Extension of the statutory regime for issuer liability

July 2008

HM TREASURY

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Executive Summary

Section 90A of the Financial Services and Markets Act 2000 (inserted by the Companies Act 2006) established a statutory civil liability regime for issuer misstatements to the market, supplementing existing criminal provisions in that Act. In addition, in section 90B, the Treasury was given power to make further provision about the liability of issuers by regulation. Professor Paul Davies was asked to advise whether changes were needed to ensure the regime was soundly-based and comprehensive. This consultation covers the Government's response to his recommendations and proposes draft regulations to amend the regime.

Professor Davies reviewed the regime and concluded that its basis was sound. He agreed with the threshold for liability in the regime (namely fraud). He agreed that the issuers currently subject to the regime (those with securities admitted to trading on regulated markets) and the statements subject to the regime (periodic disclosures under the Transparency Directive) should remain subject to the regime.

Professor Davies had the opportunity to consult extensively with stakeholders on whether the regime should be extended beyond its current limited boundaries in order to achieve comprehensive securities market coverage. There was strong support for extension of the regime, on the grounds that there were only arbitrary distinctions between the classes of issuer and disclosure subject or not subject to the regime. Extending the statutory regime would improve issuer incentives for prompt and accurate disclosure, while providing both issuers and investors with greater clarity as to the scope of liability.

In line with Davies' recommendations, the Government proposes the following extensions to the statutory regime:

- to issuers with securities admitted to trading on UK multilateral trading facilities (MTFs), as well as those admitted to regulated markets. This would bring issuers on markets such as AIM and the PLUS-quoted market into scope;
- to issuers with securities admitted to trading on an EEA regulated market or MTF, provided they have a registered office in the UK or the UK is their home state under the Transparency Directive;
- to a broad range of ad hoc and periodic disclosures to markets (over and above periodic disclosures required under the Transparency Directive), by extending the regime to information disclosed by issuers by means of a recognised information service. The person claiming damages would not have to show that the relevant information was obtained from the recognised information service. A recognised information service would be defined as any service used to publish regulated information under the Transparency or Market Abuse Directives, or information required to be published under the rules of an MTF;

- to permit sellers, as well as buyers, of securities to recover losses incurred through reliance on fraudulent misstatements;
- to permit recovery for losses resulting from dishonest delay of a disclosure. An issuer would be liable where the delay is a dishonest act and is for the purpose of enabling a gain to be made or to cause loss to another or expose another to a risk of loss.

The basis of these proposals are discussed in the body of this consultation document and draft regulations incorporating these are attached at the end of the document. Responses to consultation are requested by 9 October 2008.

Introduction

1.1 The question of whether and how far companies (issuers of securities) should be liable in damages for inaccurate statements made to the market upon which investors rely to their detriment is an important one but the answer is not obvious. On the one hand, timely, comprehensive and complete reporting by companies is a crucial element to promote the allocative efficiency of capital markets. Appropriate incentives for such disclosure are thus important. Public enforcement through FSA investigation and sanctions and private litigation by investors have the potential to reinforce each other, providing effective incentives for prompt and accurate disclosures. On the other hand, private litigation to enforce investors' rights, particularly if there is uncertainty about the scope of liability, can operate perversely by encouraging speculative litigation and settlements by issuers based on a desire to terminate litigation rather than on the harm done to shareholders.

1.2 The subject of the UK policy on issuer liability for disclosures arose during the implementation of the Transparency Directive into UK law. After consultation, the Government sought Parliamentary approval for a statutory liability regime that was established in section 90A of the Financial Services and Markets Act 2000 (FSMA), in the section inserted by the Companies Act 2006. It was acknowledged, however, that further adjustment to the regime might well be required to address some complex issues that remained unresolved. Accordingly, Treasury was given power in section 90B of FSMA to make further provision about the liability of issuers, including amendments to section 90A, by regulation.

1.3 These powers provided scope for a thorough exploration of these issues. The Government asked Professor Paul Davies QC, Cassel Professor of Commercial Law at the London School of Economics, to carry out an independent review of liability in respect of damage or loss suffered as a consequence of inaccurate, false or misleading information disclosed by issuers or their management to the market, or of the failure to disclose relevant information to the market promptly or at all. He issued a first discussion paper entitled 'Liability for misleading statements to the market' in March 2007, which discussed the background to the current state of the law on liability, its policy rationale, approaches to solving the problem, and key questions on the basis of liability and extension of the statutory regime. Professor Davies also discussed the issues extensively with stakeholders – including main market and alternative market listed issuers, lawyers and accountants, financial advisers, industry associations and investor groups – and received a total of 46 formal submissions to his consultation.

1.4 Professor Davies then published in June 2007 a final set of proposals for further change to the law in the form of 'The Davies Review of Issuer Liability: Final Report'[1]. The Government has considered these and this consultation elaborates the Government's response and brings forward draft regulations for consultation.

1.5 As a result of Professor Davies' work, a broad consensus has emerged on the main issues, which underpins his recommendations to Government. While minority views remain on significant issues, Professor Davies has explained why, on balance, he has reached the conclusions in his report.

[1] On the HMT website at www.hm-treasury.gov.uk/davies.

1.6 The balance of this paper sets out the principal policy and legal issues in design of a liability regime, Professor Davies' recommendations on these, the Government's response, consultation questions, draft regulations and an Impact Assessment.

1.7 Comments are sought on the questions set out in the body of the text and listed at Annex A and the draft regulations at the end of the document. These should be sent by 9 October 2008 to:

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2 Basis of liability

2.1 The first and fundamental question Davies posed was whether issuers should be subject to civil liability for negligent misstatements, or only for fraudulent misstatements[2]. His recommendation is that liability should be based on fraud.

2.2 The term 'fraud' is used in the standard civil (as opposed to criminal) law sense of the term (i.e., as used in the tort of deceit) to mean a statement whose maker knew it to be false or did not care whether it was true or false. Thus, someone who had a genuine belief in the truth of what was said would not be fraudulent, even if that belief were based on inadequate checking.

2.3 Negligence, on the other hand, consists of falling below the standard of care required of a reasonable person, and so a misstatement might be found to have been made negligently even if its maker believed it to be true, provided reasonable checking would have revealed the falsity of the statement. The degree of verification necessary to satisfy the standard of a reasonable person is not always apparent, leading to some uncertainty as to when statements would be judged to be negligent.

2.4 Those in favour of a negligence standard believe that it provides appropriate incentives to ensure prompt and accurate disclosure. However, a clear majority of stakeholders were in favour of fraud as the basis of liability, on two main bases. First, a negligence standard would be more likely to generate defensive and bland reporting, especially in relation to forward-looking statements, rather than the full disclosure that market participants would find most helpful. Second, a negligence standard is likely to provide much greater opportunities for speculative litigation, driven by the economic interests of law firms or third party funders, than a tightly defined fraud standard.

2.5 Davies agreed with the majority of consultees and concluded that simple negligence should not be the basis for private litigation. In doing so, however, he noted that the current partial statutory liability scheme makes the bringing of a fraud claim easier than at common law[3]. At common law, the maker of a fraudulent statement is liable under the tort of deceit only if he or she intends the recipients, or at least an identifiable class including the recipients, to rely on that statement. This would create a potential obstacle to liability in respect of statements to the market, which are not addressed to particular recipients. The statutory regime in section 90A requires instead that the recipients' reliance on the statement be reasonable, facilitating the taking of fraud actions. Davies recommended that this relaxation of the common law continue to be part of an extended statutory regime.

2.6 Davies also considered the possibility of a 'gross negligence' standard, as adopted in German law and, in practice, in US law. Five of 28 responses to his review – all from investor groups – favoured a gross negligence standard. Davies concluded that gross negligence would not be a viable third way. Gross negligence would be a new standard in British civil law, so that one would not be building on an established body of precedent generating a firm concept. He was also doubtful about the possibility of defining such a standard adequately in legislation. Indeed, it is inherent in the use of standards that their development is a matter shared between the legislature and the courts.

[2] Davies Review of Issuer Liability: Final Report, June 2007, Question 1, pp 9-18.

[3] Davies Review of Issuer Liability: Final Report, June 2007, paragraph 30, page 18.

