International
Capital
Market
Association Ltd

ICMA

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Davies Review of Issuer Liability
Savings and Investment Team (SAVI)
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Professor Davies

The Davies Review of Issuer Liability

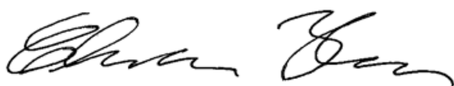
The International Capital Market Association (**ICMA**) is pleased to respond to the Discussion Paper (**DP**) on liability for misstatements to the market.

ICMA is the self-regulatory organisation and trade association representing investment banks and securities firms issuing and trading in the international capital markets worldwide.

Our response is based on extensive consultations with our member firms and their legal counsel.

We attach our general comments on the DP and responses to the specific questions therein as **Annex** to this letter and would be pleased to discuss it with you at your convenience.

Yours sincerely,



Christian Krohn
Regulatory Policy – Primary Markets
+44 (0)207 510 2704
christian.krohn@icmagroup.org

ANNEX

SUMMARY

We support the Review of issuer liability (**Review**) and believe that **DP** addresses many of the issues raised by the issuer liability regime introduced in the Financial Services and Markets Act 2000 (**FSMA**). Responding to the **DP** questions we: caution against statutory liability for negligent misstatements; support extending the regime to certain other periodic and ad hoc disclosures; oppose imposing liability for delay; believe the regime should be applied to exchange-regulated markets; oppose subordinating the claims of investors to those of other creditors; oppose extending the regime to those making statements on behalf of companies; believe that sellers of securities should have the same statutory protection as purchasers and that holders should have the right to sue on the same basis as before the changes to **FSMA**; and support the negligence measure for damages.

In terms of overarching issues, we agree with the **DP** conclusions that the development of fraud based investor action in the UK would probably not encourage a securities litigation culture similar to that of the US provided it is made very clear (by express wording in the legislation or through guidance) that the statutory regime is indeed fraud based. We also agree that the arguments for facilitating private litigation outweigh those for excluding it where fraud is involved.

However, we believe that that **Review** should consider two further issues: Firstly, in liability terms UK courts are likely to treat issuers differently depending on whether they are admitted to trading in the UK or other EEA state. To address this inequality we suggest the liability regime encompass all EEA regulated and exchange-regulated market issuers subject to a liability action under English law. Secondly, issuers making market disclosures are likely to incur liability in other member states because they are required to publish such disclosures in every member state. It will therefore be important, to encourage more disclosure, that European conflict of laws for liability in tort be amended, so that liability is to be determined under a single state's laws. If this is not done, UK companies may still be discouraged in making disclosure because of possible liability in other states.

GENERAL COMMENTS

Introduced to counter the unintended impact of the Transparency Directive (**TD**) on the English liability law pertaining to company reports, **FSMA** Section 90A raises significant issues, including inconsistencies in liability for market disclosures, uncertainty as to the threshold for liability and inequalities in terms of scope of application which need to be resolved. We fully support the Review exercise as a critical step to achieving the optimal balance between the needs of the market for timely, meaningful and accurate disclosure on the one hand and liability for inadequate or misleading disclosures on the other. We acknowledge that this is a difficult balance to strike but consider it essential to do so. If the liability threshold is set too low those making disclosures may become over cautious. In extreme cases this may even lead issuers to migrate to other markets with less onerous liability regimes. But a liability threshold that is too high may result in inaccurate disclosure to the detriment of investors and the markets as a whole.

What the market needs is more disclosure, going even beyond that which is mandated by law. So, for example, investors will benefit from disclosure of interesting information (even though it will not move the price of the issuer's securities and therefore is not required to be published under the market abuse regime). The liability regime should therefore be designed so as to encourage this by removing the disincentive of an over-zealous liability regime.

There is a further important balance to be struck between a liability regime that motivates management to make accurate disclosure and one that is so uncertain, or so easily triggered, or so draconian in its sanctions, that management spends too much time preparing disclosure. Cost, in this area, is not just to do with fees paid to advisors, but also involves undue diversion of management time. Investors need managers to run their companies and the more time that is spent in crafting reports so as to limit exposure to hair-trigger liability regimes, the less time will be available to seize market opportunities and increase profitability. There is also a risk that, if liability for disclosures is too easily incurred or if the job of director involves too much introspection for disclosure purposes, it will become increasingly difficult to recruit the right people to populate boardrooms of public companies.

