Corporate Treasurers (ACT)
Association of Investment Companies (AIC)
Professor Paul Barnes (member, Fraud Advisory Panel)
BT Group plc
Chartered Institute of Management Accountants (CIMA Global)
City of London Law Society Company Law Sub Committee
Clifford Chance LLP
Confederation of British Industry (CBI)
Deloitte & Touche LLP
Environment Agency
General Counsel 100 Group
Grant Thornton UK LLP
Herbert Smith LLP
Hermes Pension Management Ltd.
Dr Christopher Hodges (University of Oxford)
Insolvency Service
Institute of Chartered Accountants in England & Wales (ICAEW)
Institute of Chartered Accountants of Scotland (ICAS)
Institute of Chartered Secretaries & Administrators (ICSA International)
Institute of Directors
International Capital Market Association
Investment Management Association (IMA)
Investor Relations Society
KPMG LLP
Law Society Company Law Committee
Law Society of Scotland
London Investment Banking Association
London Stock Exchange AIM
National Association of Pension Funds
NERA Economic Consulting
Ogilvy Renault LLP
PLUS Markets Group
PriceWaterhouseCoopers LLP
Quoted Companies Alliance
Slaughter and May
Jeffrey Sultoon (Ashurst)
The Takeover Panel
UK Shareholders Association
Robin Woodall (member, LSE Primary Markets Group)

Unless respondents requested otherwise, their responses may be viewed on the Davies Review website at www.hm-treasury.gov.uk/davies.

Further information & next steps

Further information

Further information on the background to the Davies Review and links to research commissioned by the Review on the liability regimes in France, Germany, the US and Australia can be found at www.hm-treasury.gov.uk/davies.

Next steps

The Economic Secretary has committed to consulting fully on the Government's response to the Davies Review's proposals and to publishing a full regulatory impact assessment of these proposals. For further information contact Jack Middleton at:

Savings and Investment Team (SAVI)
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Tel: 020 7270 5272
email: Jack.Middleton@hm-treasury.gov.uk

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