

9 August 2006

EXTENDING THE SCOPE OF THE STATUTORY DAMAGES REGIME FOR DISCLOSURES REQUIRED UNDER THE TRANSPARENCY DIRECTIVE

Background and summary

1. After the Government's decision to establish a statutory regime for liability in damages to third parties in respect of disclosures under the Transparency Directive, amendments were proposed during the Committee proceedings of the Company Law Reform Bill (now the Companies Bill, [Bill 218]) to apply this statutory damages regime to:
 - i) disclosures made under the FSA's disclosure rules;
 - ii) preliminary announcements of results;
 - iii) disclosures made by companies with securities quoted on the AIM market; and
 - iv) transparency disclosures by companies admitted to trading on an EEA regulated market in situations where UK law is applicable.
2. The Minister undertook to consider the issue of liability in damages further before the Bill returned to the Commons at the Report stage.
3. The issue of liability in damages is complex. The Government established a statutory liability regime for disclosures required under the Transparency Directive because of the particular risks arising from the implementation of that directive. However, the same level of risk does not apply to other classes of disclosure. The question to be considered is whether extending the statutory regime might be justified on its own merits. However, comparison between statutory and common law regimes is not easy, nor is it clear what scope of liability in a statutory regime might be broadly acceptable to issuers, investors and other stakeholders.
4. It is argued in favour of a statutory regime, that it would reduce the increasing risk that the courts might significantly expand the scope of issuer liability from what it is currently thought to be. Greater certainty might also reduce issuers' compliance costs and encourage more informative disclosures by them.
5. Against a statutory regime, it is argued that the risk of the courts substantially expanding the scope of issuer liability may be overstated. By eliminating the possibility of liability in some circumstances (e.g., for negligent disclosures), whilst accentuating it in others (e.g., for reckless and wilfully false disclosures), a statutory regime would disturb the

balance of investors' current rights. In doing so, it risks diminishing the incentive for issuers to provide timely and accurate disclosures.

6. If a statutory regime were deemed preferable to the current common law regime, the Government would need to establish the appropriate scope. Informal indications suggest that issuers would prefer this to be the same as that governing transparency disclosures, not least for reasons of consistency. However, investors may have concerns that this would set the scope too narrowly, diminishing the incentives on issuers to provide timely and accurate disclosures.
7. The Government welcomes views from interested parties which would assist it in this consideration, and in particular, would be grateful for views on the following points:
 - i) The desirability of putting on a statutory footing the regime for liability in damages in respect of loss flowing from disclosures made under the FSA's disclosure rules (including the obligations to disclose price sensitive information), and, if so, the appropriate scope of such a regime (including whether this should be by extension of the liability regime for transparency disclosures);
 - ii) the desirability of extending the statutory liability regime for transparency disclosures to preliminary announcements of results (whether mandatory or voluntary);
 - iii) the desirability of putting on a statutory footing the regime for liability in damages in respect of loss flowing from disclosures by companies with securities quoted on the AIM market and, if so, the appropriate scope of such a regime (including whether this should be by extension of the liability regime for transparency disclosures);
 - iv) the desirability of ensuring the statutory liability regime covers all issuers subject to UK transparency rules, including issuers for which the UK is the home or host Member State, and other situations in which UK law is applicable.
8. Comments should be sent to the address below by Wednesday 6 September 2006.
9. Background and issues are discussed more fully below. Further supplementary questions are also raised and it would be helpful if those responding could address these, where relevant.

Establishment of Transparency Directive statutory liability regime

10. The decision to implement a statutory regime for liability in damages in respect of disclosures required under the Transparency Directive was made in light of uncertainty as to the impact of implementation of the Directive on the liability position, given the requirements of the Directive and increased securities market regulation. The Government concluded that, were it not to implement a statutory regime, there was a material risk that the courts would decide that Government had not implemented the Directive correctly. The same situation does not apply in relation to the classes of disclosure mentioned above. In setting the scope of the statutory damages regime, the Government's intention has been to ensure that the potential scope of liability to damages is reasonable, taking into account both expectations and the likely state of the law after the implementation of the Directive.