2.7 The consequences of this analysis are as follows. Cautious lawyers would advise their corporate clients that gross negligence was such an uncertain standard that companies should conduct themselves more-or-less on a negligence basis, thus contributing to the bland reporting mentioned above. Secondly, the uncertainty surrounding gross negligence would encourage speculative litigation. The courts would not be in a good position to strike out unmeritorious claims at an early stage of the litigation (as they would be under a fraud standard) because they would be likely to take the view that gross negligence would require a detailed examination of the facts of each case, which could occur only at a trial. Consequently, companies would be under pressure to settle such claims in order to avoid a trial, despite their unmeritorious nature, which is one of the main complaints made about the US system.

2.8 However, the choice is not between a wholly fraud-based enforcement regime and one based entirely on negligence. First, the fraud standard will be applied only to claims for compensation for misstatements under the statutory regime. Any claims in negligence which shareholders may have against a company will be expressly excepted from the statutory regime. Secondly, negligent reporting will not go unsanctioned under a regime based on fraud. Negligence is the standard adopted in the FSA rules and sanctioned by penalties which can take account of the degree of fault on the part of the issuer. Taken in the round, the enforcement regime strikes a balance between public and private enforcement of the disclosure and compensation requirements, with private enforcement being given a significant, but nevertheless subordinate, role.

Government's proposal

2.9 The Government agrees with this recommendation and proposes to make no change to the current basis of liability (i.e., fraud).

3 Markets to which the regime is applicable

Extension to UK-based multilateral trading facilities

3.1 The liability regime established in the section 90A of FSMA applies to issuers of securities admitted to trading on UK regulated markets[4]. A statutory liability regime was made necessary for such issuers as a result of the implementation of the Transparency Directive into UK law. It was not necessary to provide a statutory regime for those issuers admitted to trading on securities markets not subject to the provisions of the Transparency Directive. The Government consulted on whether it would be desirable to extend the regime to other classes of securities market, but neither issuers nor investors were convinced in the short time available that this would offer significant benefits. Given the lack of clear appetite for extension, when the Government sought the power in section 90B of FSMA, it was not envisaged that it would be used to extend the regime to other classes of securities market.

3.2 Since then, there has been time to explore the issues in greater depth. Davies' investigation has shown that while the disclosures made by issuers on other markets are typically mandated by and enforced through the rules of the market, they nonetheless are made in very similar circumstances and in response to the same investor needs, and with issuers facing similar incentives to make prompt and accurate disclosures. Crucially, it was felt that while investors expected the level of disclosures to differ from those on regulated markets, there was no principled reason why they should receive less protection against fraudulent misstatements.

3.3 This opportunity for more thorough exploration of the issues has led to a change in views in both the issuer and investor communities. It has been widely accepted that replacing the common law regime with a statutory regime would provide issuers and investors in other markets with the same benefits as in regulated markets, namely greater certainty as to investor rights in the event of fraudulent misstatements by issuers. Conversely, earlier concerns about possible unintended consequences have been replaced by the conclusion that there are no obvious disadvantages to a statutory regime. Davies' conclusions were strongly supported in consultation, in particular by the principal securities markets in the UK that would be affected by an extension of the regime – the AIM and PLUS-quoted markets.

3.4 Davies' recommendation[5] is that the statutory regime be extended beyond statements by issuers with securities admitted to trading on UK regulated markets, to include statements by issuers admitted to trading on all trading platforms for securities, or multilateral trading facilities (MTFs). For the purposes of implementation with respect to UK markets, MTFs are defined in Article 4.1(15) of the Directive on Markets in Financial Instruments (MiFID) and defined in FSMA for the purposes of Part VI of the Act in section 102B(6)[6].

[4] Currently defined in s.103 FSMA by reference to Article 1.13 of the Investment Services Directive (this will change to the definition in Article 4.1(14) of the Market in Financial Instruments Directive (2004/39/EC) when section 1272 of, and schedule 15 to, the Companies Act 2006, come into force.

[5] Davies Review of Issuer Liability: Final Report, June 2007, Question 5, page 20.

[6] Operating a multilateral trading facility is a regulated activity under Article 25D of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, for which permission under Part IV of FSMA is required from the FSA.

Government's proposal

3.5 The Government agrees with this recommendation and proposes that liability should attach in respect of all[7] securities admitted to trading on a UK regulated market or a UK multilateral trading facility.

Extension to non-UK markets

3.6 A further question, not directly addressed in Davies but inherent in his recommendation that the regime be extended beyond UK regulated markets, is whether the statutory regime should apply to UK issuers of securities admitted to trading on non-UK markets.

3.7 In considering this issue, it is important to be clear that the statutory regime can only be applied in those cases where English law is found to be the applicable law. It will not always be clear which law would be applied to a claim for compensation for fraudulent misstatements when there are conflicting liability regimes.

3.8 Where this question arises in a court in the United Kingdom or in the EEA, it is likely to be resolved in accordance with the provisions of Regulation 864/2007 on the law applicable to non-contractual obligations. Where the question arises in another jurisdiction, it will be resolved by the conflicts of law rules applied in the jurisdiction in question.

3.9 Under Article 4 of Regulation 864/2007, the applicable law for a tort would be:

- the law of the country in which the damage occurs (irrespective of the country in which the event giving rise to the damage occurred, and irrespective of the country or countries in which the indirect consequences of that event occur); or
- where the defendant and the person sustaining damage are both habitually resident in the same country when the damage occurs, the law of that country.

3.10 Article 4(3) provides for these rules to be overridden where:

> "it is clear from all the circumstances of the case that the tort is manifestly more closely connected with a country other than that indicated in paragraphs 1 or 2, the law of that other country shall apply. A manifestly closer connection with another country might be based in particular on a pre-existing relationship between the parties, such as a contract, that is closely connected with the tort in question".

3.11 Thus, where the investor and the issuer are both habitually resident in the UK, UK law may apply, though where the transaction took place on a third country market it may be argued that the damage was sustained there. It is not yet clear how the rules set out in Regulation 864/2007 would apply to such a case.

3.12 The decision as to whether English law is the applicable law under the Regulation will depend on the facts of a particular case. There will be cases in which UK issuers can expect to be held liable under the provisions of a law other than that of one of the jurisdictions of the United Kingdom. Even where a claim is brought in the UK courts, a foreign law may be held to be the applicable law. The Government cannot, even if it wishes to do so, exclude the jurisdiction of non-UK courts or the application of non-UK law in the above cases.

[7] i.e., securities issued by a UK issuer or non-UK issuer.

3.13 In the face of this uncertainty, there are two options: to extend the statutory regime to all cases where English law is found to be the applicable law; or to restrict its extension to those cases where issuers have been admitted to a narrower group of markets, such as UK or EEA markets. If the first option is taken, a UK issuer would be subject to the right of compensation we propose for fraudulent misstatements, wherever in the world its securities were admitted to trading, provided that the claim to compensation was made in a jurisdiction which would apply English law to it. If the second option is taken, the right to compensation would only apply in relation to securities which are admitted to trading in a market in the UK or the EEA.

3.14 The reason for extending the statutory regime to all cases where English law is found to be the applicable law is one of principle. It could be argued that it would be inconsistent for UK investors in UK issuers to be denied access to the UK statutory liability regime in such circumstances. Failure to do so could potentially lead to some UK investors having insufficient remedies under a third country securities regime.

3.15 The arguments against extending the statutory regime on this basis are more practical.

- First, the number of cases where the courts would apply English law outside the UK and the EEA is likely to be small. Moreover, as most overseas listings occur in jurisdictions with a well-developed securities regime, such as the US, the potential harm investors in these cases might suffer would be minimal.
- Secondly, the impact would be uncertain. The application of the statutory regime would depend entirely on the operation of the conflict of laws rules of the country in question, which could change from case to case, depending on the facts of a particular case.
- Thirdly, it would be difficult to adapt the proposed statutory liability regime which is built around concepts of European law to apply in other third countries. For example, it would be hard to adapt the EU concepts of regulated markets and MTFs or the concept of a recognised information service.

3.16 Our judgement is that, on balance, it would not be beneficial to extend the statutory liability regime to UK issuers admitted to trading in any third country in cases where English law is found to apply.

3.17 However, the arguments against extension of the statutory regime to third countries are weaker in the case of UK issuers admitted to trading on other EEA markets. European law provides for harmonised minimum disclosure requirements for issuers with securities admitted to trading on a regulated market in the EEA and establishes the principle of home state regulation for those issuers[8]. Only the home state can impose disclosure requirements above the directive minima, irrespective of where in the EEA the securities are admitted to trading.