We believe that the **DP** addresses a number of important areas where clarification of the regime is needed. These include: the basis for liability; the range of disclosures covered; liability for late statements; application to exchange-regulated markets; and issues relating to the ranking of investor claims, liability of those making statements, position of sellers and holders of shares, and measure of damages. We also consider the **DP** helpful in its analysis of the expected impact of the regime on litigation levels and of the benefits and limitations of private actions to enforce securities law.

Nevertheless we feel that DP omits two very significant issues relating to uncertainty as to the liability threshold and the cross-border implications of TD.

Uncertainty as to Liability Threshold:

We understand from the **DP** that the new statutory regime effectively amounts to a test akin to deceit under English law, so that:

- "knowledge" means the knowledge that the directors *actually* had - in other words, it does not mean knowledge that was available to them, or that they could have deduced by putting together a number of different facts that were within their knowledge; and

- "recklessness" would be strictly construed by the English courts, so that if a disclosable fact were provided to a director but he chose not to read it, he would only have been reckless if that choice was made with a dishonest intent.

We also understand from the **DP** that the only alternative option (without making significant changes to English law) would be to change the statutory test to one of negligence, imposing a standard of reasonable care on those making disclosure. Faced with this stark choice, we think that the objectives discussed earlier can only be achieved by the first alternative.

We are concerned, however, as to whether the interpretation of the first alternative will be free from doubt, at least, until it has been approved by the House of Lords in a relevant case and that, until it is, directors will be uncertain as to the scope of the test, with the result that the policy objectives that we have described are defeated. The ease with which information can be obtained in an age of computers makes the knowledge and recklessness tests particularly puzzling for many.

We therefore think that it would be important to put the **DP**'s interpretation of "knowledge" and "reckless" beyond doubt, either through express wording in the statute or through the explanatory note or guidance that is issued with the amending legislation.

Cross-Border Implications:

There are two distinct cross-border problems arising from the TD.

First, there is the problem that, because information has to be disclosed "using such media as may reasonably be relied upon for the effective dissemination of information to the public *throughout the Community"* (**TD** Article 21, emphasis added) simultaneous liability may be triggered in a number of different EEA states for information that is alleged to be misleading. This is because investors will read the information when it is relayed to them in their state and rely on it to their detriment, so that, under normal conflict rules, the applicable law to determine liability will be their local law. This result would largely negate the protection afforded to companies by the English statutory regime and defeat the policy objectives described earlier.

We appreciate that this question is beyond the remit given to Professor Davies. However, we believe that it is important that it be mentioned in the review, not least because there may be an opportunity to mitigate at least some of the risk, through the Rome II Regulation that is currently being negotiated. The draft Rome II Regulation provides as a general rule that the law applicable to a non-contractual obligation (such as liability for negligence) shall be the law of the country in which the damage arises. If, in the context of misleading disclosures, the "country in which the damage arises" is the country in which the investor reads the disclosure, then we would suggest that this rule needs to be reversed for such disclosures, to avoid multiple litigation to the detriment of companies and their investors alike. It makes sense in such cases that there should be one set of legal proceedings, applying one set of legal principles. This leads to the question - which? There may be several answers to this. One option may be that the law of the regulated market to which the issuer is admitted applies - and, if there is more than one, it will be the lead market (although consideration will need to be given as to how this is determined). Another option might be to choose the home state for the purposes of the **TD** (although this might be confusing to investors in a particular market, because they will have different rights in relation to disclosures by different issuers in the same market).

The second cross-border issue arises because the new statutory regime is limited to issuers whose securities are admitted to the United Kingdom's regulated markets or to other regulated markets, where the United Kingdom is the home Member State (FSMA section 90A(2)).

The **TD** requires all regulated market issuers to disclose their regulated information using media that ensure pan-EEA dissemination. Given London's role as host to one of the largest international investment communities in the world, it is likely that investors in the UK will invest in issuers traded on other EEA regulated markets than the UK in reliance on **TD** reports disseminated into the UK. Based on commonly accepted conflicts-of-law rules, the liability of such issuers to UK investors if such disclosure is incorrect will be determined by law of the country where the damage was suffered, i.e. English law. Given that such issuers are currently explicitly excluded from the new liability regime, their liability will be determined by the rules of general common law.

There are two possible solutions to this problem. The first is to obtain an amendment to the Rome II regulation, along the lines suggested earlier. The second is to ensure that issuers on EEA regulated markets or exchange-regulated markets (see our response to Question 5 that the statutory regime be applied to exchange-regulated markets) other than the UK for whom the UK is not the home state be covered by the new statutory regime. We would suggest that the second option be adopted in any event, because of uncertainties as to amending Rome II.

ANSWERS TO QUESTIONS POSED IN THE DP

Question 1: What should be the basis of liability?