11. The provisions to establish a statutory regime for liability in damages in respect of disclosures required under the Transparency Directive are contained in clause 1234 of the Companies Bill (Lords), [Bill 218], which has just finished its Committee stage in the House of Commons. These liability provisions are separate from the provisions in Part 6 and elsewhere of the Financial Services and Markets Act 2000, which create liability to civil penalties, and the right of a claimant to seek restitution.

12. The proposed statutory liability regime under new section 90A of FMSA would make issuers admitted to trading on a UK regulated market liable to damages in respect of periodic information to be disclosed under Articles 4, 5 and 6 of the Directive as given effect by FSA rules, but only in the circumstances and cases specified. Issuers would be liable where the disclosures contained statements or omissions that were knowingly untrue or misleading, and such statements were made in bad faith or recklessly. Issuers would only be liable to persons who acquired securities and suffered loss, as a result of relying on the statements at a time when it was reasonable for them to be relied upon.

13. The statutory liability regime excludes further liability to damages arising from reliance by other parties on the disclosures, thereby precluding any further liability on the part of issuers, and any direct liability on the part of auditors and directors. However, the existing statutory and contractual duties of the latter in relation to the preparation and approval of accounts and reports remain unchanged.

14. Further background on the decision is available in the Explanatory Notes to the Company Law Reform Bill as brought from the House of Lords on 24th May 2006 [Bill 190], paragraphs 1553 to 1566¹.

Potential for establishment of additional statutory regimes

15. Issues associated with establishment, or extension of a statutory regime to different classes of disclosure, are discussed below.

i) Disclosures required under the FSA's disclosure rules

16. The purpose of disclosures required by the disclosure rules made by FSA under Part 6 FSMA (in implementation of provisions of the Market Abuse Directive (2003/6/EC)) is primarily to ensure ad hoc price sensitive information is disclosed to markets as soon as possible after it becomes known. Any errors in the disclosed information that are subsequently identified are to be corrected promptly. The current enforcement regime for the market abuse regime, including disclosures under the disclosure rules, comprises statutory criminal and financial penalties under FSMA, as well as the restitution provisions in sections 382 and 383 of FSMA. There is a common law, rather than statutory, civil damages regime.

17. Traditionally, common law has provided only limited scope for investors to recover losses suffered in reliance on inaccurate disclosures, usually where the reliance of the party suffering loss was specifically known to the party making the disclosure. This reflects several factors. The primary purpose of the regulatory enforcement regime is to provide incentives for timely and accurate disclosures to inform actual and potential investors, rather than providing restitution for loss. Courts have been reluctant to find that a duty of care is owed to a large and varied class of the public who are likely to have different expectations in respect of the same information. Providing restitution is also problematic, given the large potential losses that might be incurred. The burden of such restitution would not necessarily be borne by the wrongdoer but often by other stakeholders (e.g., shareholders, creditors or employees) not responsible for the late or inaccurate disclosures.

18. In providing incentives for timely and accurate disclosures, the enforcement regime aims to strike a balance between the interests of

¹ Available at:
<http://www.publications.parliament.uk/pa/cm200506/cmbills/190/en/06190xad.htm>

issuers and investors by imposing appropriate sanctions on issuers and/or directors when disclosures are neither timely, nor accurate. Sanctions should reflect the fact that deliberate misleading of markets is more culpable than negligent or inadvertent error, particularly where the latter is promptly corrected. Sanctions should neither encourage defensive compliance, nor discourage informative disclosures.

Statutory regime or common law regime

19. Several reasons have been put forward for establishing a statutory regime. While the courts have traditionally been reluctant to find liability to investors, some parties argue that recent developments in securities law and the law of liability have significantly increased the risk that a court might expand the range of circumstances in which reliance on disclosures by investors in investment decision-making is reasonable. It is said that the growth of regulatory oversight has provided a clear indication of what should be published and when, so that all participants in the market have a clear idea of what should be published. This could provide a right to rely on compliance with the regime and, consequently, redress where a claimant suffers a loss because the issuer falls short of the regulatory standard.

