October 2004

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 76 – TRANSPARENCY OBLIGATIONS DIRECTIVE

Analysis of uncertainty under the Transparency Obligations Directive regarding the liability of directors and auditors arising from the publication of a publicly traded company's regular reports and financial information and its relevance to UK implementation

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 76 –TRANSPARENCY OBLIGATIONS DIRECTIVE WORKING GROUP

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1. INTRODUCTION

1.1 The role of the Financial Markets Law Committee 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. The FMLC also acts as a bridge to the judiciary to help UK courts remain up-to-date with developments in financial markets practice.

1.2 The establishment of the Financial Markets Law Committee in 2002 reflects the view, widely held across the wholesale financial markets, that arrangements should be in place to identify and analyse these areas of legal uncertainty or misunderstanding which may affect those markets. The Committee is made up of senior lawyers and representatives of financial market participants, regulatory authorities, trade bodies and associations.

1.3 Some element of legal uncertainty is inevitable in financial markets. One possible source of legal uncertainty lies in proposals for new laws or regulations. These can sometimes give rise to uncertainties or misunderstandings, if the specific features of wholesale market practice or of the existing framework of law have not been fully understood by a legislator or other public authority.

1.4 The FMLC is sponsored by the Bank of England, which provides facilities for the FMLC including its Secretariat. The FMLC is independent from the Bank and its views and any published materials should not be taken to reflect the views of the Bank.

1.5 In Summer 2003 an issue arising under the draft Transparency Obligations Directive (Proposal for a Directive of the European Parliament and of the Council on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC) was raised with the Committee. At its meeting on 25 September 2003 the FMLC resolved to address the issue, in the first instance by forming a working group to analyse in detail the nature of the issue. This paper was developed for the Committee by that Working Group. The views set out in this paper, however, are those of the Committee itself, as well as of the Working Group. Phil Wynn Owen took no formal part in the FMLC's discussions on this issue, as he will have an official role in the implementation of the Directive.

1.6 For the purposes of this paper, we use the following expressions:

'***Issuer***' means a company whose securities are admitted to trading on a regulated market (or, in the case of depositary receipts, the issuer of the securities represented by the receipts) and includes for these purposes the company's directors and officers;

'***Reports***' means a company's annual financial reports and financial information (and, where applicable, its half-yearly financial reports and interim management statements); and

'the ***Directive***' means the text as finally approved by the European Parliament on 30 March 2004. The ECOFIN Council approved the text on 11 May 2004. The formal adoption of the Directive and its publication in the Official Journal is expected in Autumn 2004.

2. THE CURRENT LIABILITY OF THE ISSUER, ITS DIRECTORS AND AUDITORS UNDER ENGLISH LAW

2.1 Where an Issuer's Reports turn out to be misleading, liability may arise. If misleading information is disseminated with an intent to deceive, either fraud or market abuse may be committed. However, this paper does not deal with criminal or regulatory liability arising from the publication of such information and instead, focuses on what civil liability may arise from negligence in the preparation or publication of that information.

2.2 Although there is no direct authority, the likely position under English law at present is that the Issuer will be liable only to a narrow group of persons and in a narrow range of circumstances for inaccurate information in its Reports.

2.3 Those responsible for Reports may incur liability to others in a number of ways. Of most relevance is liability in tort for negligent misstatement. Such liability has developed in English law over many years. Liability for negligent misstatement 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. The liability may be limited in certain circumstances by agreement (subject to certain safeguards for consumers).

2.4 English courts have established 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.

2.5 The decision in *Caparo Industries plc v. Dickman* [1990] 1 All ER 568 established the extent of auditors' liability under English law. The courts decided that auditors do not owe a general duty of care to individual shareholders, or to members of the public at large, in respect of a decision whether to invest in the company, even if those persons do in fact rely on the audited accounts when making the decision to invest or lend money (see the decision in *Galoo Ltd v Bright Grahame Murray* [1995] 1 All ER 16 where the *Caparo* principles were applied in relation to lenders).

2.6 This line of cases resulted from the finding that the statutory purpose of auditors' reports was to report to shareholders so as to assist them in questioning the management of the company, exercising their voting rights and influencing the future policy and management of the company. The purpose of such reports was not to assist shareholders, or members of the public, in making an informed assessment of the company's business performance and assets, or in relation to their present or future investment in the company.