We caution against introducing liability to investors on a negligence basis, for reasons given above. Although a rule of negligence liability has long operated for prospectuses, they are a special case, partly because new money is being raised and partly because new issues are a relatively infrequent occurrence for most companies, so that the additional cost and other burdens resulting from the negligence standard can be borne more easily. The benefits of extending the application of the negligence standard to other disclosures would in our view not outweigh the increased financial costs to issuers and would more importantly reduce the incentives to provide timely and full disclosures to the market. Also, introducing liability for ordinary negligence would be a step further than that taken in other major jurisdictions.

Question 2: Should the statutory regime be extended in principle to ad hoc statements?

We support the extension of the **TD** based statutory liability regime to the disclosures required by the Market Abuse Directive (**MAD**) and FSA Listing Rules (**LR**) and the annual update required by the Prospectus Directive (**PD**). There are significant overlaps between the disclosures that are currently in and outside the liability regime in terms of the content of the information disclosed and the regulation that applies to them. For example, a significant event affecting the issuer's business is likely to be included in a **MAD** inside information disclosure, one or more **TD** reports, and the **PD** annual update. In terms of regulatory overlap, the **TD** would classify both the **MAD** and **TD** disclosures as 'regulated information' and therefore subject to the same pan-EEA dissemination provisions of **TD** which gave rise to the need to introduce the liability regime for regular reports.

The resulting inconsistency between the scope of the new liability regime and the wider body of disclosure requirements creates a number of issues for investors, issuers and their management. For example, comparing **TD** periodic disclosures with **MAD** disclosures, the following inconsistencies are apparent:

- Investors relying on the same (incorrect) information would have very different rights depending on whether it was contained in the **TD** or **MAD** disclosure or (in case it was contained in both) whether they relied on the **TD** or **MAD** disclosure. It is likely that investors would in such cases assert reliance on the **MAD** disclosure and therefore liability under common law, frustrating the initial aims of the new liability regime.

- There is a higher ('knowledge or recklessness') liability threshold in case of **TD** reports which are made at predetermined times giving issuers time to carry out detailed investigations of facts and analyses of consequences and a lower ('reasonable care') one in case of **MAD** disclosures which are made within a much tighter timeframe which does not allow similarly comprehensive investigations. Although the standard of reasonable care might adjust to a degree to take account of the pressures on the issuer to communicate quickly to the market, this inverse relationship between the time allowed for preparing the disclosure and the threshold for liability if the disclosure turns out to be deficient appears counterintuitive.

- Under the current statutory regime the position of the issuer's management becomes uncertain. While they will have no liability for disclosures made pursuant to the **TD**, they may have a common law liability to investors for disclosure made under the **MAD**

To ensure consistency in the application of liability attached across the range of disclosures that companies admitted to the UK's regulated markets are required to make, we suggest the inclusion of the disclosures required by **MAD**, **LR** and the annual update required by the **PD** in the statutory liability regime.

Question 3: Should a liability for dishonest delay be imposed in the narrow circumstances identified in the DP or should delay be sanctioned only through public enforcement via the FSA?

While we sympathise with the view that those who dishonestly delay making required disclosures should be punished, we do not think that private litigation is the right tool to use for this purpose. There will always be some investors who will misuse such tools and, although they may be thrown out in legal proceedings, the fear generated by the threat of legal action and the inherent uncertainty of such proceedings will act as an undesirable inhibitor to those making disclosure. We can see no problem with leaving enforcement against those who delay disclosure in the hands of the FSA whose enforcement of the existing **FSMA** and market abuse requirements act as sufficient deterrent to dishonest delay.

Question 4: If the statutory regime were to be extended to ad hoc announcements, should it be (a) confined to disclosures of inside information (the most pressing case), (b) applied to all RIS announcements or (c) confined to announcements made under the FSA Disclosure and Transparency Rules (i.e. excluding ad hoc announcements made under the Listing rules)?

Referring to our answer to Question 2, we believe that the statutory regime should be extended to all classes of ad hoc and periodic disclosures required by **LR** and **MAD** and the annual update required by the **PD**. We also believe that the statutory regime should be extended to voluntary announcements, so that such announcements are encouraged and the market is better informed. However, it will be important to define carefully which disclosures are within the regime, and we would suggest that this is done by reference to where the disclosure appears (for example, any announcement through an Regulated Information Service). It should also be made clear that mere repetition of that information (for example, on the issuer's website) does not remove it from the statutory regime.

Question 5: Should Section 90A apply to non-regulated markets? Does your answer differ according to whether section 90A is extended to cover ad hoc statements?

We believe that the statutory regime should be applied to non-regulated markets (here referred to as exchange-regulated markets). We agree that a regime limited to regulated markets could have 'spill over' effect on exchange regulated markets in that such a differentiation might lead a court modify the application of *Caparo* to issuers on latter market. Although the **TD** does not apply to exchange-regulated markets, the disclosures made by issuers on these markets will in practice rise to the same need to clarify the applicable liability regime. We agree that the extension of the statutory regime to exchange-regulated markets would bring clarity to the liability position and make it clear that there could be civil liability for fraudulent statements (which would not be inconsistent with the 'light touch' approach to regulation of those markets). It would also create level playing field between the two market types (increasingly appropriate in the light of the growing movement of issuers between the two markets). Finally, we agree that the extension of liability would support any steps by the relevant exchanges to increase the effectiveness of their regulation.

Question 6: Should the claims of investors for damages under section 90A or any extension of it be subordinate to the claims of other unsecured creditors?

We believe that the claims of shareholders as creditors should rank equally with those of other unsecured creditors. We are not aware of any convincing arguments to change the apparent position under English law (as outlined in the **DP**) which does not subordinate investor's claims to those of other creditors.

Question 7: Should statutory liability for fraudulent misstatements be extended to those who make the statement on behalf of the company?

We do not believe that the statutory liability regime should be extended to those making statements on behalf of the company. Although directors and advisors carry no direct liability to investors, we believe that shareholders are likely to put pressure on directors as a consequence of any liability imposed on the company. The potential reputational and other losses will act as an indirect deterrent. Moreover, the Companies Act 2006 will now make it easier for shareholders to bring action against its directors on behalf of the company. We also agree with the **DP** analysis that imposing liability on directors may not in fact achieve any (direct) deterrent purpose because D&O insurance is likely to transfer the costs of the liability back to the company. Finally, we do not believe that the UK should impose more stringent liability regime than, for example, Germany and France where directors are protected from liability.

Question 8: Should statutory protection be extended to sellers and holders of securities as well as to buyers?

We believe that a distinction should be made between sellers who should enjoy the same entitlement to claim compensation as purchasers, and holders of securities who should not. While it may be unusual for a company to put out a misleading pessimistic statement and so generate sales rather than an overoptimistic one generating purchases of securities, in principle we see no reason to treat sellers relying on a misstatement differently to reliant purchasers. As regards securities holders, we agree with the **DP** analysis that it very difficult to establish whether a person who holds (or continues not to hold) securities does so in reliance on the misstatement. On this basis and consistent with international practice we do not believe statutory protection should be extended to holders of securities. We do, however, think that existing shareholders who are unable to exercise their stewardship rights because they are given misleading information should have the right to sue, on the same basis as before the changes introduced by the Companies Act 2006; and we are not clear as to whether **FSMA** section 90A(6) may have inadvertently taken away such rights.

Question 9: Should the deceit or the negligence measure of damages be adopted in the statutory regime?

We believe that the negligence measure of damages should be adopted in the statutory regime. The negligence approach appears consistent with at least the US where the approach focuses on the loss caused to the investors by the misstatement and is thus much closer to that for the tort of negligence in the UK than the tort of deceit despite the fraud basis of the US substantive laws. We also believe that the approach in the tort of deceit where damages are not limited to losses connected with the misrepresentation may lead to disproportionate damages for claimants.

The fact that the new statutory regime is based on the concept of deceit should not, in our view, inevitably mean that the measure of damages should be that for an action based on deceit. It should be possible to legislate to set out the basis for determination of damages without altering the basis for determining liability.

COMMENTS ON THE OVERARCHING ISSUES RAISED IN THE DP

Can super-optimal levels of fraud-based litigation be avoided?

We agree with **DP** analysis that the development of fraud-based investor action in the UK would probably not encourage a private securities litigation culture similar to that of the US, provided it is clear to the market that the statutory regime is indeed fraud based. As we have said, we doubt that this will be so and it will therefore be important that it is made very clear, so that maverick investors (and, indeed, uncertain courts) do not misunderstand the position.

The benefits and limitations of private actions to enforce securities law

We agree with the **DP** analysis that the benefits of facilitating private litigation outweigh those for excluding it where fraud is involved. Although the achievements of private litigation are modest in terms of both deterrent effect and compensation, this does not provide sufficient reason to exclude litigation entirely where fraud is involved. Such an exclusion would remove almost any possibility of compensation being provided to investors mislead by fraud and damage market confidence and any emerging 'equity culture' which is a subsidiary aim of the EU level reforms.