20. The previous paragraph sets out an abbreviated statement of an unusually complex issue. It does not, for instance, deal with issues of causation and quantification of loss that would have to be resolved in any successful action for damages. However, a statutory regime could establish clear boundaries to the circumstances in which liability would arise, and the class of persons to whom actionable duties would be owed, and, in doing so, would at least in part provide an answer to these questions. Moreover, providing greater certainty for issuers would reduce unnecessary costs (e.g., additional legal, review or insurance costs) and encourage more informative disclosures by directors.

21. Others argue that a statutory regime would be disadvantageous. They argue that the risk of a court significantly expanding the scope of liability is overstated. They also argue that a statutory regime would disturb the balance of investors' rights by eliminating the possibility of liability in a wide range of circumstances (e.g., for incorrect disclosures arising from negligence). Whilst it is difficult to be certain precisely what rights investors would be losing, it is clear that there would be a diminution in their current ability to argue before a court that they should be permitted to recover losses. Moreover, the mere possibility that such an issue can be argued before a court is an important incentive for issuers to provide timely and accurate disclosures.

22. While a statutory regime would eliminate the possibility of liability in some circumstances, it would also increase the likelihood of an issuer being held liable in other circumstances (e.g., for reckless or deliberately inaccurate disclosures). Explicit statutory recognition would create exposure to liability when the conditions were met.

Scope of a statutory regime

23. If a statutory regime were to be adopted, it is not clear what scope would be needed to strike the right balance between the interests of investors and issuers, providing appropriate incentives to make timely and accurate disclosures in compliance with FSA rules, and a suitable, but limited, right to recover losses.

24. While some issuers may argue that that they should face no liability whatsoever, we would expect more support for an extension of the Transparency Directive liability regime (see paragraphs 10 to 14). This would provide limited restitution to a narrow class of investors in those cases where behaviour was highly culpable (i.e., inaccurate disclosures were reckless or deliberate). They would argue that this would be broadly in line with the traditional position, encouraging more informative disclosures and protecting company funds from being used to compensate distant claimants. While there would be a small diminution in the incentive to provide timely and accurate disclosures, this would not be significant because FSA enforcement and sanctions provide the principal incentives for this.

25. Investors, however, may have concerns that extending the transparency directive liability regime might set the scope of the regime too narrowly and restrict its possible development. They may want stronger incentives for timely and accurate disclosures – or at least their maintenance at the current level.

26. In addition to setting standards of liability for failure to make accurate disclosures, a statutory regime would need to determine the liability (if any) for failure to disclose promptly (i.e., in the timescale or circumstances required by FSA rules). Indications from issuers suggest that they might be uncomfortable if statutory liability were to extend to this area. However, given that timeliness is of the essence in disclosure of price sensitive information, persuasive arguments would be needed to exclude liability completely. Absence of liability would reduce the incentives for timely disclosure.

27. It is not clear what scope of liability is needed to provide appropriate incentives to ensure accurate and timely disclosures. It may be necessary to establish a statutory liability regime with a greater scope

of liability than that proposed for the Transparency Directive liability regime.

28. It might be appropriate, for example, to define some limited circumstances in which negligent issuers might be liable (only reckless or deliberate wrongdoers are liable under the Transparency Directive statutory regime), for example, when a negligent disclosure was not corrected as soon as reasonably practicable, or where the loss was suffered by a particularly vulnerable class of investor. (These investors tend to be retail investors and could perhaps be defined as those investors who could show that they relied solely on the disclosure in making investment decisions.)
29. Alternatively, it might be possible to increase incentives by expanding the scope of the Transparency Directive liability regime to permit recovery of losses by persons who retained or sold shares in reliance on the disclosures (whereas the current provisions limit recovery to persons who relied on the disclosures in acquiring shares).