3.18 The effect of minimum harmonisation and the requirement to comply with additional home state disclosure requirements is to make the application of the UK statutory regime more practical, as its interaction with disclosure requirements is clearer. Moreover, it is possible to think of cases, such as where both issuer and investor are resident in the UK, and the securities are admitted to trading on an EEA market,

[8] The principle of home state regulation does not apply to issuers with securities admitted to trading on MTFs.

where English law may be held to be the applicable law under regulation 864/2007, so that the UK liability regime would apply.

3.19 Accordingly, the Government proposes that statutory regime be extended to UK issuers[9] admitted to trading on EEA markets[10]. The Government is conscious of the difficult issues raised by this question and welcomes comments on these proposals.

Government's proposal

3.20 **The Government proposes that the statutory liability regime apply to:**

- **issuers of all securities admitted to trading on a UK regulated market or multilateral trading facility; and**
- **issuers of securities admitted to trading on an EEA regulated market or multilateral trading facility, where the UK is the home state for the issuer under the Transparency Directive or the issuer has its registered office in the UK.**

[9] The definition of UK issuers requires clarification. To ensure consistency with the Transparency Directive, it is proposed to align the definition of UK issuer with the definition of issuer for which the UK is the home member state under the Directive. Applying this definition to issuers with securities admitted to trading on an EEA MTF, a UK issuer is defined as an entity with its registered office is in the UK. In summary then, a UK incorporated company with its registered office elsewhere in the EU and with securities admitted to trading on a non-UK market would not be subject to the liability regime. On the other hand, a company incorporated outside the EEA with securities admitted to trading on a regulated market in the UK or the EEA and which has chosen the UK as its home member state, would be subject to the liability regime.

[10] As noted above, neither the Transparency Directive, nor the principle of home state regulation, apply to issuers with securities admitted to trading on MTFs. However, it would be excessively complex to extend the statutory regime to issuers with securities admitted to trading on EEA regulated markets but not to EEA MTFs.

4 Securities and issuers to which the regime is applicable

Securities to which the regime is applicable

4.1 At present the statutory regime applies to securities traded on a UK regulated market. Securities are defined in section 102A of FSMA as "anything which has been, or may be, admitted to the official list", an extremely broad definition. However, the right to compensation created by section 90A applies in respect of securities traded on a regulated market and in relation to information published in response to requirements for periodic disclosures set out in Articles 4, 5 and 6 of the Transparency Directive. Thus the securities that come within the scope of the regime are those defined as "securities" in the Transparency Directive.

4.2 Article 2(1)(a) of the Transparency Directive defines "securities" as transferable securities as defined in Article 4(1), point 18 of MiFID, with the exception of money market instruments having a maturity of less than 12 months. In turn, this is the definition of "transferable securities" in section 102A(3) of FSMA. Hence, the securities coming within the scope of the statutory regime, with the exception of the specified short-term money market instruments, are:

> "that class of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:
>
> > (a) shares in companies and other securities equivalent to shares in companies and partnerships or other entities, and depositary receipts in respect of shares:
> >
> > (b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
> >
> > (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates, or yields, commodities or other indices or measures"[11]

4.3 One of the questions which has arisen in considering extension of the statutory regime is the categories of securities in respect of which there should be a right to compensation. There are a number of options.

- It would be possible to limit the securities covered by the regime to debt and equity securities (including depositary receipts representing such securities). To some observers, this represents the natural scope of the regime. The majority of the disclosures within the scope of section 90A and with the potential to influence value will concern such securities, which include shares, convertible notes, preference shares, depositary receipts, bonds and other forms of transferable securitized debts, equity and debt securities issued by special purpose vehicles[12] and by closed-end investment companies.
- However, as indicated above, the current definition of "securities" has a wider meaning, including derivative instruments which are negotiable on

[11] Per Article 4(1), point 18 of MiFID

[12] This raises the question of the liability of the promoters of a transaction using an SPV. Though they would not be "issuers" for the purpose of our proposed provisions, the entity would have a right of action against the promoters in respect of any advice they received from them.

the capital markets in two categories: (a) instruments (such as options or warrants) which give a right to acquire or sell transferable securities, and (b) instruments which give rise to a cash settlement determined by reference to transferable securities, currencies, interest rates, or yields, commodities or other indices or measures (such as some exchange traded funds). There is nothing to indicate that this definition has given rise to any problems in practice (this may reflect the fact that the value of such derivatives is determined by the behaviour of the underlying instruments, and therefore the issuers do not in practice make disclosures of substance in relation to their derivatives).

- Another option would be to extend the definition of "securities" still further, to encompass all financial instruments as set out in Section C of the Annex to MiFID. One factor in favour of such an approach is the proposed extension of the regime to MTFs in the UK and to regulated markets and MTFs in the EEA, as a greater range of financial instruments will be traded on these markets. However, the Government sees no obvious benefit in this approach. The regime is intended to cover disclosures by issuers to the market that have the potential to influence the value of the traded securities that they have issued. As indicated above, issuers of derivatives do not in practice make public disclosures as envisaged by the regime and relied on by investors transacting in the derivatives[13].

4.4 Accordingly, the Government is not minded to extend or restrict the definition of securities to which the regime is applicable beyond "transferable securities" as defined in section 102A(3) of FSMA.

Issuers subject to the regime

4.5 The range of securities within scope also raises the question of whom should be considered the issuer of the security (and so liable to pay compensation for misstatements). For example, in the case of depositary receipts under Article 2(1)(d) of the Transparency Directive the issuer of the securities represented by the depositary receipt (i.e., the underlying securities) is deemed to be the issuer of the depositary receipt. In practice a decision to acquire or sell depositary receipts will be influenced by information published by the issuer of the underlying securities, not the issuer of the depositary receipts (who may not be responsible for the publication of any information to the market). It is therefore reasonable that the issuer of the underlying securities should be liable to pay compensation to investors who have suffered loss by acquiring or selling depositary receipts in reliance on information it has published. The same principle applies in the case of other secondary securities within the scope of Article 4.1(18)(c) that give the right to acquire or sell other underlying transferable securities.

4.6 But such a rule is only appropriate where issuer of the underlying securities has consented to the admission of the secondary securities to trading, as only then can it be regarded as having taken responsibility for the securities and, in most cases, any disclosure obligations. The issuer of the underlying securities to which depositary receipts or other securities within the scope of 4.1(18)(c) relate may neither have consented to the admission to trading of these securities, nor even be aware that they have been issued. This risk of this is heightened by the increase in the number and range of markets to which securities can be admitted and to which the liability regime applies. Where the issuer of the underlying securities has not consented to the

[13] To the extent that an issuer of a derivative instrument makes fraudulent misstatements which are relied on by investors, they would remain subject to civil actions in the tort of deceit and to the criminal prohibition in section 397 of FSMA against making misleading statements.

admission to trading of the secondary securities, it is not appropriate that it should be liable to compensate investors in such securities for their loss. In such circumstances, the issuer of the secondary securities will remain the issuer who is liable to pay compensation to investors in respect of any misstatements it may make.

4.7 In addition, we propose as a general rule under our regime that only securities which have been admitted to trading by or with the consent of the issuer will be within the scope of the regime. The identity of the issuer is to be determined by the requirements in the preceding paragraph. Where the person identified as the issuer has not given consent to admission (e.g., if an exchange were to permit the trading of securities without reference to the issuer), the securities will be excluded from the scope of the regime.

4.8 We appreciate that there may be other securities where these principles are relevant, and we would be grateful for consultees' views as to whether the issuer of the underlying securities should be made liable to pay compensation under our regime in relation to any other derivative securities.

Government's proposal

4.9 The Government proposes:

- **that the regime apply to "transferable securities" as defined in section 102A(3) of FSMA;**
- **in the case of depositary receipts and other secondary securities giving a right to acquire or sell other transferable securities, the issuer liable to pay compensation shall be the issuer of the underlying securities, provided that the secondary securities concerned have been admitted to trading by or with its consent;**
- **for depositary receipts and other secondary securities admitted to trading without the consent of the issuer of the underlying securities, and for all other derivative instruments, the issuer of the depositary receipts, other secondary securities or derivative instruments shall be liable to pay compensation under the regime.**

5 Disclosures subject to the regime

Identification of relevant disclosures

5.1 The current statutory liability regime applies to periodic disclosures required under the Transparency Directive from issuers of securities admitted to trading on regulated markets. When Professor Davies consulted, there was a strong majority in favour of the extension of the statutory regime to ad hoc disclosures[14], on the ground that the distinction between periodic and ad hoc disclosures was arbitrary as far as the applicable liability regime is concerned. Professor Davies recommended[15] that the regime be extended to apply to ad hoc disclosures. The Government agrees with this recommendation.

