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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 76 – TRANSPARENCY OBLIGATIONS DIRECTIVE

Analysis of liability for information in a publicly traded company's regular reports
and financial information under the proposed Transparency Obligations Directive

Financial Markets Law Committee
c/o Bank of England
Threadneedle Street
London EC2R 8AH
www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

**ISSUE 76 – PROPOSED TRANSPARENCY OBLIGATIONS DIRECTIVE
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1. INTRODUCTION

Summary: The proposed Transparency Obligations Directive creates and increases existing uncertainties, as described in this paper. The Directive establishes a statutory requirement for a company whose securities are publicly traded to ensure appropriate transparency towards investors by regularly publishing and/or making available to the public its Reports and Financial Information in each Member State. This will mean that an issuer (and possibly its auditors) could be exposed to liability in many jurisdictions at the same time and on the basis of different tests of liability and to a variety of sanctions. It appears to us that these consequences may not have been intended by policy makers, and are contrary to the intention of other European legislation. The proposed Transparency Obligations Directive provides an opportunity to remove various cross-border uncertainties which are both created and increased by the Directive. In the interests of pan-European business and a single common market, this opportunity should be taken.

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 Committee 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 is proposals for new law or regulation. 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 Committee is sponsored by the Bank of England, which provides facilities for the Committee including its Secretariat. The Committee 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 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, COM (2003) 138 final) was raised with the Committee. At its meeting on 25 September 2003 the Committee resolved to address the issue, in the first instance by forming a working group to analyse in detail the nature of the issue.

1.6 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.

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

‘**Reports and Financial Information**’ means a company’s annual financial reports and financial information (and, where applicable, its interim and quarterly financial accounts);

‘the **Original Proposal**’ shall mean the original Transparency Obligations Directive proposals, reference 2003/0045 (COD);

‘the **ECOFIN Text**’ shall mean the revised text which was published following the ECOFIN meeting on 25 November 2003, reference 14921/1/03 REV 1; and

‘the **Directive**’ shall mean the text as finally adopted.

1.8 The Original Proposal has been changed following the ECOFIN meeting on 25 November 2003 where the ECOFIN Text was approved. As matters of principle the arguments presented in this paper apply to both proposals.

2. LIABILITY SHOULD BE BASED ON HOME MEMBER STATE

2.1 Where information given by an issuer of publicly traded securities (an **Issuer**), either at the time of issuance and/or subsequently, is false or misleading, legal liability may arise. In some cases, if there has been an intent to deceive, it may be determined that a crime has been committed or some other civil penalty (for example, market abuse) has arisen. That lies outside the scope of this paper, which addresses only civil liability and focuses on liability of those persons responsible for periodic and ongoing financial information not that given in a prospectus at the time of issuance of securities.

2.2 The Original Proposal and the ECOFIN Text would clearly permit an Issuer (and possibly its auditors) to be sued in relation to the information contained in the Reports and Financial Information at the same time in more than one jurisdiction on the basis of more than one test of liability. An English company (and we suspect that this is the case in other jurisdictions, although a consideration of the laws applying in those jurisdictions other than the United Kingdom is outside the scope of this paper) is currently held to provide its Reports and Financial Information only to its shareholders and therefore those responsible for the information contained therein are held only to have a duty of care to those persons. In the UK such information, although part of the public record, is not thought to give rise to additional liability to the public at large.

2.3 Under Article 17.1 of the ECOFIN Text, an Issuer will be required to disclose its Reports and Financial Information to members of the public at large in a timely manner throughout the European Union. This requirement to disclose information in every European Union jurisdiction implies that an Issuer (and possibly the relevant auditors) could be sued in relation to such disclosure in as many as 25 Member States, on the basis of different tests of liability and exposed to a variety of sanctions.

2.4 For example, a French company whose shares are currently publicly traded in Paris must presumably send its Reports and Financial Information to shareholders in all the jurisdictions in which they are situated. Under the Directive, however, it will be required to disclose 'regulated information' in all EU Member States, whether or not it has shareholders in those countries and, further, it must make them available to the public at large. So, even if there were no shareholders in the United Kingdom, it will be required to make available its Reports and Financial Information in England thus potentially bringing them within the scope of the English law of tort for negligent misstatement. Accordingly, if an investor in the England invests in the company and it subsequently appears that the information was inaccurate or incomplete, a French company may well find itself facing simultaneous proceedings in France and England (and elsewhere in the EU, assuming that similar liability provisions apply locally) in relation to that disclosure.

