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Extension of the Statutory Regime for Issuer Liability in the UK

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HM Treasury has published a consultation on proposals to extend the statutory regime under which issuers may be liable to investors for misstatements to the market[1]. The existing statutory liability regime is restricted to a limited universe of financial information published by issuers whose securities are traded on regulated markets. The Government has now announced its intention to extend the scope of this regime to capture issuers whose securities are admitted to trading on a wider variety of markets and to capture a broader range of publicly disseminated material, thereby allowing a larger range of investor to recover and, importantly, to permit recovery for losses resulting from "dishonest delays" in disclosure.

Background

At present, issuers that make untrue or misleading statements to the market risk criminal sanction under section 397 of the Financial Services and Markets Act 2000 ("FSMA"). Under that section, a person commits a criminal offence if, broadly, he knowingly or recklessly makes misleading statements, dishonestly conceals material facts or engages in certain misleading practices, for the purpose of inducing or being reckless as to whether it may induce, another person to enter into, or to refrain from entering into, an agreement to buy or sell securities. The scope of that criminal offence is significantly broader than the existing civil regime, even following its proposed extension, though the high standard of proof required for a conviction has rendered it a blunt tool in enforcement cases. Indeed, there has only been one prosecution under that section to date[2].

In addition, a person who makes a negligent or fraudulent misstatement may in certain circumstances be liable at common law in the torts of negligence or deceit to a third party who, having relied upon that statement, suffers loss.

Section 90A of FSMA, which was enacted in 2006, implemented the United Kingdom's obligations under the Transparency Directive by enabling buyers (but no one

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

2 R v Rigby, Bailey and Rowley, 2005

else) to recover from issuers (but no one else), losses flowing from any untrue or misleading statement or omission of a required disclosure in certain financial information published by the issuer, to the extent that such misstatement or omission resulted from fraud by the issuer. Under section 90B of FSMA, HM Treasury was empowered to extend the scope of the regime. In the context of a possible exercise of that power, Professor Paul Davies was commissioned to carry out an independent review of civil liability for losses suffered as a consequence of inaccurate, false or misleading information disclosed by issuers to the market, or the failure to disclose relevant information to the market promptly or at all. Professor Davies' recommendations[3] form the basis of HM Treasury's legislative proposals.

HM Treasury's Proposals

HM Treasury is proposing the creation of potential statutory liability for all information that is either published by means of, or where the availability of that information has been announced by the issuer by means of, a "recognised information service", whether or not the information is required to be published through that service. Recognised information services will include the eight newswire services that are "regulated information services" through which London listed companies make their regulatory announcements[4].

HM Treasury has proposed that recovery for losses resulting not only from misstatements and omissions, but also from the dishonest delay of a disclosure, will be permitted. This proposal was opposed by the majority of those consulted, but was supported by investor groups. The intention of HM Treasury, in drafting the relevant statutory provisions, is to reduce the risk of defensive behaviour by issuers. Accordingly, HM Treasury has specified the species of delay that will attract liability. Under the proposed formulation, an issuer would be liable where the delay is a dishonest act, which takes place for the purpose of enabling a gain to be made (by themselves or another person), causing a loss to another person or exposing another person to a risk of loss. Whether this formulation is sufficiently precise to avoid defensive behaviour is questionable. Furthermore, the interaction of this provision with the Financial Services Authority's Disclosure and Transparency Rule (DTR) 2.5.1 will require careful consideration. DTR 2.5.1 expressly permits the disclosure of inside information to be delayed to avoid prejudice to the issuer's legitimate interests if certain tests are met, including that the failure to disclose would not be likely to mislead the public.

HM Treasury is also proposing to expand the liability regime by capturing the following issuers within the liability regime:

[3] http://www.hm-treasury.gov.uk/media/4/7/davies_review_finalreport_040607.pdf

[4] http://www.fsa.gov.uk/Pages/doing/ukla/ris/contact/index.shtml

- issuers of transferable securities admitted to trading on a UK regulated market or a UK multilateral trading facility (for example, an alternative trading system); and

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

This is the first time that markets other than regulated markets would be captured by this regime. Importantly, HM Treasury has decided against the further extension of the statutory liability regime to UK issuers admitted to trading on markets outside the European Economic Area. HM Treasury has also decided against either narrowing the scope of securities to which the regime is applicable to only debt and equity securities, or widening it to encompass the full range of financial instruments set out in MiFID.

Where liability arises in the context of depositary receipts and other similar secondary securities, HM Treasury proposes that the issuer liable to pay compensation will be the issuer of the underlying securities (that is, not the depositary); but only if the secondary securities in question have been admitted to trading by that issuer, or with its consent. In the case of secondary securities admitted to trading without the consent of the issuer, and all derivative instruments, liability will rest with the issuer of the secondary securities or derivative instruments. Further consideration needs to be given to the potential impact of this on unsponsored depositary receipt facilities.

The proposed expanded regime will permit sellers, as well as buyers, of securities to recover losses incurred through reliance on fraudulent misstatements or omissions. It will be easier to bring a claim under the proposed statutory regime than it is under the tort of deceit since deceit requires the issuer to have intended reliance on the misstatement, whereas the proposed statutory regime will only require the reliance to have been reasonable.

Professor Davies considered at length the basis upon which issuers should be subject to civil liability. Ordinary FSA disciplinary matters typically apply a "negligence" standard. However, that basis of imposing liability was rejected, as was a "gross negligence" standard. Accordingly, the "fraud" basis of liability that section 90A currently uses is to be retained under the proposals for the expanded statutory regime. This is particularly important as many market participants believed and continue to believe that a simple negligence standard would have generated defensive and bland reporting by issuers, particularly in relation to forward-looking information that the market can find so valuable.

HM Treasury was concerned that the new provision might be interpreted as a restriction of any general statutory or common law rights a shareholder might have to bring a claim for negligence against the company in which it has an investment. The proposed legislation therefore states explicitly that the new provisions do not affect the rights of a holder of securities in his capacity as such.

The proposed expansion of the regime looks on its face to be a reasonable set of measures. However, the detail of the changes will need careful consideration during the course of the consultation period.

In short, if enacted in the form presently proposed, the reforms to section 90A will broaden the scope of civil liability, and render it easier for a person who suffers a loss, having relied reasonably on certain types of fraudulent misstatements or omissions, or as a result of a dishonest delay in disclosure, to recover. The steps that will need to be taken to mitigate this legal risk will overlap significantly with those measures that issuers do and should put in place in connection with their regulatory obligations under FSMA and the Financial Services Authority's continuing obligations for listed issuers. However, the reforms are likely to mean that civil claims against issuers for fraudulent misstatements or omissions or delays in disclosure will be somewhat more likely to succeed in the future.

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