2.7 These cases also relied on another line of reasoning. Lord Bridge of Harwich quoted, with approval, the following passage from a New Zealand case[1]:

> *"It does not seem reasonable to attribute an assumption of responsibility unless the maker of the statement ought in all the circumstances, both in preparing himself for what he said and in saying it, to have directed his mind, and to have been able to direct his mind, to some particular and specific purpose for which he was aware that his advice or information would be relied on. In many situations that purpose will be obvious. But the annual accounts of a company can be relied on in all sorts of ways and for many purposes".*

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1 *Scott Group Ltd v McFarlane* [1978] 1 NZLR 553 at 566.

2.8 He then described the possible diversity of investors' purposes:

> *"I should in any event be extremely reluctant to hold that the question whether or not an auditor owes a duty of care to an investor buying shares in a public company depends on the degree of probability that the shares will prove attractive either en bloc to a take-over bidder or piecemeal to individual investors or to lend money to a company".*

2.9 The reason for the courts' reluctance to impose a wider duty of care is that it was considered unreasonable to impose liability when (because of the possible multitude of investors' - or the wider public's - purposes) it would be difficult, if not impossible, for auditors (and by implication, the Issuer) to prepare their statements appropriately for all such persons and for all such purposes[2].

2.10 The principles laid down in *Caparo* do not prevent auditors from owing a duty of care to shareholders or investors where there is a special relationship between them which justifies the imposition of such a duty. An example is where the auditor has actually allowed his report to be provided to a particular investor, with the intention or knowledge (or where intention or knowledge can reasonably be imputed) that the investor would rely on it for a particular purpose (*Possfund Custodian Trustees Ltd v Diamond* [1996] 2 All ER 774). *Caparo* decided that publication of an audit report is not in itself sufficient to create a duty and therefore liability.

2.11 The *Caparo* principle is likely to apply by analogy to the Issuer and its directors[3].

2.12 The position as it relates to auditors is complicated by the fact that, under English law, auditors cannot exclude or limit their liability[4]. The counterbalance to this lack of a cap or other limitation on liability has always been the narrow duty of care imposed on auditors following *Caparo*. In some Member States the duty of care owed by auditors to a wider class is to some extent balanced by other features of their legal systems (for example, a cap on their own liability) which tend to reduce auditors' exposure to claims.

The issues raised by the Directive

2.13 The Directive may alter the present English law position (as set out above) by extending the duties of the Issuer and auditor in respect of Reports.

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2 See also the references in the speeches of the House of Lords to the dictum of Cardozo J., in the American case of *Ultramares v Touche* (1931) 174 NE 441 at 444, concerning the risk of exposing auditors to "liability in an indeterminate amount for an indeterminate time to an indeterminate class".

3 Although there seems to be no express authority on the point, this conclusion is also consistent with the general position that directors owe their duties to the company itself and not to individual shareholders, and that the proper person to sue in respect of breaches of duty by the directors is generally the company itself.

4 Following a consultation process, the UK Government issued a written statement to the House of Commons on 7 September 2004 stating that it did not intend to extend the duty of care owed by auditors nor did it intend to change the rules relating to auditors' caps on liability; it also said it would consider further whether auditors should be permitted to agree proportionate liability in their engagement contracts.

3. THE POSSIBLE LIABILITY OF THE ISSUER AND AUDITOR UNDER THE DIRECTIVE

Ambiguity regarding the liability of the Issuer and its directors

3.1 The Directive requires the Issuer to publish its annual financial report[5], half-yearly financial reports[6] and interim financial statements[7]. The Reports are required to be made available to "the public *throughout the European Union*"[8].

3.2 The explicit objectives of the Directive are set out in Recital (29) and include the objective of "ensur[ing] investor confidence through equivalent transparency throughout the Community". There are extensive references throughout the Recitals to the objective of investor protection and the importance of providing information to investors[9].