2.5 Although such liability may arguably already exist today if, for example, a French company voluntarily makes its reports available to persons in the United Kingdom, the position will be made worse by the provisions in the Directive as the French company is now mandated to disclose to the public throughout the EEA, its Reports and Financial Information. Although accepting multi jurisdictional liability may exist under the law of some EEA jurisdictions at present, it is at best confused and uncertain and in practice, is treated as a low level risk. The provisions in the Directive will exacerbate this confusion. Given the requirement to disclose this information to the public, this will provide, or in some cases establish, a clearer path to liability. It is clear, if the Directive is brought into force as presently proposed, that Issuers, auditors and other persons responsible for the information contained in these Reports and Financial Information will be required to take advice on and understand, and cater for, all EU legal systems, with the inherent uncertainty and cost that entails.

2.6 The Directive will add additional uncertainty for those who manage companies. At present, when a disclosure for which there may be potential liability is being prepared, those responsible for the document will take full account of that liability in determining what is said, what is omitted and how it is prepared and drafted. If the Directive is brought into effect in its current form, this will be a difficult, time consuming and expensive task particularly as there is no harmonisation of liability laws across the EU. Going forward, a publicly traded company will potentially have to take account of the liability regimes of 25 Member States after enlargement. As different standards of liability are employed across the EU Member States, an Issuer will be required to include different types of information in its annual report in order to satisfy the liability standards in each jurisdiction. This will make the task of producing its Reports and Financial Information overly cumbersome and a large amount of additional information may be required to be included.

2.7 The Directive forms part of the Financial Services Action Plan. One of the key aims of this is to bring about the Single Market, facilitating companies who wish to issue securities in order that they may raise capital throughout the EU. Although there currently exists the potential for liability in different jurisdictions, encouraging such a common market will, if it is successful, radically increase the multi-jurisdictional nature of shareholders and investors interests in any particular company thereby effectively increasing the likelihood of multi-jurisdictional actions against an issuer. Now is the time to act and clarify the position with a practical solution to

effectively prevent multiplicity of actions (probably based on the same misstatement) by limiting the question of determining liability and sanctions to the relevant home Member State. If this question is not addressed, the resulting situation, whereby simultaneous claims in up to 25 Member States could be brought, will be costly for the Issuer, diminish shareholder funds in the process, and be very time-consuming to the company. Potentially, this resulting situation may also be very time-consuming for the judiciary and court systems within the EU. Furthermore, it would be fundamentally unfair as a judicial matter and contrary to the principles of natural justice to put a company and its directors and senior officers through such a process. Such an outcome might infringe the basic human rights of those involved.

2.8 It seems that this result would also defeat one of the policy aims of the Single Market, in that if investor A in country A and investor B in country B buy the same shares at the same price relying on the same misstatement, and both successfully sue under existing national liability laws in their own countries, one may succeed and the other fail, or one may be awarded more than the other by the operation of such laws. Thus the economic (albeit not legal) value of their investments will be revealed as divergent, possibly markedly so. The market could also be distorted by this, with shareholders structuring their investments so that they hold securities in countries which have “investor friendly” liability laws – and forum shopping could be encouraged within the EU.

2.9 Accountability for liability in connection with Reports and Financial Information can only properly be assessed by the courts and on the basis of the laws in the jurisdiction of incorporation of the company. The impact of the multiplicity of company law issues, which are jurisdictionally specific, is clearly recognised in the draft Rome II Regulation¹ (see paragraph 3.6 below).

2.10 Liability for Reports and Financial Information should not be a question for the courts of the relevant Member State in which a shareholder or a member of the public happens to receive this information. We accept there is a policy argument that for consumer goods, eg a broken kettle, a consumer ought to be able to bring action in the home jurisdiction of the consumer to complain about the broken kettle. Defects in consumer goods are principally matters of simple fact and one can understand why policy makers chose, in balancing the interests of consumers and manufacturers of consumer goods, to permit consumers to bring action in their country of residence. This would not be a suitable basis for the determination of liability for the Financial Services sector and we feel that the more appropriate way to determine liability for Reports and Financial Information is in the country of incorporation of the company, rather than in the country to which the Reports and Financial Information happens to be received. If the Directive is left as presently proposed, the liability approach to complex financial statements (based on an individual jurisdictions company and other laws) will be treated as being akin to broken kettles – this would not be appropriate.