5.2 It is important to define the relevant disclosures to which the regime should apply taking into consideration the proposed extension of the regime to issuers admitted to trading on MTFs, as well as on regulated markets. Davies considered the following options for scope of disclosures:

- limiting disclosure to the current requirements, namely announcements required under FSA rules implementing the Transparency Directive;
- extending it to ad hoc disclosures of inside information under the provisions of the Market Abuse Directive (MAD); or
- extending it to all announcements made by way of a Regulated Information Service (RIS).

5.3 Davies found unanimous agreement, among those who expressed a view, that the regime should attach to those statements put out through a Regulated Information Service (RIS). This would provide issuers and investors with a consistent and easily understood regime that covered the principal disclosures likely to affect the value of the securities[16].

5.4 This definition works well with securities admitted to trading on a regulated market. Under Article 21(1) of the Transparency Directive, the home member state is required to ensure that the issuer discloses regulated information – which includes periodic financial disclosures under the Transparency Directive and ad hoc disclosures under the MAD – in a manner ensuring fast access on a non-discriminatory basis. Under the Transparency and Disclosure Rules, issuers admitted to UK regulated markets are required to use an RIS.

5.5 FSA rules do not directly specify the required disclosures for issuers admitted to trading on UK MTFs, nor the channels through which such disclosures must be disseminated[17]. While such issuers are subject to general securities law, typically the rules of the MTF prescribe the required disclosures, the channels for dissemination and the enforcement procedures. Thus the AIM market rules require disclosures to be made to an RIS. The PLUS market rules for issuers require the use of an approved information service, defined as an RIS and Newstrack PLUS. Hence, to provide equivalent treatment

[14] Although one consultee would agree to this only if the basis of liability were to be gross negligence.

[15] Davies Review of Issuer Liability: Final Report, June 2007, Question 2, page 19.

[16] Davies Review of Issuer Liability: Final Report, June 2007, Question 4, pp 21-22.

[17] Under MAR 5.3.7 the FSA has provided guidance on the circumstances in which it will impose a variation on the Part IV permission of the operator of an MTF that operates a primary market in shares not admitted to trading on a regulated market in order to satisfy MAR 5.3.1 requirements (which may include disclosure requirements).

for MTFs, the regime should be applied to disclosures made by means of the service used for the dissemination of information required to be disclosed under the rules of the MTF.

5.6 The avenues for disclosure – respectively information services used for the publication of regulated information in pursuance of obligations under the Transparency Directive (including all RISs), and information services used for the dissemination of information which the rules of an MTF require to be published – are hereafter termed recognised information services.

5.7 It is possible that the rules of an MTF might not specify information to be disclosed under its rules. This is not the case in relation to the MTFs in the UK, but it may apply in relation to EEA MTFs. In such a case, the statutory regime would only apply to securities admitted to trading on the MTF where the issuer of those securities chose to publish information in relation to them on an information service also used for the dissemination of information required to be published under the Transparency Directive. Where the issuer chose not to use such a service, he would not be subject to the statutory regime. We do not think that this would in practice prove to be a problem, but we would be interested in consultees' views on this question.

5.8 Davies recommended that the regime be applied to disclosures made by means of a recognised information service, rather than limited to those required to be made by such means. While perhaps conceptually purer, such a limitation would reduce the certainty of the regime by permitting disputes over whether disclosure was actually required by the rules. This would be undesirable.

5.9 Given the appetite for a statutory regime from issuers and their advisers, we would expect them to take advantage of this rule to bring as wide a range of announcements under the regime as possible. This is desirable. Where information has the potential to affect the price of securities, it should generally be subject to the regime; where it does not, the matter is irrelevant. Nor, given the uncertainty over the development of the law, does Davies regard this as impinging materially on plaintiffs' rights.

5.10 Consequently, there is a risk that issuers may overload recognised information services (in particular, the RISs) to ensure that all disclosures are subject to the statutory liability regime. However, this may be mitigated as the regime will also apply to information where the availability of that information has been announced by the issuer using a recognised information service. Moreover, responses to Professor Davies suggested that this risk was not perceived as significant and we hope that it would be ameliorated by the cost of making such disclosures. The Government welcomes views on the extent of this risk and whether the proposal below manages it effectively.

Government's proposal

5.11 The Government agrees with Davies recommendation and proposes that the scope of disclosure of the statutory regime should be:

- **all information published by the issuer by means of a recognised information service;**
- **other information where the availability of that information has been announced by the issuer by means of a recognised information service; and**

- **a recognised information service for these purposes will include both RISs and information services used to disseminate information which is required to be published by the rules of an MTF.**

Exceptions to the regime

5.12 Davies thought it important that the statutory regime for investors should not reduce shareholder rights as against their companies[18] (notwithstanding that the circumstances in which a claim might successfully be brought are not entirely clear). Consultation responses supported this position. Specifically, he concluded that the statutory regime should not remove existing rights of parties in respect of information released for shareholder purposes (as opposed to information released to the market), but issued through an RIS as a matter of course. Davies considered the position of circulars required to be sent to shareholders but also disclosed via an RIS (e.g., in relation to significant transactions under LR10, related party transactions under LR11 or under the Takeover Code).

5.13 The government agrees that the statutory regime, and in particular the protection granted to issuers in respect of certain misstatements, should not remove any rights shareholders may have to bring a claim for negligence against their companies. Accordingly, we propose to provide expressly that the protection conferred by the statutory regime does not affect the rights of a holder of securities in his capacity as such (see paragraph 6(4)(a) of the proposed schedule 10A). We would welcome views as to whether this is sufficient, or whether any further provision is necessary.

5.14 Davies also commented[19] that section 90A(6)(b) would not affect negligence liability arising where express responsibility has been taken by an adviser, such as an auditor, for the accuracy of a particular document. In such a case, a claim against the adviser would be founded on the separate statement that the document was accurate, which would not be affected by the regime. We agree, and we do not therefore propose to make separate provision preserving liability in this case.

Government's proposal

5.15 The Government agrees with this recommendation and proposes that the statutory regime should provide that the proposed immunity does not affect the rights of a holder of securities in his capacity as such.

Application where information is available from multiple sources

5.16 A question arises as to liability where the information relied on is acquired from a secondary source (e.g., its republication in a news item), rather than directly from a recognised information service (the primary source). Under the statutory regime, liability will arise where the investor has relied on the relevant information, irrespective of its precise source. While the Government proposes to define the relevant information by reference to its primary source, this is simply the most convenient way of defining scope. It would be unfair to deny a remedy simply because the plaintiff could not show that the information was obtained directly from a recognised information service. Indeed it could impose an unnecessary evidential hurdle to valid claims. Accordingly, provided that an investor can prove that the information in question was published on a recognised information service, he will not have to prove that he obtained the information himself from the recognised information service.

Government's proposal

5.17 The Government proposes that the issuer be liable, irrespective of whether the person claiming damages obtains the relevant information from a recognised information service, or other source, provided that the information was published on a recognised information service.

[18] Davies Review of Issuer Liability: Final Report, June 2007, paragraphs 41-49.

[19] Davies Review of Issuer Liability: Final Report, June 2007, paragraph 46.

6 LIABILITY FOR DISHONEST DELAY

6.1 Professor Davies considered[20] if a liability for dishonestly delayed – in addition to inaccurate – announcements should be imposed by the statutory regime, or whether such delay should be sanctioned only through public enforcement via the FSA. Delayed announcements do not give rise in principle to liability at common law and so the extension of statutory liability would create a liability where none currently exists. Davies concluded that liability for dishonest delay is correct in principle in order to reinforce incentives for prompt disclosure to markets.

6.2 A majority of consultees replied that delay should be sanctioned only through FSA enforcement. However, among consultees, there was support from investor groups in favour of imposing a liability for dishonest delay.

6.3 The Government recognises the concerns of issuers and their advisers about the risks involved in creating a liability for dishonest delay. Assessing the truth or falsity of a statement is a question of fact. Delay is qualitatively different to misstatement, in that it requires a greater element of judgement as to what delay may be permissible. Thus it is more difficult to infer honesty or dishonesty from the circumstances of any delay. This uncertainty could increase the vulnerability of issuers to litigation and increase defensive behaviour. The uncertainty is increased by the potentially wider scope and less predictable application of private law remedies, compared to the public law remedies available through the FSA tribunal process.