3.3 Recital (10) and Article 7 of the Directive specifically address the responsibility and liability of companies for losses caused by inaccurate or unreliable information and respectively state that:

> *"(10) Appropriate liability rules should be applicable to the issuer, its administrative, management, or supervisory bodies, or persons responsible within the issuer, as laid down by each Member State under its national law or regulations. Member States should remain free to determine the extent of the liability."*

> *"7. Member States shall ensure that responsibility for the information to be drawn up and to be made public in accordance with Articles 4, 5, 6 and 12 lies at least with the issuer or its administrative, management or supervisory bodies and Member States shall ensure that their laws, regulations and administrative provisions on liability apply to the issuers, the bodies referred to above or persons responsible within the issuers."*

3.4 On the basis of the present position under English law, the interpretation of the provisions described above arguably has the effect of broadening the class of person to whom the Issuer (and possibly its auditors) owes a duty of care. The effect of the change in the duty of care will, in turn, have a deep impact on market practice. Currently Reports include information of great interest to shareholders (such as the chairman's personal view of the company's prospects). The extension of the duty of care to persons other than shareholders and the resulting extension in liability will necessitate that Issuers include only information that has been validated with the rigour and diligence applicable to prospectuses.

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5 Article 4.1 provides that the issuer shall make public its annual financial report at the latest four months after the end of each financial year and shall ensure that it remains publicly available for at least five years.

6 Article 5.1 provides that the issuer of shares or debt securities shall make public a half-yearly report covering the first six months of the financial year as soon as possible after the end of the relevant period, but at the latest two months thereafter. The issuer shall ensure that the half yearly report remains available to the public for at least five years.

7 Article 6.1 provides that an issuer whose shares are admitted to trading on a regulated market shall make public a statement by its management during the first six-month period of the finanical year and another such statement during the second six-month period of the financial year. The statement will set out a general desciption of the financial position and performance of the issuer and its controlled undertakings, together with an explanation of material events and transactions that have taken place during the relevant period.

8 (emphasis added) Article 17.1 provides that the home Member State shall ensure that the issuer discloses the information in a manner that ensures fast access to it on a non-discriminatory basis.

9 See Recitals (1), (2), (4), (6) and (17), discussed further in paragraph 3.7 below.

This will be onerous for Issuers and will diminish the information that they feel safe to release.

Class of People to whom a Duty of Care is Owed

3.5 If the class of those to whom a duty is owed is widened, the question arises whether legal certainty requires it to be defined during implementation, or subsequently by the courts. The Directive refers to "investors". This will include some or all of the following:

(a) existing shareholders – for the purpose of monitoring and influencing the management of the company (the present position);

(b) existing and past shareholders – in respect of their personal investment decisions – and so in relation to profit gained or lost as a result of their decisions to buy or sell, or to refrain from buying or selling on the basis of the financial information provided;

(c) non-shareholders (i.e. the public) throughout the EU – in relation to profit lost as a result of investment decisions not to buy shares in the Issuer on the basis of the financial information provided.

3.6 The uncertainty created by the Directive arises because it is unclear how the objectives of the Directive will be interpreted and therefore how the *Caparo* principles will be applied to it as a matter of English law. It does not necessarily follow from the fact that certain classes of person (i.e. investors) are in the future to be assured of access to Reports, that such material is necessarily produced for their purposes nor that they should necessarily be given the right to compensation if the information turns out to be wrong. However, the purpose of the Directive appears to be that the published Reports should inform the investment decisions of the public. As the purpose of the Directive must be implemented into English law, there is a very real risk that, on *Caparo* principles, those responsible for the information (including the Issuer and possibly the auditors) will be held accountable to investors who rely on the information and suffer loss as a result.

3.7 The recitals to the Directive add considerable weight to the argument that the purpose of the Reports is to inform investment decisions. Recital (1) states that "the disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets." Recital (2) refers to the objective of ensuring "appropriate transparency towards investors through a regular flow of information." Recital (4) states that "Greater harmonisation of provisions of national law on periodic and ongoing information requirements for security issuers should lead to a high level of investor protection throughout the Community." Recital (6) states that "a high level of investor protection throughout the Community would enable the removal of barriers to the admission or securities to regulated markets situated or operating in the territory of a Member state." Recital (17) states that rules relating to publication of information should also apply to issuers who do not have a registered office in a Member State "so as to ensure the effective protection of investors and the proper operation of regulated markets within the Community". Article 6 adds further weight to this by stating that the Commission will examine in future whether the transparency of reporting "meets the objective of allowing investors to make an informed assessment of the finanical position of the issuer".

