

September 2006

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 76 – TRANSPARENCY OBLIGATIONS DIRECTIVE LIABILITY

Legal assessment of the proposed statutory liability regime in the Companies Bill in relation to Transparency Obligations Directive disclosure

The logo for the Financial Markets Law Committee is a 3D-style rectangular block with the text "Financial Markets Law Committee" written on its top surface. The text is arranged in four lines, with "Financial" on the first, "Markets" on the second, "Law" on the third, and "Committee" on the fourth. The block is tilted slightly to the right and has a light blue-grey color with a subtle gradient and shadow effect.

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 76 WORKING GROUP

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1 Introduction and executive summary

a) Introduction

- 1.1 The role of the Financial Markets Law Committee (“FMLC”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2 The Companies Bill¹ includes provisions to introduce a statutory liability regime in relation to certain types of company disclosure, in light of developments in this area arising from the Transparency Obligations Directive (“TOD”).² These provisions are currently contained in clause 1234 of the Companies Bill and are limited to disclosure made under Article 4, 5 and 6 of TOD.
- 1.3 On 9 August 2006, HM Treasury published a consultation entitled “Extending the scope of the statutory damages regime for disclosures required under the Transparency Directive”³ and invited the FMLC, among others, to comment on the scope of the statutory liability regime. This paper is not a direct response to the questions raised in that consultation, as the issues discussed cover questions of policy, upon which it is not within the remit of the FMLC to comment. Instead, this paper is intended to assist those involved in the policy decisions by drawing attention to elements of uncertainty that arise out of the questions raised in HM Treasury’s consultation.

b) Executive summary

- 1.4 This paper makes the following points:
 - a. The disclosure obligations of those whose securities are admitted to EEA regulated markets include *ad hoc* disclosure of important information as it becomes available (for example, under the Market Abuse Directive (“MAD”))⁴ and regular reporting (for example, under TOD).
 - b. There is very considerable overlap between information that will be disclosed under the *ad hoc* MAD regime and that required for regular TOD reports.
 - c. There is also a legal overlap between the two types of disclosure. *Ad hoc* MAD disclosures are required by TOD to be disclosed to the public in the same way and for the same purpose as the regular reports. It would therefore appear that they are subject to the same uncertainties as to liability as led to the proposal to introduce a statutory liability regime for regular TOD reports.

¹ Formerly the Companies Law Reform Bill, introduced into the House of Lords on 1 November 2005

² 2004/109/EC (“TOD”)

³ Available at

http://www.hm-treasury.gov.uk/media/F36/09/fin_transparencymad090806.pdf

⁴ 2003/6/EC (“MAD”)

- d. As a consequence there is a degree of artificiality in applying different liability measures to MAD *ad hoc* and TOD regular reporting regimes and, given the uncertainty in the way in which common law principles would be applied to the *ad hoc* disclosures under English common law, to do so is likely to create legal uncertainty for issuers admitted to the UK's regulated markets and for those who use the financial markets.

2 The disclosure regimes

2.1 Issuers whose securities are admitted to EEA regulated markets are subject to a variety of disclosure obligations. HM Treasury's consultation discusses these in distinct groups, according to the laws and rules that give rise to them, as follows:

- a. *TOD disclosures* – TOD requires that, unless an exemption is available, any entity whose securities are admitted to an EEA regulated market must make public its annual, half-yearly and (if its shares are so admitted) its quarterly reports.⁵ The annual and half-yearly reports must contain, in addition to the financial statements for the period covered, a management report and a responsibility statement.⁶ The management report must contain a retrospective review of the important events that have occurred during the period and a prospective assessment of the issuer's likely future development.⁷
- b. *MAD disclosures* – MAD requires⁸ that issuers inform the public as soon as possible of inside information (broadly defined as non-public information which, if made public, would have a significant effect on the prices of the issuer's securities⁹).

2.2 For convenience, an Annex is attached to this paper that sets out the relevant provisions in the various EU Directives that give rise to disclosure obligations on companies.

3 Liability regimes

3.1 It is proposed that the Companies Bill introduce a provision into the Financial Services and Markets Act 2000 that TOD reports be subject to a statutory liability regime, the essential features of which are that:

- a. The issuer (and no one else) should have liability to investors for mistakes or omissions from the reports.
- b. That liability should only arise if the investor, having acquired securities in reliance on the report, suffered a loss in respect of them as a result of

⁵ TOD Articles 4(1), 5(1) and 6(1)

⁶ TOD Articles 4(2) and 5(2)

⁷ TOD Articles 4(5) and 5(4). Article 4(5) cross refers to Article 46 of the Fourth Council Directive (78/660/EEC) and Article 36 of the Seventh Council Directive (83/349/EEC), the texts of which, as amended, are set out for convenience in the Annex, paragraphs 1 and 2

⁸ MAD Article 6(1)

⁹ MAD Article 1(1), set out for convenience in paragraph 5 of the Annex.

any untrue or misleading statement in, or omission from, the report *and* a manager of the issuer knew that the report contained the untrue or misleading statement or omission or was reckless as to whether it did.

- c. There should be no other civil liability (including no liability under the common law in negligence) in relation to such untrue or misleading statements or omissions.
- 3.2 Other disclosures (including MAD disclosures) would, on the current draft of the proposed legislation, remain subject to common law liability regimes, including negligent misstatement. Such liability occurs where a person possessing certain skills or knowledge makes a statement to another whom he knows (or ought to know) will rely on it for a given purpose, and that other person does in fact rely on it to his detriment. English courts have indicated that liability for negligent misstatement can be established only where there is sufficient proximity between the parties and where it is just and reasonable to impose a duty of care. In order to establish proximity, the statement must be made to, or knowing that it will be provided to, the potential claimant and relied on by that person, although certain judicial statements have suggested alternative tests, and the true test of liability is to some extent uncertain.

4 Interaction between the disclosure regimes

- 4.1 There is a very considerable overlap between the two disclosure regimes, in two respects.
- 4.2 Firstly, any item of information that is disclosed as inside information during a financial period is likely also to be referred to in the following half-yearly or annual report because, if it was capable of significantly affecting the price of the issuer's securities, within Article 6 of MAD, it will also be an "important event" within Articles 36 or 46 of the Fourth or Seventh Council Directive or Article 5 of TOD, and therefore have to be disclosed under Article 4 or 5 of TOD.
- 4.3 For example, a company may make a preliminary announcement of its results, because they are price sensitive, and these will then be included in the subsequent annual report. Or a company may make an announcement of an event that has caused a major disruption to its production (perhaps a factory fire), together with an assessment of its financial impact, which will then be mentioned again in the subsequent report.
- 4.4 Secondly, there is a legal overlap. Inside information is required to be disclosed under MAD; but it is also required to be disclosed under Article 21(1) of TOD, because it is expressly included in the definition of "regulated information" by Article 2(1)(k) of TOD. Inside information is, therefore, subject to the same implications as to liability under TOD as annual, semi-annual and quarterly reports.

5 Consequences of that interaction

- 5.1 It is important to analyse this overlap in the light of the liability regime that may be applied to the different types of disclosure.
- 5.2 If MAD disclosures were left outside the statutory regime, they would continue to attract liability at common law. In the absence of any decided cases, there will be considerable uncertainty as to when such liability will arise. English courts have proved reluctant in the past to find such liability unless it is reasonable to do so; and they have taken policy into consideration when determining liability.
- 5.3 Where the incorrect information appears both in MAD disclosure and in TOD reports – for example, the preliminary results and the audited financial statements are both wrong, in the same way – the courts may find it illogical to hold the issuer liable in negligence in relation to the preliminary results when there would be no liability under the statutory provisions for the final report (because the statutory standard of knowledge/recklessness is substantially higher than the negligence standard of reasonable care). The court may well find it difficult to award damages to an investor who bought on the basis of the preliminary results, when the investor who bought on the basis of the annual report (containing the same figures) would have no right to compensation, as a result of the higher statutory standard of proof. It could also be argued that it makes little sense to find such liability, given that the time pressure to make prompt disclosure under MAD means that there is much less scope to verify information than in the context of an annual report. It would seem sensible that, as the opportunity to take care increases, so the threshold for liability should decrease – not the other way round.
- 5.4 It may be that, to avoid this result, the courts could apply the statutory thresholds of knowledge/recklessness in determining whether a duty of care has been adequately discharged in relation to MAD disclosure. However, such standards do not sit comfortably with common law concepts of negligence. Indeed, they appear to introduce a concept of “gross” negligence into English law, which is not currently recognised. It is difficult to understand a duty of care as an obligation not to mislead someone knowingly, or not to be reckless as to this result.
- 5.5 Another possibility is that the courts could find that there is no duty of care in relation to MAD disclosures; but it is difficult to see how they could do this. To do so would be inconsistent with the fact that MAD disclosures are “regulated information” and therefore subject to the same TOD provisions, regarding their purpose and their manner of publication, as the regular TOD reports, which are presumably intended to give investors a right of action (otherwise the statutory liability regime for TOD reports would not have been proposed).
- 5.6 From the analysis outlined above it is clear that there are a number of possible liability regimes that could be postulated. However, it would be for the courts to determine, on the basis of the facts brought before them, what liability arises

to investors for MAD disclosures. Until they do so, the matter will remain uncertain.

6 Other disclosures

- 6.1 The analysis set out above has addressed the requirements of TOD and MAD. However, issuers that are admitted to UK regulated markets and that are UK listed are subject to other disclosure requirements – for example, if they have a primary listing for their shares, they are subject to various disclosure requirements under the UK Listing Authority’s class tests.¹⁰
- 6.2 The analysis in this paper applies equally to these other disclosure requirements, not least because they are swept into the disclosure regime under TOD as a result of being within the definition of “regulated information”, since the listing rules are part of the regulations adopted under Article 3(1) of TOD.
- 6.3 Any attempt to resolve the uncertainties referred to in this paper should, therefore, extend to anything within the scope of TOD’s definition of regulated information.

¹⁰ Listing Rules Chapter 10

Annex

1 Contents of Annual Management Report (unconsolidated)

“Article 46

1. (a) The annual report shall include at least a fair review of the development and performance of the company's business and of its position, together with a description of the principal risks and uncertainties that it faces.

The review shall be a balanced and comprehensive analysis of the development and performance of the company's business and of its position, consistent with the size and complexity of the business;

(b) To the extent necessary for an understanding of the company's development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters;

(c) In providing its analysis, the annual report shall, where appropriate, include references to and additional explanations of amounts reported in the annual accounts.

2. The report shall also give an indication of:

(a) any important events that have occurred since the end of the financial year;

(b) the company's likely future development;

(c) activities in the field of research and development;

(d) the information concerning acquisitions of own shares prescribed by Article 22 (2) of Directive 77/91/EEC.

(e) the existence of branches of the company;

(f) in relation to the company's use of financial instruments and where material for the assessment of its assets, liabilities, financial position and profit or loss,

— the company's financial risk management objectives and policies, including its policy for hedging each major type of forecasted transaction for which hedge accounting is used, and

— the company's exposure to price risk, credit risk, liquidity risk and cash flow risk”

Extract from Fourth Council Directive (78/660/EEC) as amended

2 Contents of Annual Management Report (consolidated)

“Article 36

1. The consolidated annual report shall include at least a fair review of the development and performance of the business and of the position of the undertakings

included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

The review shall be a balanced and comprehensive analysis of the development and performance of the business and of the position of the undertakings included in the consolidation taken as a whole, consistent with the size and complexity of the business. To the extent necessary for an understanding of such development, performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.

In providing its analysis, the consolidated annual report shall, where appropriate, provide references to and additional explanations of amounts reported in the consolidated accounts.

2. In respect of those undertakings, the report shall also give an indication of:

- (a) any important events that have occurred since the end of the financial year;
- (b) the likely future development of those undertakings taken as a whole;
- (c) the activities of those undertakings taken as whole in the field of research and development;
- (d) the number and nominal value or, in the absence of a nominal value, the accounting par value of all of the parent undertaking's shares held by that undertaking itself, by subsidiary undertakings of that undertaking or by a person acting in his own name but on behalf of those undertakings. A Member State may require or permit the disclosure of these particulars in the notes on the accounts;
- (e) in relation to the use by the undertakings of financial instruments and, where material for the assessment of assets, liabilities, financial position and profit or loss,
 - the financial risk management objectives and policies of the undertakings, including their policies for hedging each major type of forecasted transaction for which hedge accounting is used, and
 - the exposure to price risk, credit risk, liquidity risk and cash flow risk.

3. Where a consolidated annual report is required in addition to an annual report, the two reports may be presented as a single report. In preparing such a single report, it may be appropriate to give greater emphasis to those matters which are significant to the undertakings included in the consolidation taken as a whole.

Extract from Seventh Council Directive (83/349/EEC) as amended

3 Contents of Half-yearly management reports

“5(4) The interim management report shall include at least an indication of important events that have occurred during the first six months of the financial year, and their impact on the condensed set of financial statements, together with a description of the principal risks and uncertainties for the remaining six months of the financial year. For issuers of shares, the interim management report shall also include major related parties transactions.”

Transparency Directive (2004/109/EC)

4 Interim management statements

“6(1) . . . [The interim management statement] shall provide:

- an explanation of material events and transactions that have taken place during the relevant period and their impact on the financial position of the issuer and its controlled undertakings; and
- a general description of the financial position and performance of the issuer and its controlled undertakings during the relevant period.”

Transparency Directive (2004/109/EC)

5 Inside information

“6(1) Member States shall ensure that issuers of financial instruments inform the public as soon as possible of inside information which directly concerns the said issuers”

Market Abuse Directive (2003/6/EC)

“1(1) ‘Inside information’ shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments”.

Market Abuse Directive (2003/6/EC)

6 Regulated information

“2(1)(k) ‘Regulated information’ means all information which the issuer . . . is required to disclose under this Directive, under Article 6 of Directive 2003/6/EC . . . or under the laws, regulations or administrative provisions of a Member State adopted under Article 3(1) of this Directive”

Transparency Directive (2004/109/EC)

“21(1) The home Member State shall ensure that the issuer . . . discloses regulated information in a manner ensuring fast access to such information on a non-discriminatory basis and makes it available to the officially appointed mechanism referred to in paragraph 2.”

Transparency Directive (2004/109/EC)

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† Please note that, in light of their official responsibilities, Clive Maxwell and Sally Dewar took no part in the FMLC's consideration of this issue.