6.4 Equally, the Government understands investors' concern that dishonest delay in making disclosures can be just as effective as a direct misstatement in creating a false market and harming the interests of buyers and sellers of securities. Indeed, Davies noted that no one identified a principled (as opposed to a practical) reason why dishonest delay should not be the subject of civil litigation.

6.5 This is a finely balanced issue. The Government's view is that it is appropriate to create a liability for dishonest delay to reinforce the incentives for prompt disclosure, provided that the scope of liability can be precisely drawn to ensure that legitimate delay is not penalised and defensive behaviour on the part of issuers is not promoted.

Test for dishonest delay

6.6 The more restrictive the definition of delay that attracts liability, the greater the certainty for issuers and the greater the difficulty for investors in securing redress. Davies considered whether requiring that delay should be deliberate would be sufficient but concluded that it would provide too broad a scope for liability. The basis for delay must be more than intention, since most delays will be intentional and often for good reasons (to check the facts before publication, for example). Issuers would face great pressures in approaching any decision to delay release if it could be challenged afterwards on this basis. A requirement for recklessness would also be insufficient. There would be considerable uncertainty as to what delay would be considered to be "reckless" for these purposes, and though this might be a more difficult standard to meet, there would justifiable fear that some forms of negligent delay would be drawn into the net.

6.7 Hence, Davies has recommended that liability should only attach to dishonest delay. He further suggests that the definition of dishonesty should focus on the purpose of the delay, and that civil liability should only be imposed if the purpose, or the

[20] Davies Review of Issuer Liability: Final Report, June 2007, Question 3, page 23.

predominant purpose, fell within a prohibited category[21]. Drawing on the test for criminal behaviour under section 397 of FSMA, he suggested that such a purpose could be inducing investors to acquire (or possibly dispose of) securities, or, more narrowly in his view, to enable a gain to be made or to inflict a loss on a person who acquired or sold the issuer's securities during the period of delay[22].

6.8 The Government agrees that such a test is appropriate. This would ensure liability in those cases where directors, for example, deliberately delayed disclosures in order to buy or sell securities on non-public information. It would ensure that some important cases where disclosure was deliberately delayed, for example, to give the board time to consider the implications of disclosure, to conclude contractual negotiations or to check the accuracy of a disclosure before publication, would not incur liability for dishonest delay.

6.9 However, requiring the claimant to show that the defendant sought to enable a gain to be made may still be too broad a test for civil liability. There are cases where an issuer may wish to delay a disclosure to mitigate serious potential harm. It could be argued that such actions are equivalent to enabling a gain to be made. However, most market participants would not consider these actions to be dishonest, nor is there any obvious benefit in the Government's imposing additional pressure, in the form of potential liability for dishonest delay, on issuers in these cases.

6.10 Accordingly, to prevent delays benefiting the issuer but recognised by the markets as appropriate, falling within the scope of the regime, the Government proposes that a further condition must be satisfied before an issuer would become liable to pay compensation. The claimant should also have to prove that those with managerial responsibility within the issuer (who would therefore have been responsible for the delay in publication) have acted dishonestly in delaying the publication of the information. Under the test in *R v Ghosh*[23] this will involve two questions – first, would their conduct in delaying publication be regarded by reasonable and ordinary people as being dishonest, and secondly did those concerned appreciate that their conduct was dishonest.

6.11 In such cases the issuer's clear intent will often be referenced by minutes of board discussions and potentially through communications with regulators. This would provide compelling evidence that the issuer is not acting dishonestly in delaying publication.

6.12 The proposed test does not, indeed cannot, completely exclude the risk of action against directors for dishonest delay. Potential claimants will explore minutely any avenue for redress and directors will always be aware that, in the event of a finding of dishonesty, the company or its liquidators would seek to recover damages from the directors. However, the chances of success are minimal unless plaintiffs can show that the principal motivation of the relevant officers in delay was to enable someone to make a gain or to inflict a loss, and that reasonable people would consider these actions dishonest.

6.13 It can be seen from the above examples that a breach of the FSA's rules would not, on its own, necessarily qualify as dishonest delay giving rise to a right to

[21] Davies Review of Issuer Liability: Final Report, June 2007, paragraph 49, pages 23 and 24.

[22] The test in section 3 of the Fraud Act 2006.

[23] [1982] QB 1053.

compensation. This is acknowledged by Davies[24]. Equally, the fact that a delay is not regarded as dishonest would not mean that there was no breach of the FSA's rules. The FSA's rules are intended to have a wider reach than the statutory liability regime by covering delay arising from negligence and recklessness.

6.14 The Government welcomes views on whether this proposal strikes the appropriate balance and is captured in the provisions of the draft regulation.

Government's proposal

6.15 The Government agrees with this recommendation and proposes to extend the statutory regime to include liability where the issuer:

- **acts dishonestly in delaying publication of the information; and**
- **by the delay intends to enable a gain to be made or to cause loss to another or expose another to the risk of loss.**

[24] Davies Review of Issuer Liability: Final Report, June 2007, paragraph 49, page 24.

7 OTHER ISSUES

Trading off-market

7.1 Professor Davies recommended that liability should not depend on whether the relevant transaction takes place on or off market. The appropriate test is that the investor relied on the statement in circumstances where it was reasonable to do so.

Government's proposal

7.2 The Government agrees with this recommendation and proposes that liability should attach irrespective of whether the relevant transaction takes place on or off market.

Extension to sellers of securities

7.3 The current statutory regime applies only for the benefit of acquirers of shares. Davies recommends that it be extended to include the sellers, but not the holders, of securities[25].

7.4 There was no majority in consultation on whether statutory protection should be extended to sellers and holders of securities, as well as to buyers. Fourteen consultees are in favour of extending the regime to sellers only and this comprised a consensus across key investor and issuer stakeholder groups. A mixed group of eight stakeholders are in favour of extending both to sellers and holders on the grounds that there is no justification for treating holders differently from buyers and sellers and the fact that it might be harder for holders to prove a loss should not mean they are deprived of a right of action. Six consultees want no change.

7.5 Davies recommends extending the regime to include sellers of securities as their loss is the same as that suffered by buyers (i.e., the difference between the price paid and the price which would have prevailed had the truth been known). He is not aware of any foreign regime that excludes sellers, though it is acknowledged that claims by sellers are rare, because issuers' misstatements tend to be optimistic rather than pessimistic.

7.6 Davies concluded, however, that the regime should not be extended to include holders of securities. While there is an argument in principle for inclusion, the determination of reliance on a misstatement in the absence of a transaction presents severe evidential difficulties. For this reason, foreign liability regimes also tend to exclude holders.

Government's proposals

7.7 The Government agrees with this recommendation and proposes to extend the regime to include sellers (but not holders) of securities.

Application to directors and advisers

7.8 An important question is whether the statutory regime should apply to directors and advisers who make statements on behalf of the company. The common law does so, but the statutory regime in section 90A of FSMA, which replaces the common law, applies only to issuers and excludes liability on the part of others. A clear majority of consultation responses reject extending liability beyond the company, with investor groups disagreeing.

7.9 On the one hand, it was argued that individuals who make fraudulent misstatements should not be protected just because they were making such statements on behalf of a company. In response, it was argued that extension of liability was unnecessary because the company had appropriate remedies against both directors and advisers.

[25] Davies Review of Issuer Liability: Final Report, June 2007, Question 8, page 24.

7.10 Davies concluded[26] that while there is an argument in principle in favour of extension (at least to directors) because of the deterrent impact upon directors of civil liability, it would nonetheless produce a cleaner legislative package if the statutory regime excluded director and adviser liability. Directors would remain liable to the company in negligence and liable to be sued by the company or by a shareholder on behalf of the company through the new derivative action procedure of the 2006 Act. Directors would continue to be exposed to the FSA's penalty regime if 'knowingly concerned' in the contravention by the issuer (under section 91(2) of FSMA 2000).

Government's proposal

7.11 The Government agrees with this recommendation and proposes not to extend the statutory liability regime to directors and advisers.

Measure of damages

7.12 Davies asked which measure of damages was appropriate: that for fraud (i.e., the tort of deceit) or for negligence. He concluded[27] that it would be difficult to formulate effective rules that would not tie the courts' hands in an undesirable way and thus recommended, in agreement with most of the legal consultees, that the issue was one better left for the courts to decide. In doing so, he noted that the effect of this would be that damages are likely to be assessed by reference to the loss cause by reliance on the statement, and not the loss caused by its falsity.

Government's proposal

7.13 The Government agrees with this recommendation and proposes to make no changes to the statutory regime in respect of assessment of damages.

Subordination of investor claims to unsecured creditors

7.14 The current position is that investors' claims under the statutory regime rank with those of other unsecured creditors, and ahead of those of shareholders. On the question of whether investors' claims should be subordinated to those of other unsecured creditors in the case of the issuer's insolvency, there was a near-even split of consultation responses. Davies concluded[28] that it raised important issues about the nature of equity investment in companies and the role of a company's legal capital, with potential ramifications outside the area of securities litigation (for example, in the area of capital maintenance). He agreed with those consultees who argued that the issue required wider consideration, and that also that there is no reason to delay other changes while this is resolved. The Government agrees with his recommendation that this issue needs wider consideration.

Government's proposal

7.15 The Government agrees with this recommendation and proposes to consider further the issue of subordination of investors' claims.

[26] Davies Review of Issuer Liability: Final Report, June 2007, Question 7, page 25.

[27] Davies Review of Issuer Liability: Final Report, June 2007, Question 9, page 26.

[28] Davies Review of Issuer Liability: Final Report, June 2007, Question 6, page 27.

A Consultation questions

The Government would be grateful for comments on the following proposals for the statutory regime for issuer liability for misstatements, and for any comments (preferably using the headings below) on their formulation in the draft regulations at the end of the document.

The Government proposes:

1. to make no change to the current basis of liability (i.e., fraud).

2. that liability should attach in respect of securities admitted to trading on a UK regulated market or a UK multilateral trading facility.

3. that the statutory liability regime apply to:

- issuers of all securities admitted to trading on a UK regulated market or multilateral trading facility; and

- issuers of securities admitted to trading on an EEA regulated market or multilateral trading facility, where the UK is the home state for the issuer under the Transparency Directive or the issuer has its registered office in the UK.

4. that the regime apply to:

- "transferable securities" as defined in section 102A(3) of FSMA;

- in the case of depositary receipts and other secondary securities giving a right to acquire or sell other transferable securities, the issuer liable to pay compensation shall be the issuer of the underlying securities, provided that the secondary securities concerned have been admitted to trading by or with its consent;

- for depositary receipts and other secondary securities admitted to trading without the consent of the issuer of the underlying securities, and for all other derivative instruments, the issuer of the depositary receipts, other secondary securities or derivative instruments shall be liable to pay compensation under the regime.

5. that the scope of disclosure of the statutory regime should be:

- all information published by the issuer by means of a recognised information service;

- other information where the availability of that information has been announced by the issuer by means of a recognised information service; and

- a recognised information service for these purposes will include both RISs and information services used to disseminate information which is required to be published by the rules of an MTF.

6. that the statutory regime should provide that the proposed immunity does not affect the rights of a holder of securities in his capacity as such.

7. that the issuer be liable, irrespective of whether the person claiming damages obtains the relevant information from a recognised information service, or other source, provided that the information was published on a recognised information service.

8. to extend the statutory regime to include liability where the issuer:

- acts dishonestly in delaying publication of the information;
- by the delay intends to enable a gain to be made or to cause loss to another or expose another to the risk of loss.

9. that liability should attach irrespective of whether the relevant transaction takes place on or off market.

10. to extend the regime to include sellers (but not holders) of securities.

11. not to extend the statutory liability regime to directors and advisers.

12. to make no changes to the statutory regime in respect of assessment of damages.

13. to consider further the issue of subordination of investors' claims.

B IMPACT ASSESSMENT

Summary: Intervention & Options

Department /Agency:	Title:
HMT	Statutory liability regime for fraudulent misstatements by issuers of securities

Stage: Consultation	Version: 1	Date: 17 July 2008

Related Publications: Davies Review of Issuer Liability, Liability for misstatements to the market, A discussion paper by Professor Paul Davies QC, March 2007; Davies Review of Issuer Liability: Final Report by Professor Paul Davies, June 2007

Available to view or download at:

http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_liveindex.cfm

Contact for enquiries: James Templeton	Telephone: 020 7270 5000

What is the problem under consideration? Why is government intervention necessary?

Timely, comprehensive and complete reporting by companies is a crucial element in promoting the allocative efficiency of capital markets. Lack of certainty as to the existing common law position with regard to issuer liability in damages for inaccurate statements made to the market was partially resolved by the introduction of a statutory liability regime. These proposals aim to extend the existing statutory regime to ensure complete clarity.

What are the policy objectives and the intended effects?

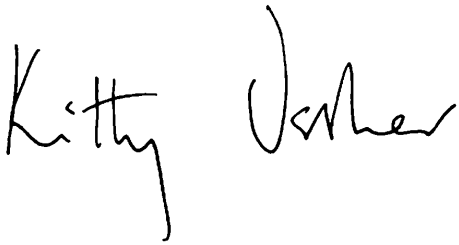
The purpose of the statutory regime is to clarify the existing common law position with regard to issuer liability in damages for inaccurate statements made to the market. The proposed extension of the statutory regime, working in conjunction with the FSA public law regime, aims to ensure optimal incentives for prompt and accurate disclosures, without encouraging costly speculative litigation and settlements by issuers based on a desire to terminate litigation, rather than on the harm done to shareholders.

What policy options have been considered? Please justify any preferred option.

The option of extending the statutory regime to wider classes of issuers and statements by issuers is compared against the base case of making no changes to the existing statutory regime. The preferred option of extension was selected on the basis of the recommendations by Professor Davies' review, reflecting his conclusion as to the policy mix that best balances the rights of investors with the incentives placed on issuers..

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The proposed extension to the regime is the result of an extensive independent policy review led by Professor Paul Davies QC. The Government will monitor the impact of the extended regime and review in due course.



Economic Secretary to HM Treasury

17 July 2008

Summary: Analysis & Evidence

Policy Option:	Description: **Extend the statutory liability regime to cover a wider range of disclosures by a larger group of issuers of securities.**

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' :
One-off (Transition) **Yrs**		One off costs of legal advice on the changes to the statutory regime and ongoing costs of increased levels of litigation
£3.5m – 5.2 m		
Average Annual Cost (excluding one-off)		
£0.4m–1.3m p.a.	10	**Total Cost** (PV) £11.7m

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' :
One-off **Yrs**		Ongoing benefits of more reliable and detailed reporting reflected in a small reduction in the cost of equity capital.
£		
Average Annual Benefit (excluding one-off)		
£1.7m p.a.	10	**Total Benefit** (PV) £14.6m

Other **key non-monetised benefits** by 'main affected groups'

Easier for parties harmed by fraudulent misstatements to secure compensation. More security for issuers in making detailed disclosures to the market.

Key Assumptions/Sensitivities/Risks

Price Base Year	Time Period Years	**Net Benefit Range** (NPV)	**NET BENEFIT** (NPV Best estimate)
		£ N/A	**£ N/A**

What is the geographic coverage of the policy/option?			UK wide	
On what date will the policy be implemented?			2008	
Which organisation(s) will enforce the policy?			N/A	
What is the total annual cost of enforcement for these organisations?			£ to be confirmed	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ N/A	
What is the value of changes in greenhouse gas emissions?			£ N/A	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro **voluntary**	Small **voluntary**	Medium	Large
Are any of these organisations exempt?	Yes	Yes	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of £ N/A	Decrease of £ N/A	**Net Impact**	**£** N/A

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

Partial Impact Assessment

Proposal

A statutory liability regime with regard to issuer liability in damages for inaccurate statements made to the market upon which investors rely to their detriment was introduced in the Companies Act 2006 which inserted section 90A into the Financial Services and Markets Act 2000. These proposals would extend the statutory regime to cover a wider range of statements by issuers (ad hoc statements and dishonestly delayed statements, as well as periodic disclosures) admitted to trading on a wider range of markets (UK and EEA regulated markets and MTFs, rather than just UK regulated markets).

Objective

Timely, comprehensive and complete reporting by companies is a crucial element in promoting the allocative efficiency of capital markets. The statutory regime introduced in 2006 clarified the existing position with regard to issuer liability in damages by imposing liability for fraudulent misstatements in respect of disclosures under the Transparency Directive by issuers of securities admitted to trading on regulated markets. These proposals would extend the regime to ensure that the benefits of clarification are extended throughout the market for tradable securities. The revised statutory liability regime would supplement public enforcement through FSA investigation and sanctions, to ensure optimal incentives for prompt and accurate disclosures, without encouraging costly speculative litigation and settlements by issuers based on a desire to terminate litigation rather than on the harm done to shareholders.

Options

There was strong support from issuers and investors for the extension of the statutory liability regime in Professor Davies' consultation. Accordingly, we have not investigated the option of reversion to the previous common law regime. This impact assessment has been prepared on the basis of the option recommended by Professor Davies, which reflects his conclusion as to the policy mix that best balances the rights of investors with the incentives placed on issuers, and after he had canvassed opinion extensively in both the issuer and investor communities. It assesses the incremental costs and benefits of this option against the base case of making no changes to the existing statutory liability regime.

Who is affected

Approximately 3,500 issuers of securities admitted to trading on regulated markets (e.g., the main market of the LSE) and on MTFs (such as AIM and PLUS-quoted) in the UK and the investors in those securities. The regime will be extended to ad hoc and dishonestly delayed disclosures for issuers with securities admitted to trading on regulated markets, and to periodic, ad hoc and dishonestly delayed disclosures by issuers with securities admitted to trading on MTFs. A small number of UK issuers admitted to trading on regulated markets and MTFs in other EEA states will also be affected.

Costs and benefit analysis

The key to identifying the costs and benefits is a robust understanding of the changes in behaviour expected to result from extensions to the statutory regime. The perceptions of the parties affected are a critical signal of expectations about the likely changes to behaviour. It is significant that both issuers and investors support regulatory intervention by means of an extension to the existing statutory regime, reflecting a belief that the benefits exceed the costs.

In general issuers and their advisers have been the more enthusiastic promoters of the statutory regime. While it is acknowledged that clarifying issuer obligations by means of a statutory liability regime could increase the overall level of litigation, this additional litigation will be inflicted on parties whose behaviour can be categorised as dishonest. The use of a demanding fraud test for misstatement means that the majority of issuers will face less risk of speculative litigation and less risk of the courts unexpectedly extending remedies for reckless or negligent misstatement.

Institutional investors have also generally supported a statutory regime, although less enthusiastically than issuers. They have welcomed the facilitation of legal action in respect of fraudulent misstatements and dishonest delay but have been concerned by the demanding threshold for success and the fact that statutory clarification reduces the potential for the courts to extend remedies in this area.

Issuer disclosure costs

Some issuers, particularly larger companies with an equity listing, will wish to seek advice on the impact of extending the statutory regime. Equally, larger issuers with an equity listing tend to be admitted to trading on regulated markets and thus are more likely to be familiar with the existing regime. Issuers range widely in size, with a significant tail of smaller issuers who are less likely to take advice. A reasonable estimate of the one-off cost over the range of issuers would be £1,000 - £1,500 per issuer. Over 3,500 issuers, the potential cost could be in the range of £3.5 – 5.25 million.

There is likely to be little impact on the day-to-day checking process by issuers. Issuers and directors already face significant financial and reputational penalties for negligent misstatements. In line with the requirements set out in the Combined Code (for issuers on the main market) and associated guidance, they are required to have robust disclosure assurance processes, which are capable of detecting at the less demanding threshold of accidental or negligent misstatements, as well as the fraudulent misstatements that are intended to trigger liability under a statutory regime. Moreover, the statutory regime is intended primarily to clarify issuer liability, rather than to expand its scope. We would not expect scrutiny costs to increase materially if the risk of liability does not change significantly. Indeed, the greater certainty for issuers and their advisors provided by the statutory regime has the potential to limit or offset growth in the depth and costs of scrutiny. We are not aware of costs increasing significantly with the implementation of the initial statutory regime and see little reason for material changes to processes as a result of extending the statutory regime.

It has been suggested that expanding the range of statements covered by the regime (from periodic disclosures under the Transparency Directive to include a wide range of ad hoc disclosures) may divert disclosures to recognised information services from other publication media. Issuers would incur any incremental costs from using the recognised information service, while the services themselves could be at risk of overloading.

We think this is unlikely. The bulk of the disclosures included in the extended statutory regime – periodic and ad hoc disclosures – are already made by means of a recognised information service.

Comments to Professor Davies' review suggest that the risk of overloading is not seen as significant. It should also be ameliorated by the proposal that a disclosure published elsewhere is subject to the statutory regime if specifically referenced in a disclosure to a recognised information service.

Litigation costs

However, clarifying the liability for misstatement, albeit subject to a demanding test of issuer fraud, is likely to increase the incidence of litigation in cases of fraudulent misstatement. The increase is likely to be small. But the potential costs of such cases are significant, even when settled before trial. It is reasonable to envisage perhaps 2 – 3 cases over the next ten years, with costs in the region of £1-2 million for each side. It is reasonable to expect that a similar number of cases would be settled before trial with costs of £0.25 – 0.5 million for each side. This gives a ten year cost range of £5 – 15 million, or an annual average transaction cost range of £0.5 - £1.5 milllion.

Note that the costs of damages or settlement are excluded from the IA. These are not a transaction cost, but a sanctioned transfer of wealth between parties, and as such do not represent an economic cost.

The statutory regime has deliberately been shaped, principally by selecting a demanding fraud test for liability, to minimise the potential for speculative litigation and the corresponding pressure on issuers to settle in order to terminate litigation, rather than compensate for harm done to shareholders. Accordingly, we do not anticipate incremental costs from speculative litigation.

Investment analysis costs

Investors already undertake a broad range of investment analysis and verification and engage with issuers, to improve the quality of their own investment decisions and to improve the performance of the companies in which they invest. There is no reason to expect the extension of the statutory regime to affect these ongoing processes.

Benefits

The benefits of extending the statutory regime are harder to calculate reliably, although this has not prevented the proposals from gathering widespread support from affected parties.

By clarifying the liability for and thus increasing the likelihood of litigation and substantial damages in respect of fraudulent misstatement, we expect a statutory regime to reduce the incidence of these misstatements. But the relationship is far from a simple linear one. Directors contemplating dishonesty already face an array of penalties and are likely to mislead only in extreme and pressured circumstances.

Such fraudulent misstatements do harm in two ways. First, they transfer wealth between parties. This can be unjust, but does not impose a net economic cost (or benefit). Secondly, the risk of such transfers increases the cost of capital to issuer and the risk to investors with regard to any particular portfolio of investments.

Reducing the incidence of fraudulent misstatement increases the quality of disclosure and improves confidence in reporting. This is an unambiguous benefit to investors, reducing the risk-adjusted return required from an investment, and similarly for issuers, leading to a comparable reduction in the cost of capital. We have not been able to identify any empirical evidence as to the magnitude of the reduction in the risk-adjusted cost of capital or how it might affect different entities. As a

large number of factors impact on the cost of capital it would not be feasible to isolate the impact of this single driver. However, by way of illustration, if the effect of the regime was to reduce the cost of equity capital (thus excluding debt capital) by a very small amount, of the order of one hundredth of a basis point (or 0.0001% p.a.) the effect on UK regulated markets and MTFs with a collective market capitalisation of £1.7 trillion would amount to £1.7 million p.a..

The greater likelihood of litigation and substantial civil damages in cases of fraudulent misstatement will increase the pressure on fraudulent issuers to settle promptly with FSA without admission of liability, even if this means larger fines and restitution to investors. More and faster settlements would mean lower legal and administrative costs. It is not fanciful to assume that these could be of the order of 10 – 20% of litigation costs, or say £100,000 – 200,000 p.a.

Investors would also benefit by being able to secure redress for harm done to them. Again, the compensation is not an economic benefit for the purpose of the IA, but a transfer of wealth from the issuer to the successful litigants. In effect, it represents a transfer from all shareholders in the issuer to a sub-set of shareholders (those who transacted on the basis of a fraudulent misstatement).

Small firms impact test

The statutory liability regime will apply to 3,500 issuers with securities admitted to trading on regulated markets and MTFs. These are invariably among the largest companies. It will not apply as a rule to the approximately 40,000 medium sized companies in the UK, or the much larger number of small companies.

Competition

The proposed statutory liability regime is not expected to reduce competition. By improving the quality of disclosure by issuers with securities admitted to trading it would be expected to improve the range of investment opportunities to investors

Legal aid

Commercial civil action is rarely covered by legal aid and there is no obvious reason for this to change.

Enforcement and sanctions

The statutory liability regime creates obligations in respect of statements by issuers of securities admitted to trading on a regulated market or an MTF. It is enforced by means of civil action by parties alleging harm and the remedy is damages. It exists alongside a public law regime of FSA rules made under FSMA 2000 and governing disclosures by issuers. The FSA has the power to impose criminal and financial penalties and to order restitution.

Monitoring and Review

No formal review is scheduled. The Government will monitor the impact of the regime to ensure it delivers the intended policy benefits.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	Results in Evidence Base?	Results annexed?
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Draft Regulations laid before Parliament under section 429(2) of the Financial Services and Markets Act 2000, for approval by resolution of each House of Parliament.

D R A F T S T A T U T O R Y I N S T R U M E N T S

2008 No.

COMPANIES

The Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2008

Made - - - -	***
Coming into force - -	***

The Treasury make these Regulations in exercise of the powers conferred on them by section 90B of the Financial Services and Markets Act 2000(**a**):

Citation and commencement

1.—(1) These Regulations may be cited as the Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2008.

(2) These Regulations come into force on [ ] 2008.

Amendments to the Financial Services and Markets Act 2000

2.—(1) The Financial Services and Markets Act 2000 is amended as follows.

(2) For section 90A (compensation for statements in certain publications), substitute—

> **"Compensation: liability of issuers in connection with published information**
>
> **90A.** Schedule 10A makes provision about the liability of issuers of transferable securities to pay compensation to persons who have acquired or disposed of securities and who have suffered loss in respect of those securities as a result of—
>
> (a) a misleading statement or dishonest omission in certain published information relating to the securities; or
>
> (b) a dishonest delay in publishing such information."

(3) After Schedule 10, insert the Schedule 10A contained in the Schedule to these Regulations.

(**a**) 2000 c.8; sections 90A and 90B were inserted by section 1270 of the Companies Act 2006 (c. 46).

Transitional provision

3.—(1) The amendments made to the Financial Services and Markets Act 2000 by these Regulations have effect in relation to information first published on or after [commencement date].

(2) Section 90A of that Act, in the form inserted by the Companies Act 2006, continues to apply to information first published before that date.

name
name
date Two of the Lords Commissioners of Her Majesty's Treasury

SCHEDULE

Regulation 2(3)

"SCHEDULE 10A

Section 90A

COMPENSATION: LIABILITIES IN CONNECTION WITH PUBLISHED INFORMATION

PART 1

SCOPE OF THIS SCHEDULE

Securities to which this Schedule applies

1.—(1) This Schedule applies to transferable securities that meet the following two conditions.

(2) The first condition is that the securities—

(a) are admitted to trading on a regulated market or multilateral trading facility situated or operating in the United Kingdom, or

(b) are admitted to trading on a regulated market or multilateral trading facility situated or operating elsewhere in the EEA and the United Kingdom is the home State of the issuer.

(3) The second condition is that the securities are admitted to trading as mentioned in sub-paragraph (2) by or with the consent of the issuer.

(4) For the purposes of this Schedule the United Kingdom is the home State of an issuer of securities—

(a) in the case of securities in relation to which the transparency obligations directive applies, if the United Kingdom is the home Member State for the purposes of that directive (see article 2.1 of the directive);

(b) in any other case, if the issuer has its registered office or, if it does not have a registered office, its head office in the United Kingdom.

Published information to which this Schedule applies

2.—(1) This Schedule applies to—

(a) information published by the issuer of the securities by means of a recognised information service; and

(b) information published by the issuer of securities otherwise than by means of a recognised information service if the availability of the information has been announced by the issuer by means of such a service.

(2) This Schedule applies whether or not the information is required to be published or announced, or to be published or announced by such means.

(3) A "recognised information service" means a service—

(a) used in pursuance of article 21 of the transparency obligations directive for the dissemination of regulated information, or

(b) otherwise used by issuers of securities for the dissemination of information required to be published by the rules of a regulated market or multilateral trading facility.

Exclusion of listing particulars and prospectuses

3.—(1) This Schedule does not apply to information contained in listing particulars or a prospectus.

(2) In sub-paragraph (1), "listing particulars" includes supplementary listing particulars and "prospectus" includes a supplementary prospectus.

PART 2

LIABILITY IN CONNECTION WITH PUBLISHED INFORMATION

Liability of issuer for misleading statement or dishonest omission

4.—(1) The issuer of securities to which this Schedule applies is liable to pay compensation to a person who has—

(a) acquired or disposed of such securities issued by it, and

(b) suffered loss in respect of them as a result of—

(i) any untrue or misleading statement in published information to which this Schedule applies, or

(ii) the omission from any such published information of any matter required to be included in it.

(2) The issuer is liable in respect of an untrue or misleading statement only if a person discharging managerial responsibilities within the issuer knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading.

(3) The issuer is liable in respect of the omission of any matter required to be included in published information only if a person discharging managerial responsibilities within the issuer knew the omission to be a dishonest concealment of a material fact.

(4) A loss is not regarded as suffered as a result of the statement or omission unless the person suffering it acquired or disposed of the relevant securities—

(a) in reliance on the information in question, and

(b) at a time when, and in circumstances in which, it was reasonable for him to rely on it.

Liability of issuer for dishonest delay in publishing information

5.—(1) The issuer of securities to which this Schedule applies is liable to pay compensation to a person who has—

(a) acquired or disposed of such securities issued by it, and

(b) suffered loss in respect of them as a result of delay by the issuer in publishing information to which this Schedule applies.

(2) The issuer is liable only if a person discharging managerial responsibilities within the issuer—

(a) acted dishonestly in delaying the publication of the information, and

(b) by the delay intended to enable a gain to be made (by themselves or another) or to cause loss to another or expose another to a risk of loss.

(3) In sub-paragraph (2), "gain" and "loss" have the same meaning as in sections 2 to 4 of the Fraud Act 2006 (see section 5 of that Act).

Exclusion of other liabilities

6.—(1) The issuer is not subject—

(a) to any other liability than that provided for by paragraph 4 in respect of loss suffered as a result of reliance by any person on—

(i) an untrue or misleading statement in published information to which this Schedule applies, or

(ii) the omission from any such published information of any matter required to be included in it;

(b) to any other liability than that provided for by paragraph 5 in respect of loss suffered as a result of delay in the publication of information to which this Schedule applies.

(2) A person other than the issuer is not subject to any liability, other than to the issuer, in respect of any such loss.

(3) References in sub-paragraphs (1) or (2) to a person being subject to a liability include a reference to another person being entitled as against him to be granted any civil remedy or to rescind or repudiate an agreement.

(4) This paragraph does not affect—

(a) the rights of a holder of securities in his capacity as such;

(b) the powers conferred by sections 382 and 384 (powers of the court to make a restitution order and of the Authority to require restitution);

(c) liability for a civil penalty;

(d) liability for a criminal offence.

PART 3

SUPPLEMENTARY PROVISIONS

Interpretation

7.—(1) In this Schedule—

"multilateral trading facility" has the meaning given in article 4.1.15 of the markets in financial instruments directive;

"regulated market" has the meaning given in article 4.1.14 of that directive.

(2) References in this Schedule to the issuer of securities are—

(a) in relation to a depositary receipt, derivative instrument or other financial instrument representing securities where the issuer of the securities represented has consented to the admission of the instrument to trading as mentioned in paragraph 1(2), to the issuer of the securities represented;

(b) in any other case, to the person who issued the securities.

(3) References in this Schedule to the acquisition or disposal of securities include—

(a) acquisition or disposal of any interest in securities, or

(b) contracting to acquire or dispose of securities or of any interest in securities.

(4) For the purposes of this Schedule the following are persons "discharging managerial responsibilities" within an issuer—

(a) any director of the issuer (or person occupying the position of director, by whatever name called);

(b) in the case of an issuer whose affairs are managed by its members, any member of the issuer;

(c) in the case of an issuer that has no persons within paragraph (a) or (b), any senior executive of the issuer having responsibilities in relation to the information in question or its publication.

(5) The following definitions (which apply generally for the purposes of Part 6 of this Act) do not apply for the purposes of this Schedule:

(a) section 102A(6) (meaning of "issuer");

(b) section 102C (meaning of "home State" in relation to transferable securities);

(c) until paragraph 11(2) of Schedule 15 to the Companies Act 2006 (amendment of definition of "regulated market") comes into force, section 103(1) ("regulated market")."

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