The content of Reports

3.8 An extension in the class of person to whom a duty of care is owed will, as a practical matter, result in a change in the nature of Reports and, therefore, the scope of work required to produce them. This is because the contents of the information must necessarily take account of the purposes for which it is produced. The Directive may therefore have the effect of increasing the burden on those responsible for producing and verifying the information. This will result in increased costs for the Issuer.

Liability

3.9 Article 7 and Recital (10) require Member States to ensure that the responsibility and liability for drawing up and publicising Reports lies at least with the Issuer and its administrative, management, or supervisory bodies. Member States are required to ensure that their laws, regulations and administrative provisions on liability apply to the Issuer and such bodies and persons. Given the obligation to make public the Reports, this may mean that the United Kingdom would find it difficult to deny liability to the investing public in relation to the Reports (even if it wishes that to be the case). Furthermore, companies that do not fall within the scope of the Directive will remain subject to the present law as set out at Section 2 and not the likely new law.

The possible liability of auditors under the Directive

3.10 The Directive requires that an Issuer's financial statements are audited in accordance with specified standards and that the audit report is disclosed in full to the public together with the annual financial report (Article 4.4)[10]. Similarly, Article 5.4 requires that the audit report must be disclosed in full where the half-yearly report has been audited.

3.11 It is not, however, clear that auditors fall within the categories of persons referred to in the provisions on liability in Article 7 and Recital (10) of the Directive (referred to in paragraphs 3.3 and 3.9 above). Although auditors are clearly responsible for reports such as those drawn up under Article 4.4 (auditing of financial statements) which must be "disclosed in full to the public", it seems unlikely that auditors should be regarded as 'persons responsible within the issuers' in the terms of Article 7.

3.12 However, the liability position of auditors may change under English law regardless of whether they fall within the ambit of Article 7 of the Directive. It has been explained in Section 2 above that, under present English law, auditors owe a duty of care only to existing shareholders in respect of the supervision of the management of the Issuer (that is, to the first category of persons set out in paragraph 3.5 above). However, the repeated references in the Directive to the Reports that are to be required to be made public (which, as discussed in paragraph 3.1 above, makes them available to the public at large throughout the EU) will, make it possible to argue that, as a matter of English law, auditors' liabilities have been extended. Again, those liabilities will be extended in the manner set out at paragraph 3.4 above.

3.13 The impact on English auditors of such an interpretation of the Directive will be different to the impact on auditors in other Member States owing to the features described at paragraph 2.12 above.

The relationship of the Directive with other proposed legislation

3.14 The Commission's Proposal for a Directive of the European Parliament and Council on Services in the Internal Market will govern the provision of services such as audit services within the EU. It may be that some clarification of the extent of the liability of auditors will be made in that Directive. However, it is by no means clear that this will be so and, in any

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[10] ECOFIN Text changed most references to "disclosed to the public" to "made public", although this change appears to have been overlooked in the second paragraph of Article 4.4.

event, the Services Directive is planned to be implemented at a later date than the Transparency Directive and so, at the least, there would be a period of uncertainty in the interim. That uncertainty should be resolved now.

3.15 Accordingly, we do not consider that the uncertainties and possible changes to English law that will result from implementation of the Directive can be left to be resolved by other reforms.

Jurisdictional issues

3.16 The Directive requires Reports to be made available to investors throughout the Member States. This raises the obvious risk of multiple liability in different jurisdictions depending on where the information was received and acted upon. This is in contrast to the present position which permits an Issuer to choose where it makes such information available. Therefore, in this respect, also, the Directive may considerably extend the potential liability burden on Issuers and others responsible for financial information.[11]

3.17 The Commission's Proposal for a Regulation of the European Parliament and Council on the Law Applicable to Non-Contractual Obligations ("Rome II") is intended to harmonise the European conflicts of law treatment of torts (such as negligent misstatement). Article 1(2)(d) of the proposal states that it will not apply to "the personal legal liability of those responsible for carrying out the statutory audits of accounting documents." This will mean that, in determining whether a tort has been committed by an auditor, the current English law rules would continue to apply, unaffected by Rome II[12].