2.11 The opportunity must now be taken to clarify the position in relation to the determination of liability in relation to Reports and Financial Information. We suggest that the question of determining liability is made solely by reference to the

¹ COM (2003) 427(01), Art. 1, para 2(d)

laws in the Issuer's relevant home Member State. This would ensure a consistent approach between the Directive and the draft Rome II Regulation, and indeed, other Community legislation.

3. CONSISTENCY OF COMMUNITY LEGISLATION

EU Regulation on Insolvency Proceedings

3.1 The Regulation aims to introduce uniform conflicts of law rules for insolvency proceedings and connected judgments to help address the difficulties arising when insolvency involves a number of different European jurisdictions. In broad terms, the Regulation provides that main insolvency proceedings are to be opened in the Member State where the debtor has the 'centre of main interests' (in the context of the Directive this would be the home Member State). In relation to a company, there is a rebuttable presumption that the place of the registered office is the centre of main interests. The Regulation clearly sets out how to determine the jurisdiction where insolvency proceedings may be opened thus avoiding the problem of parallel proceedings across the EU.

Prospectus Directive

3.2 Prospectuses are commonly used to sell securities in a number of different states, both within and outside the EU. Accordingly, the question arises as to why similar problems do not arise in connection with the Prospectus Directive.

3.3 Exposure to parallel proceedings does not arise under the Prospectus Directive in the same way as currently anticipated under the Directive. The Prospectus has to be published, but only in the state in which the market to which the securities are to be admitted is located². So, if the securities are to be admitted to the London Stock Exchange, the prospectus will be published in the United Kingdom and liability for negligent misstatement under English law will potentially arise; but not otherwise.

Market Abuse Directive

3.4 The issue of exposure to parallel proceedings etc. is limited under the Market Abuse Directive. An Issuer must take reasonable care to ensure that disclosure of certain information to the public is synchronised as closely as possible between all investors in all Member States but only in the Member State or States where financial instruments are admitted to trading on regulated market or for which a request for admission to such a market is made³. So, again, if the securities are admitted to the London Stock Exchange, information will need to be disclosed in the United Kingdom and liability for negligent misstatement under English law will potentially arise; but not otherwise.

² Prospectus Directive, Article 14.2.

³ Market Abuse Directive, Article 6.1 and Directive 2003/124/EC implementing the Market Abuse Directive as regards the definition of public disclosure of inside information and the definition of market manipulation, Article 2.4.

Other Directives

3.5 Many other Directives adopt a home Member State approach to regulation and the imposition of liability such as the E-Commerce Directive, the Distance Marketing of Consumer Financial Services Directive and the proposed new Directive on the free movement of services.

Rome II Regulation

3.6 The approach we suggest for the Directive is consistent with what we believe is the policy underlying the draft Rome II Regulation. The main operative provision of this Regulation will establish that the proper law for a claim in tort are those of the place where the damage is suffered. An important exception however is made for the accountants who prepare the audit report and a company's officers and members in respect of liability for company debt – we believe the latter limb of this exception is too narrow, both generally and specifically to cover the liability discussed in this note. The underlying philosophy would, we believe, support the proposals in this note. The reason for this exception is that the audit report is tightly bound up with company law (which is necessarily that of the place where the company is established) and, as a consequence, the appropriate law and jurisdiction should be the company's "home" state. The annual and semi annual reports required under the Directive are equally tightly bound up with company law – they derive from the 4th and 7th Company Law Directives; so the same logic should apply to them. Similarly if the accountants should have the benefit of this exception for these good reasons then so should the company and its officers and members.

4. THE PROPOSED SOLUTIONS

4.1 To address this point in relation to the risk of publicly traded companies and their directors being liable in many competing jurisdictions simultaneously, we would suggest that the text of the Directive should be amended so as to specify that the civil liability which arises as a result of the actions required pursuant to the Directive should only be determined by the Issuer's home Member State. Under the Directive, there is a clear policy intent to alter the behaviour of companies as regards the release of information but not otherwise to amend national law, particularly in respect of the administrative measures or sanctions which each Member State may apply. Such measures should be effective, proportionate and dissuasive. Adopting a home Member State approach as suggested below would best achieve this and create a more certain and fair disclosure environment for Issuers.

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Secretary: Martin Thomas, Bank of England

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