Consistency

30. One argument for extending the Transparency Directive liability regime to disclosures made under the disclosure rules is that it would provide consistency between the regimes. Without consistency, issuers might be encouraged to delay disclosures of price sensitive information, to include it in transparency disclosures that would be subject to a statutory liability regime.
31. Consistency is desirable in principle. However, it must be weighed against other considerations. Differences can be justified by differences in the purpose, content, standards and sanctions applied to classes of disclosure. It is not clear that relatively modest differences in the civil liability regime would delay important market disclosures, given that anyone so doing would be in breach of their obligation to disclose information promptly and subject to the FSA's enforcement powers (including the ability to impose unlimited fines). In addition, we must also consider if ensuring consistency between the liability regime for transparency disclosures and disclosures under the disclosure rules would simply move the boundary issue further down the line, for example by encouraging issuers to include what would have been voluntary statements in their disclosures of price sensitive information.

Request for views

32. We would welcome stakeholder views on the desirability of putting on a statutory footing the regime for liability in damages in respect of loss flowing from disclosures made under the FSA's disclosure rules (including the obligations to disclose price sensitive information), and, if so, the appropriate scope of such a regime (including whether this should be by extension of the liability regime for transparency disclosures).

33. Respondents may also wish to consider:

(a) would simple extension of the Transparency Directive liability regime as in clause 1234 at present be adequate?

(b) Should there be liability for failure to make disclosures promptly?

(c) if so, should this be qualified by a requirement to show bad faith or recklessness on the part of the issuer (or relevant responsible person within the issuer)?

(d) should existing shareholders be able to sue in respect of losses arising from sales in reliance upon the incorrect information?

(e) should there be different levels of duty of care owed to different classes of market participant, and in particular retail investors?

ii) Preliminary announcements of results

34. Preliminary announcements of results are a sub-set of disclosures required under the disclosure rules discussed in the preceding section. The civil damages regime is the same common law regime as that applying to other disclosures of this class. While preliminary announcements are currently mandatory for listed companies, the FSA has been consulting on a proposal whereby they would be voluntary (although such announcements would still have to conform to the requirements in FSA rules with regard to form and content). In addition, the Transparency Directive is bringing forward the date by which the annual report and the half yearly report must be made public (to four and two months respectively), which could reduce the demand for preliminary announcements or put pressure on issuers to bring them out earlier.

35. It can be argued that preliminary announcements are a special case, because of the unusually high degree of overlap between the content of disclosures required under the Transparency Directive and the content of preliminary announcements. Subjecting these to different

liability regimes could have perverse effects, encouraging opportunistic legal action by investors and encouraging issuers to reduce the content of preliminary announcements, or to abandon them altogether (if voluntary) to take advantage of a more certain statutory liability regime.

36. The counter argument is that issuers provide meaningful preliminary announcements because these are valued by the investor community, and the difference between a statutory and common law liability regime is unlikely to affect this position. A further argument is that extending the statutory liability regime to preliminary announcements might encourage issuers to delay announcements of price sensitive information until they could be subsequently included in preliminary announcements. (However, as discussed earlier, the fact that issuers remain subject to sanctions when they fail to disclose price sensitive information promptly would check this tendency.)

37. If the statutory liability regime were to be extended to cover preliminary announcements, it could cover all the information within a preliminary announcement, or be restricted to information subsequently included within a transparency disclosure. Simplicity suggests that the former is simpler to draft and operate, but this may present an opportunity for abuse by including information not normally included in the annual or half-yearly report. However, it is not clear if the risk or impact of such abuse would be serious.

38. We would welcome stakeholder views on the desirability of extending the statutory liability regime for transparency disclosures to preliminary announcements of results (whether mandatory or voluntary).

iii) Companies with securities quoted on the AIM market

39. AIM companies are required to comply with the requirements of company law and to make disclosures in accordance with the AIM market rules (including the requirement to disclose price sensitive information). Statutory enforcement provisions apply to disclosures required by company law (e.g., provision of annual accounts) and the AIM market enforces its own rules. Civil liability is governed by the common law, and as discussed above, the courts have been reluctant to attach civil liability to an issuer making an inaccurate disclosure.

40. The fundamental difference between the disclosures required of AIM companies and those required under the transparency rules is that the former are required under the private and contractual relationship of exchange listing, whereas the latter are statutorily required to be

prepared and made public throughout the EU, under a directive importing a possibility of liability. Other things being equal, this reduces the risk of civil liability being attached to AIM disclosures. Accordingly, the reasons which led the Government to implement a statutory liability regime for transparency disclosures do not exist in the case of AIM disclosures. Moreover, it would be unusual to have a statutory liability regime for non-statutory disclosures, where there is more potential for liability risk to be managed through the rules of the market and the behaviour of participants (e.g., by attaching disclaimers to disclosures).

Statutory or common law liability regime

41. The arguments for and against establishing a statutory liability regime for disclosures required of AIM companies are similar to those in relation to disclosures under the disclosure rules, set out in paragraphs 16 to 31 above, with the fundamental difference that the disclosures required of AIM companies are non-statutory and therefore the risk that the courts will significantly increase the scope of liability is less than for transparency disclosures.

42. We would welcome stakeholder views on the desirability of putting on a statutory footing the regime for liability in damages in respect of loss flowing from disclosures by companies with securities quoted on the AIM market and, if so, the appropriate scope of such a regime (including whether this should be by extension of the liability regime for transparency disclosures).

43. Further, is your position affected by the decision on possible extension of the Transparency Directive liability regime to disclosures required under the FSA's disclosure rules by issuers on a regulated market?

iv) Disclosures by companies admitted to trading on an EEA regulated market

44. At present, the proposed statutory liability regime for transparency disclosures would apply to all issuers whose securities are admitted to trading on a UK regulated market.

45. Under the Transparency Directive, issuers are under the jurisdiction of rules made by their home Member State. Most UK companies must have the UK as their home Member State, irrespective of where they

are admitted to trading². However, a number of UK companies³ have a choice as to their home Member State.

46. Under the Directive, issuers are also under the jurisdiction of rules made by any host Member State⁴. However, such rules cannot exceed the Directive minima.
47. The Government's approach to implementation has been that issuers required to make disclosures under UK transparency rules should generally be subject to the civil liability regime applying to those disclosures in UK courts. UK companies required to make disclosures under another Member State's transparency rules should generally be subject to the civil liability regime applying to those disclosures in the courts of the other Member State.
48. On this basis, it would seem appropriate to ensure that the liability regime covers all issuers subject to the UK transparency rules, which will include all issuers for which the UK is the home Member State (a group encompassing most UK companies, irrespective of whether they are admitted to trading in the UK or in another EEA Member State, but potentially excluding those which have chosen another home Member State) and all issuers for which the UK is the host Member State.
49. We would also note that it is not possible to prevent UK nationals acquiring securities in an issuer admitted to trading in another EU Member State (for which the UK is neither home nor host Member State) through an exchange in the other Member State, and then seeking damages in the UK courts according to UK law. If the issuer is a UK person, it can be sued in the UK since the UK will be the default jurisdiction for action in tort under the terms of the Brussels Regulation⁵ on jurisdiction and enforcement of judgements. In some circumstances, the UK person could also be sued in another Member State. While we would not wish to encourage actions by UK nationals in respect of issuers for which the UK is neither the home nor host Member State (or equivalent actions by foreign nationals in relation to issuers for which the UK is home Member State), if the UK courts were to hear an action and apply UK law, it would seem appropriate that the UK liability regime should apply.

² Issuers of shares, or of debt with a denomination of less than 1000 Euro, whose registered office is in the UK, are required to have the UK as their home Member State

³ Those companies with a registered office in the UK, for which the only listed securities are debt securities with a denomination of more than 1000 Euro

⁴ Any Member State other than their home Member State, in which their securities have been admitted to trading

⁵ Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters – see Articles 2 and 5

50. We would welcome stakeholder views on the desirability of ensuring the statutory liability regime covers all issuers subject to UK transparency rules, including issuers for which the UK is the home or host Member State, and other situations in which UK law is applicable.

Timing of responses

51. We would be grateful for responses to the above questions by 6 September 2006, addressed to:

Mr Jack Middleton
Saving and Investments Team
HM Treasury
1 Horseguards Road
LONDON
SW1A 2HQ

Or by email to jack.middleton@hm-treasury.x.gsi.gov.uk