3.18 The principle behind Rome II's exclusion of liability for audit work is that the question of liability cannot be separated from the law governing the company to which the audit relates. In other words, audit liability should be governed by the law of the home state of the company concerned. However, by itself, the exclusion of audit liability from Rome II will not necessarily achieve that result. It may be, depending on the circumstances of the particular claim, that the application of the English law rules under the Private International Law (Miscellaneous Provisions) Act 1995[13] would produce the result that an audit liability claim in tort would be governed by the same law as governs the contractual audit engagement. That result would be a sensible one where the liability in question essentially arises out of a contractual relationship, but whether this is achieved will depend on an assessment of the particular circumstances of the individual claim and so is not assured. Further, where the claim is not governed by the law of the audit contract, it will not necessarily be governed by the law of the Issuer's home state.

3.19 If these principles are to be applied without this uncertainty, express provision to this effect is necessary.

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11 We have addressed this issue in our paper entitled, "Analysis of liability for information in a publicly traded company's regular reports and financial information under the proposed Transparency Obligations Directive" published on 23 January 2004, at www.fmlc.org.

12 The current English choice of law rules are principally those set out in the Private International Law (Miscellaneous Provisions) Act 1995.

13 Under sections 11 and 12 of the Act, the claim would be governed by the law of the country in which the relevant events occurred unless it would be substantially more appropriate to apply the law of another country.

4. POSSIBLE SOLUTIONS

4.1 Whether current English law as to the duty of care that is owed in the preparation of Reports should be extended by the Directive is a matter of interpretation of the requirements of the Directive and the way in which that interpretation is implemented in the United Kingdom. While legal interpretation is within the remit of the Committee, policy decisions as to implementation are not. However, important policy decisions will inevitably have to be addressed when implementing the Directive since, for the reasons explained in this paper, there is otherwise a risk that the Directive would produce a change in English law by default[14]. Accordingly, the Committee has considered possible solutions, one of which is discussed below.

4.2 If there is to be a change in the purpose for which Reports are drawn up and published and therefore an increase in the number of persons to whom a duty of care is owed, the Issuer, its directors and its auditors must be aware of these changes. There may be an extension in the scope of work required in the preparation of Reports. Reports will be more likely to resemble current prospectuses and the statements within them will require a greater degree of due diligence[15]. A significant increase in liability could over time lead to an increase in the insurance coverage required. The effect would also be to increase significantly the burden and associated costs born by the Issuer and others in the production of annual reports and financial information.

4.3 We believe that it is reasonably clear, on a purposive interpretation of the Directive, that it is intended that the Reports should inform the investment decisions of the public and that those responsible within the Issuer should be liable for any misinformation contained within them. However, it does not follow that any resulting liability has to lie in negligence. If it is not considered desirable to introduce broader civil liability by changing the current position under the *Caparo,* an alternative option may be to introduce appropriate regulatory controls and sanctions, such as statutory fines, on those responsible for the issue of such financial information.

4.4 Further, it has been noted that while English law does not presently impose a general responsibility to investors on auditors, current English law does not permit auditors to limit their liability. This is in contrast to the position in some other Member States. If auditors' responsibilities are to be extended by the Directive, this does raise again the question of whether auditors should be permitted to limit their liability by agreement.

4.5 As noted at paragraph 3.4 above, if the purpose for which Reports are drawn up is to be extended, this will necessarily affect their contents and the amount of work that is required to produce them. We would recommend that, rather than leaving the law to evolve with uncertainty through case law, the requirements should be set out clearly in advance.

4.6 Finally, regard needs to be had to the jurisdictional issue raised in paragraphs 3.16 to 3.19 above.

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[14] It should also be noted that, whereas the Directive will apply to listed companies, other companies will remain subject to the present law as set out at Section 2

[15] It should be noted that Article 10 of the Directive of the European Parliament and Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC was specifically amended so that annual reports and other such documents which do not constitute prospectuses, but which may be issued in conjunction with a prospectus, would ***not*** be required to be prepared to the same standard as prospectuses.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS