ALERT MEMORANDUM

Problems with the Tesco value range

12 April 2017

On 28 March 2017, the UK Financial Conduct Authority ("**FCA**") and the Serious Fraud Office ("**SFO**") announced the imposition of sanctions on Tesco plc and its subsidiary Tesco Stores Limited ("**Tesco plc**" and "**TSL**" respectively, and together, "**Tesco**") in connection with an inaccurate trading update published by Tesco in August 2014.

The FCA has found that Tesco had committed market abuse in relation to Tesco securities and has required Tesco to compensate investors for associated losses, while the SFO has entered into a deferred prosecution agreement ("**DPA**"), which will see TSL pay a financial penalty of £129 million.

If you have any questions concerning this memorandum, please reach out to your regular firm contact, any of our partners or counsel listed in the "Our Practice" section of our website or the following authors:

LONDON

Simon Jay
+44 20 7614 2316
sjay@cgsh.com

Bob Penn
+44 20 7614 2277
bpenn@cgsh.com

Sunil Gadhia
+44 20 7614 2260
sgadhia@cgsh.com

Katherine Dillon
+44 20 7614 2295
kdillon@cgsh.com

James Brady
+44 20 7614 2364
jbrady@cgsh.com

clearygottlieb.com

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The Tesco case is notable for several reasons. First, it represents the first use by the FCA of its statutory powers to require a listed company to pay compensation in connection with market abuse. Tesco appears to have benefitted from being "extremely co-operative" with the FCA and avoided a further financial penalty partly because of its "exemplary conduct" since the misconduct came to light, as well as the redress scheme. Similarly, the SFO gives considerable weight to the level of co-operation provided by a company when considering whether a case is suitable for resolution by a DPA rather than by prosecution. The SFO's use of the DPA route also indicates that this enforcement practice (the fourth DPA entered into by the SFO, and following on from the high profile £497 m penalty imposed on Rolls-Royce in January 2017), while relatively new in the UK, is likely to continue to develop as a tool in the SFO's enforcement armoury. Lastly, the case raises (but does not resolve), the question of at which level in an organisation it is necessary to establish actual or constructive knowledge of misconduct in order to make a finding of organisational culpability, for both civil and criminal purposes.

Background

- On 29 August 2014, Tesco plc stated in a trading update that it expected trading profit for the six months to 23 August 2014 to be in the region of £1.1bn.

- On 22 September 2014, Tesco plc issued a "corrective" trading update in which it stated that it had "*identified an overstatement of its expected profit for the half year, principally due to the accelerated recognition of commercial income and delayed accrual of costs.*" The accounting information in question was provided by TSL.

- The price of Tesco plc shares and bonds fell following the September statement. According to the FCA, the market price for the Tesco shares was artificially inflated during the period between 29 August and 22 September and created a "false market" as a result of the August overstatement of profits.

- The FCA also found that Tesco knew or ought reasonably to have known that the information on which the August update was based was false or misleading (although with no finding of knowledge at Tesco plc board level).

- The FCA has therefore determined that Tesco committed market abuse contrary to Section 118(7) of the Financial Services and Markets Act 2000 ("**FSMA**")[1].

- While the FCA declined to impose a fine on Tesco, it has ordered Tesco to compensate "net purchasers" of Tesco plc shares and bonds within the false market period of 29 August 2014 and 22 September 2014.

- Compensation for shares will be set at 24.5 p per share (established by the FCA with the assistance of an independent expert) plus interest. Total compensation before interest has been estimated by Tesco and the FCA to amount to around £85 m. The compensation scheme will be administered by KPMG.

- Separately, TSL has agreed a DPA with the SFO in relation to false accounting by TSL between February and September 2014. The DPA is a voluntary agreement under which TSL will not be prosecuted provided the business fulfils certain requirements, including paying a financial penalty of £129 m.

- The DPA was formally approved by Sir Brian Leveson P in the Crown Court at a public hearing on 10 April 2017 but has not been published due to reporting restrictions put in place pending the conclusion of criminal prosecutions of certain former Tesco executives who have been charged

[1] Section 118(7) of the Financial Services and Markets Act 2000 was repealed upon the coming into force of the Market Abuse Regulation ("**MAR**"). The equivalent provision is now to be found at Article 12(1)(c) of MAR.

with fraud and false accounting, including the former Managing Director of Tesco UK[2], with a trial date fixed for September 2017.

Findings and liability issues

The FCA Final Notice published on 28 March 2017 finds that Tesco committed market abuse contrary to Section 118(7) of FSMA, namely:

> *"dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading."*

The FCA was satisfied that the August trading update created a false or misleading impression regarding the market price for Tesco shares (which are "qualifying investments" traded on the London Stock Exchange) and certain listed Tesco bonds. The FCA was also satisfied that Tesco knew or ought reasonably to have known that the accounting information disseminated to the market in the August update was false or misleading.

While the FCA has repeatedly clarified in the Final Notice that it makes no suggestion that the Board of Tesco plc possessed the requisite knowledge for a finding of market abuse, the FCA was nonetheless content that "*there was knowledge at a sufficiently high level but below the level of the Tesco plc Board as to the false and misleading nature of the August Statement for that knowledge to constitute the knowledge of Tesco plc, within the specific context of, and for the purposes of, market abuse.*"

It is therefore clear from this case that the existence of actual or constructive knowledge below board level is sufficient in the FCA's view to establish a finding of market abuse and consequent civil liability for a company. However, as the FCA does not clarify in its statement the individual executives who were found to possess the requisite knowledge (or constructive knowledge), or at exactly what "level" of management such knowledge existed, it is difficult to draw concrete conclusions about the FCA's views.

As far as criminal liability is concerned, it is unclear whether the SFO would have been able to establish the requisite level of criminal culpability at the level of the "controlling mind(s)" of TSL in order to bring a successful corporate criminal prosecution. Although three senior executives, including the former Managing Director of Tesco UK, face criminal charges of fraud and false accounting, the level of knowledge required for corporate criminal liability under English law is high, and the law is complex. It has traditionally been challenging to prosecute large organisations. The advent of the DPA regime offers the SFO an alternative course by allowing the resolution of potential criminal charges without having to prove the requisite knowledge to the criminal standard of proof at trial. Tesco plc was not a party to the DPA and it has not been suggested by the SFO that it would seek to bring a criminal prosecution against Tesco plc, although the economic and governance consequences of the financial penalty and the other conditions of the DPA will affect the entire Tesco organisation.

Penalties and restitution

Under section 384 of FSMA, the FCA has the power to require a person concerned in market abuse to compensate one or more persons that have suffered loss or have otherwise been adversely affected as a result of the market abuse. While these powers were established in 2001, they not yet been used by the FCA (or its predecessor the Financial Services Authority) - although the FCA has in recent years imposed various mandatory investor redress schemes on banks and other regulated financial firms involved in mis-selling of financial products.

The Tesco case therefore represents the first example of a statutory investor compensation scheme being imposed by the FCA for market abuse. Compensation will be available in relation to "net purchases" of Tesco shares and certain bonds during

[2] While it is assumed that the individuals charged by the SFO acted on behalf of TSL, the job titles publicly reported refer only to "Tesco UK".

the false market period (that is, shares or bonds bought and not sold during that period), based on the amount of loss suffered due to the inflated purchase price during that time (adjusted, where appropriate, for hedging and partial sales). Interest will also be payable on the loss amounts from the period of 19 September 2014 until 120 days post-commencement of the compensation scheme, at a rate of 4% p.a. for retail investors and 1.25% p.a. for institutional investors. Neither the FCA Final Notice nor the Tesco announcements and FAQs relating to the scheme explain the basis for the calculation of the losses or the differential interest rates to be applied – except to acknowledge the assistance of independent experts.

The terms of the scheme are such that a purchaser of Tesco shares or bonds that accepts an offer of compensation under the scheme will waive the right to bring future claims against Tesco with respect to the market abuse. It is unclear at this stage how existing claimants in a class action brought against Tesco by a number of (mainly institutional) investors for losses in connection with the false accounting information will respond to the compensation scheme.

The FCA also has powers (distinct from its compensation powers) to impose financial penalties for civil market abuse offences. In this case, however, the FCA has limited its punitive action to the public censure of Tesco. This is partly in recognition of both the SFO penalty and the compensation scheme, although the FCA has praised the "*exemplary approach of the Tesco plc Board since the discovery of the overstatement*", noting that both Tesco has been "*extremely cooperative and proactive in the offering of information*", including making a number of voluntary disclosures.

With respect to the DPA, both Tesco and the SFO have stressed that Tesco has " *fully cooperated with the investigation and undertaken an extensive programme of change, which the SFO has recognised in offering the DPA. This programme includes extensive changes to leadership, structures, financial controls, partnerships with suppliers, and the way the business buys and sells".*

In financial terms, Tesco has announced that it expects to incur losses of £235 m in respect of the SFO penalty, compensation scheme and related costs, which will effectively be borne by current shareholders (while former shareholders who sold during the period between 29 August and 22 September will retain a windfall). It is unclear whether this figure includes the ongoing costs incurred in implementing the necessary remediation programme and handling potential shareholder litigation.

Conclusions

While the matter has generated substantial negative publicity and financial consequences for Tesco, the potential for serious reputational damage associated with a potential criminal prosecution, and the associated protracted uncertainty for shareholders, appears to have been curtailed as a result of the settlements reached with both the FCA and the SFO. At the same time, the outcome enables the SFO to achieve a financial penalty, while avoiding the uncertainties and costs of a complex corporate prosecution. It also enables the FCA to achieve an outcome that compensates investors.

Unsurprisingly, the result has been viewed by some commentators as a "soft option" for both Tesco and the UK authorities, in offering a relatively convenient solution for all parties together with reputational and economic benefit (or at least economic certainty) on both sides. The greater economic certainty that a settlement offers to the parties and the market is, however, to some degree at the expense of legal certainty and definitive "justice". The DPA approach enables companies to limit uncertainty and reputational damage, but does not result in judicial findings on important aspects of corporate criminal liability. A DPA, however, comes at a price in terms of the level of transparency and openness required with the SFO, and the subsequent investigation may also expose individuals to prosecution. The SFO's director has warned in an interview following the Tesco DPA that UK businesses should not consider DPAs "the new normal". This echoes the comments of Sir Brian Leveson P approving the Rolls-Royce DPA, who

warned of the "cataclysmic risks" for companies who fails to disclose misconduct and engage with the SFO.

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