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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

# ICAEW REP 39/06

## IMPLEMENTATION OF THE TRANSPARENCY OBLIGATIONS DIRECTIVE

***Memorandum of comment submitted in July 2006 by the Institute of Chartered Accountants in England and Wales in response to the Financial Services Authority's consultation paper 'Implementation of the Transparency Directive, Investment Entities Listing Review', published in March 2006***

**Contents** **Paragraph**




INVESTOR IN PEOPLE

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on consultation paper (CP) 06/4 *Implementation of the Transparency Directive, Investment Entities Listing Review*, published for comment in March 2006 by the Financial Services Authority (FSA). Our comments address Part 1 of the consultation paper, *Implementation of the Transparency Directive*.

## WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

## MAJOR ISSUES

### Approach to Implementation

4. We welcome the reticence of the FSA to provide additional guidance on the new interim management statements, at least pending the first year or two of experience of the new regime. Good practice and common understandings emerge over time, through discussions between companies and their stakeholders and advisors and through the good example of innovative reporters. Further guidance, even if presented as non-mandatory in nature, could hamper this evolutionary process.

5. We applaud the general approach of 'copying out' the requirements of the Transparency Obligations Directive (TOD). However, this overall approach (minimal embellishment and guidance) has to be reflected fully in the day-to-day activities of enforcers: professional judgement may lead to reports that vary in style and content, whilst still complying with the spirit of the requirements. If the FSA has in mind certain minimum standards or practices, it should make this clear from the outset.

6. We would also sound a note of caution. The FSA's proposed approach contrasts to some extent with the approach adopted in relation to the Prospectus Rules and Disclosure Rules, where the relevant Directive

provisions were translated into practical provisions that worked in a UK context. The approach suggested for the TOD leaves the practical impact unclear in places. It also means that the language and concepts in the proposed new rules as regards continuing obligations for issuers do not match with the existing language and concepts in the Listing Rules and Disclosure Rules. We believe that the FSA could copy out the substance of the TOD, but improve the drafting to make the requirements substantially clearer. We also recognise that in some areas some implementation guidance may be required to avoid confusion. As a minimum, we suggest that a special edition of 'List!', along the lines of edition No. 9, would be of great benefit for issuers and other market participants seeking to get to grips with the new requirements.

**Overlap with Company Law**

7. The lack of attention in the CP to the unhelpful overlap between company law and the Listing Rules in relation to directors' remuneration disclosures is a serious shortcoming. The failure to address this issue seems unacceptable given the FSA's previous assurances that it would address this overlap of law and regulation. It also appears to contradict the statement in this CP (in paragraph 2.33) that the FSA had "taken particular note of the requirements of UK Company Law, and considered whether duplication of these requirements in our regime is justified". In this situation some 'joined-up government' would reduce an acknowledged burden of regulation. The FSA should not delay dealing with this situation any further.

8. The requirements of the Listing Rules for disclosure of directors' remuneration almost entirely duplicate those of Schedule 7A to the Companies Act 1985. The requirements in the Listing Rules should have been withdrawn in 2002 when the new statutory requirements came into effect. The Listing Rules provisions apply only to companies incorporated in the UK with a listing of equity securities. In our view all such companies are within the scope of the legal requirement to prepare a directors' remuneration report. However, if the FSA is able to identify a class of companies that it believes should make these disclosures despite being outside of the scope of the legal requirement, it should simply require such companies to prepare a report in accordance with Schedule 7A.

9. We understand that the FSA has asked the DTI to make amendments to Schedule 7A and intends to withdraw the relevant Rules when these changes become law. We disagree with this approach. We do not perceive that there are any significant requirements in the Listing Rules that are not already required by Schedule 7A. If the FSA believes otherwise and can justify this on cost/benefit grounds, we recommend that these should be included in the Listing Rules as specific additional requirements, thereby eliminating all of the duplicated material.

10. On a similar theme, we urge the FSA to keep in view the forthcoming Company Law Reform (CLR) Act. It would be unfortunate if new regulatory overlap was to occur as a result of the new Act. We urge the FSA to liaise with the DTI to avoid this outcome.

**Responsibility Statements and Names of Persons Responsible**

11. The requirements relating to the directors' sign-off of the financial statements are not expressed in terms that align precisely with Section 226A of the Companies Act. This is unhelpful. More fundamentally, DTR 4.1.13R(3) effectively requires sign-off by each and every director. This seems unnecessary, both as a matter of policy and in terms of implementation. We see nothing in Article 4(2)(c) that requires unequivocally the statement to be made on a non-collective basis. We appreciate that the Article refers to statements in the plural, but consider that this could simply refer to a statement for the accounts and a statement for the management report. In addition, we see no benefit in the names of the whole board appearing on the statement. The statement must be made on behalf of the board, and somewhere, for example in the directors' report, the members of the board must be identified. The TOD does not specify that the names should be in the statement itself, only that the names should be 'clearly indicated'.

12. A similar point arises in relation to auditors. Article 4.4 of the TOD requires the audit report to be signed by the person or persons responsible for auditing the financial statements. DTR4.1.8R goes further, requiring signature by "all the persons" responsible for auditing the financial statements. We suspect that the wording in the TOD was designed to deal with joint audit situations. However, the wording in the DTR is unclear and could lead some to think that what is required is the signature of the audit partner AND others involved in the audit for that firm (compare the CLR bill, Clause 493, which requires the signature of the senior auditor). The wording in the rules should be clarified to avoid potential confusion.

**True and Fair View?**

13. Recital 9 to the TOD states:

'*A condensed set of financial statements, as part of a half-yearly financial report, also represents a sufficient basis for giving a true and fair view of the first six months of an issuer's financial year*'.

We continue to have serious concerns over this assertion, and, more importantly, the requirement in Article 5.2(c) of the TOD for issuers to publish statements confirming that the interim accounts provide a true and fair view. It is generally held in the UK that, in order to provide a true and fair view, financial statements must comply in full with the requirements of applicable accounting standards, including the disclosure provisions. We strongly endorse this view and consider the FSA's statements on this issue in paragraph 2.14 of the CP to be unhelpful. For example, in the case of a company that shortens its accounting period to six months, the half yearly report and the short period full set of financial statements will both be regarded as 'true and fair' despite having a different form and content. We are concerned that the logical conclusion of this approach may be a tendency for the term 'true and fair' to be used as a mere label for 'compliant with applicable standards'.

14. We have been informed that, notwithstanding the wording of the TOD, other Member States are considering the scope for a requirement on issuers that falls short of true and fair, for example 'prepared in accordance with …'. The FSA should consider whether it has any flexibility in this regard under the Directive.

15. A related point arises in connection with reviews of interim statements by auditors. Although there is no requirement for a review by auditors under the current Listing Rules, many large UK listed companies choose to have one, thereby improving market confidence in the published figures. The Auditing Practices Board (APB) has stated in its recently-issued Work Programme for 2006/7 that it will adopt for use in the UK the International Standard on Review Engagements ‘Reporting on Interim Financial Information Performed by the Independent Auditor of the Entity’ (ISRE 2410). The concept underlying that standard is that only interim financial statements comprising a full set of general purpose financial statements can ‘give a true and fair view’ or ‘present fairly’. Any other financial statements, including condensed interim financial statements, cannot. When the latter are produced, ISRE 2410 requires the auditors to give "a conclusion as to whether anything has come to the auditor's attention that causes the auditors to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework". We strongly support this approach: 'true and fair' should be retained as the gold standard, associated solely with a complete set of general purpose financial statements.

16. It seems likely that audit firms will report in the form required by ISRE 2410 on those condensed half-yearly financial statements (whether prepared under IAS 34 or UK rules) required by the proposed new rules; they seem unlikely to be prepared to report on a true and fair basis for the reasons cited above. This discrepancy between the statement required from responsible persons and the form of conclusion provided by the auditors may have serious consequences in the UK. At worst, it might cause listed companies to abandon the auditors' review of the half-yearly financial statements; at best, it may leave a degree of confusion in the minds of readers of half-yearly reports which include a report from the auditors.

**IAS 34 vs UK GAAP**

17. As noted above, we expect the APB to adopt ISRE 2410. Under that standard, the auditor's review report must identify the ‘applicable financial

reporting framework'. We are aware that there is uncertainty in this context about what constitutes 'UK GAAP' for companies not preparing half-yearly financial statements under IAS 34. The Accounting Standards Board (ASB) guidance on interims is non-mandatory and the proposed requirements in the Listing Rules, while emulating IAS 34 in some key respects, fall short in others. For example, the proposed Listing Rule does not specify the full range of primary statements that should be prepared - the cash flow statement, statement of recognised income and expense and statement of changes in equity are not mentioned. In addition, there is a concern that DTR4.2.9 requires the directors to confirm they have prepared the half-yearly report in accordance with 'the applicable set of accounting standards'.

18. Given that the majority of issuers will be applying IAS 34, it would seem reasonable to put the remaining issuers on a footing that is practically identical, not just similar. Since the ASB best practice statement is based on IAS 34, we suggest that the FSA explore how best to incorporate that statement into its rules, possibly following an overhaul and update of the statement. This might be done by asking the ASB to replace the statement with a Reporting Standard (following the example of the Reporting Standard on the OFR – although this was subsequently downgraded to a Statement) which could be incorporated into the FSA rules by cross-reference. We encourage the FSA to discuss this matter with the ASB as soon as practicable.

19. We also observe that, as a matter of principle, it might be argued that it is inappropriate to require responsible persons to state that half-yearly reports are true and fair in both sets of circumstances.

20. We recognise that much of the material in draft rule DTR 4.2.5 is a copy out from a CESR recommendation. A further advantage of the approach suggested above would mean that much - if not all - of the material would become redundant and could be dropped from the rules. We note moreover that the Commission's draft implementing measures, published on 7 June 2006, do not implement fully the CESR recommendation.

**Publication of the Auditor's Review**

21. Draft DTR 4.2.8(1) states:

*"If the half-yearly financial report has been audited or reviewed by auditors, the audit report or review must be reproduced in full*".

The current wording of the Listing Rules is similar, but only requires publication of auditor reviews carried out "pursuant to the Auditing Practices Board guidance on Review of Interim Financial Information". The new, less precise wording has raised concerns that ANY review by auditors would have to be published, including one carried out under US auditing standards or even private reporting engagements on particular aspects of the half-yearly report. This would be undesirable. The FSA should introduce wording to prevent this by referring to the relevant APB guidance.

**Liability for Issuers and Auditors**

22 We understand that there are concerns that the TOD's provisions may extend the liability of directors and auditors beyond the current UK legal position. We note the FSA's reference, in paragraph 2.11, to the paper published in 2004 by the Bank of England Financial Markets Law Committee (FMLC). The FMLC paper highlights a number of potentially serious issues surrounding the liability implications of the TOD which have not been addressed in the FSA consultation paper.

23. However, following our consideration of draft clause 899 of the CLR Bill, which would insert a new Section 90A to the FSMA, we have concluded that this uncertainty appears to be overestimated. Although the clause addresses only the company's liability to investors relying on the financial statements, it seems to leave the current legal position broadly intact for directors and auditors, as explained in the analysis provided in the Appendix to this response. In spite of this, if uncertainties are deemed to remain over whether liability has been extended for directors or auditors, the FSA should liaise with HM Treasury and the DTI at the earliest opportunity to establish how best to address these uncertainties, particularly if further amendments to the CLR Bill were required to deal with them.

24. Finally on this point, we do not understand why the FSA is seeking to introduce a Listing Rule placing responsibility for published information on the issuer AND the directors (end of paragraph 2.10 of the CP). The FSA gives no rationale for this intention and we think it should be reconsidered: it could disturb the existing common law position for directors and auditors unnecessarily (and apparently contrary to the stated intention of government). We would certainly wish to see a further consultation on this matter if the FSA were to press ahead. In addition, DTR4.1.3 seems to be redundant and likely to confuse, so we suggest it is removed and left to the new Section 90A of FSMA.

**Related Party Disclosures**

25. Notwithstanding our appreciation of the FSA's 'light touch' approach, it is incumbent on the FSA to ensure that any deletions from the Listing Rules as a result of the implementation of the TOD take place only after careful consideration, i.e. on the basis that the requirements are a burden on cost-benefit grounds and/or they are already required by law or other regulation, such as accounting standards. We note that the Commission's draft implementing measures, as published on 7 June, include clarification of the 'major related party transactions' to be disclosed as part of the new interim management report for issuers of shares. We presume that the FSA will need to incorporate these implementing measures in the Disclosure Rules in the

near future and would suggest refraining from deleting the existing requirements until this occurs.

**Timing of Implementation/Transitional Arrangements**

26. We continue to have concerns over the ability of some smaller listed companies to meet the new four month filing deadline for annual financial reports. The FSA should highlight the need for companies to assess the implications of the new regime as soon as possible and should not underestimate the difficulties involved for some companies in meeting the new reporting deadlines for annuals and interims.

27. We strongly support the proposed approach to the transitional implementation for financial information, which provides the maximum time for companies to prepare for the new regime. We hope that the European Commission will not look to override this approach. Any earlier implementation would be problematic, particularly as the Commission has not yet finalised its own implementing measures and the FSA will not finalise its rules until October 2006. This leaves very little time for companies to implement the relevant changes if the transition is more rapid than is proposed by the FSA.

28. It will nevertheless be important for the FSA to ensure that in the transitional period the Handbook sets out both the existing and new requirements and explains very clearly when each is applicable. The alternative may be some confusion in the market.

29. We have some concern about the transitional provisions in relation to disclosure of major shareholdings. For example, will it be the case that on 20 January 2007 every person with an interest under the new provisions will have to disclose their interests, or is there to be some sort of ‘grandfathering’ arrangement? We recognise that this would be difficult in view of the mismatch between the type of interest required to be disclosed under the current regime and the interests required to be disclosed under the TOD.

**Convertibles**

30. The FSA proposes in paragraph 2.24 of the CP that issuers of convertible securities should not be subject to the TOD requirements on ongoing information to holders of securities ‘on the basis that the TOD does not specify whether a convertible security is a share or debt security’. In our experience, issuers of convertibles have listed equity shares and therefore do not require any special rules in relation to the convertibles. On this basis we support the FSA approach.

**Architecture**

31. The draft rules implementing the TOD are inserted into the Disclosure Rules Sourcebook, which will be renamed the ‘Disclosure and Transparency Rules’.

The new rules will be identified separately. Any retained measures that go beyond the TOD minimum requirements will be kept in the Listing Rules. We query whether the revised architecture of the Sourcebook is sensible in relation to the reporting requirements for financial information, i.e. some within the Listing Rules sourcebook and some within the Disclosure and Transparency Rules sourcebook. In addition, some of the new rules will apply to AIM and OFEX companies whereas others will not.

32. We recommend that the FSA consider restructuring all the rules for ease of use, with notation to indicate the source of each rule and to which types of entity it applies. The same types of rules, for example on financial information, would be gathered in one place (with notation if necessary to indicate their source). Similarly, rules should, where possible, be segregated to show where they apply to issuers on different markets, i.e. the regulated markets only vs the regulated markets plus AIM and OFEX. The current proposals may only serve to confuse issuers about their obligations in what is already a complex situation.

## RESPONSES TO SPECIFIC QUESTIONS

### Question 1

***Do you agree with our proposal not to add to the TD requirements for interim management statements? Do you feel that FSA guidance in this area at this stage would be helpful or unhelpful, and why?***

33. As discussed above in paragraph 4, we agree that at this stage FSA guidance would be unhelpful. The FSA should be prepared to let market practice develop in this area.

### Question 2

***Do you agree with our proposal to copy out the TD requirements on ongoing information to holders of securities and with our analysis of the implications for issuers of convertible securities?***

34. This question relates to 'non-periodic information for holders of securities'. We have examined the proposed ‘copy out’ but have some concerns about the clarity of the rules in DTR Ch 6. For example, there is a requirement that electronic communications cannot be made to shareholders without a decision of shareholders in a general meeting (DTR 6.1.8(1)). Does this allow for existing consent to be ‘grandfathered’ and can consent be by way of provisions in the articles of association (as provided for listed companies in the CLR Bill)?

35. There appears to be a requirement for issuers to enable those who have a right to direct the exercise of voting rights to obtain information (DTR6.1.8). There has been substantial debate about the provision for beneficial holder

rights in relation to the CLR Bill and we are concerned that the concept may be brought in 'through the back door' in the Transparency Rules. We would welcome clarification about what this means and how the FSA will interpret it.

36. To conclude, although we support 'copy out' in substance, we believe that in this context the FSA could improve the drafting of the TOD and add appropriate guidance without adding any further burdens to issuers.

**Question 3**

***Do you agree that the Listing Rule requirement for listed issuers to either send half-yearly reports to holders of its securities or insert the report in a national newspaper should be removed?***

37. We agree that given the requirements of the Directive it is sensible to remove this Listing Rule.

**Question 4**

***Do you agree with our proposal to retain the existing requirement for listed issuers of exclusively wholesale debt to produce annual reports? If not, is this because you believe that investors will be able to rely on other information provided to investors, such as that from credit rating agencies, to make investment decisions about such securities?***

38. On balance, we agree that annual reports should still be required from issuers of wholesale debt, although we recognise that institutions can demand any information they require for investment decisions. As this is a regulated market, participants must recognise that there will be a price to pay, in terms of disclosure, for entry to that market.

**Question 5**

***Do you agree that the approach taken in relation to issuers on the PSM should mirror that for wholesale debt issuers?***

39. In our view, the decision on whether to require an annual report should be left to the PSM, reflecting its status as an unregulated market. This contrasts with our answer above to Question 4 in relation to the regulated market. If the PSM is intended to operate as an unregulated market, the FSA should forbear from imposing regulation unless it is absolutely necessary.

**Question 6**

***Do you agree with our proposal to retain the Listing Rule requirement that issuers falling outside the scope of IAS34 should reflect in half-yearly reports any accounting policy changes that will be applicable in the annual report on the basis that this provides additional clarity to the TD requirement?***

40. We agree that the FSA should continue to require companies not obliged to use IAS 34 to use in their half-yearly accounts the accounting policies expected to be applied in the annual accounts.

**Question 7**

***Do you agree with our proposal to retain the Listing Rule requirement on the timeliness and content of dividend statements on the basis that this provides additional clarity to the TD requirement?***

41. We are content with the retention of the Listing Rule requiring issuers of shares to produce statements of dividends that comply with certain standards of timeliness and content.

**Question 8**

***Do you agree with the proposed change of preliminary statements of annual results from a mandatory to permissive regime?***

42. We recognise that there are valid arguments both for and against this change. On the one hand, in the light of the requirements of the TOD it seems logical to move to a permissive regime for preliminary statements. It would seem reasonable to let the market dictate practice, given there are overarching protections arising from, for example, the obligation for issuers not to publish misleading information. On the other hand, if the market is likely to continue to favour preliminary announcements of some sort and companies are likely to continue to publish them (if only to ensure the prompt release of price sensitive information, such as results for the year), some limited guidance may be appropriate.

43. On balance, we agree with the FSA's proposed approach, but we suggest that the impact of withdrawal of the mandatory requirement should be reviewed within two years of implementation.

**Question 9**

***Do respondents agree with our proposed retention of LR9.8.4R(2)(3)(4), LR9.8.6R(3)(5)(6)(7), LR9.8.10R, LR9.8.11R and LR9.8.12R?***

44. We broadly agree with the FSA's approach, but have some minor comments:

- Details of small related party transactions: it is unclear why it is appropriate in this case to go beyond the 4$^{th}$ and 7$^{th}$ Directives (paragraph 2.38, 2$^{nd}$ bullet).

- Going concern statement: we accept the retention of the going concern disclosure requirement only if investors confirm to the FSA that they regard this as valuable (paragraph 2.38, 5$^{th}$ bullet). We tend to the view that the statement is unnecessary, even if it provides investors with some ‘comfort’, because going concern problems are flagged in the market far in advance of any statement in the annual report. Nor does the statement in any way mitigate the responsibilities of either directors or auditors to consider important going concern issues in accordance with accounting and auditing standards.

**Question 10**

***Do you believe LR9.8.4R(1)(5)(6)(9)(10)(11)(12)(13), LR9.8.5G, LR9.8.6R(1)(2)(4) and LR9.8.13R rules provide benefits? If you do, please explain how you use the information covered in each of these rules? If you were not able to access such information through annual reports, but could access it from other (possibly fragmented) sources, would you be disadvantaged?***

45. We accept these various proposed deletions, including the withdrawal of the requirement regarding directors’ beneficial interests on deregulatory grounds, although we anticipate that in practice many companies will continue to provide this information (paragraph 2.51 of the CP).

**Question 11**

***Do you agree that we should apply major shareholding disclosure rules to holdings in issuers with shares admitted to trading on a regulated market, and to holdings of shares of UK companies traded on exchange-regulated markets such as AIM and OFEX?***

***Alternatively, do you think the scope of the shareholder notification requirements should be limited to the TD minimum: holdings in issuers with shares admitted to trading on a regulated market for which the UK is the home member state?***

46. We agree with the proposed approach.

**Question 12**

***Are there any notifiable interests under the CA1985 that you consider are not covered by the TD but which you believe should be maintained? Do you agree that the partial exemption from notification for voting rights held in the trading book should be available to credit institutions and investment firms?***

***Do you agree with either of the two alternative approaches to replicate, or make more stringent, respectively the effect of the CA1985 for stock lenders? Are there any side effects?***

47. We agree with the FSA's proposals and its preferred approach to stock lenders.

**Question 13**

***Which of the approaches (TD minimum or CA1985) to notification thresholds would you prefer? Depending on the thresholds adopted, do you agree with our proposed implications for disclosures by market makers?***

48. We prefer the Companies Act 1985 approach.

**Question 14**

***Which of the notification deadlines (TD minimum or CA1985 and Listing Rules) would you prefer?***

49. We prefer the Companies Act 1985 and Listing Rules approach.

**Question 15**

***Do you agree that the FSA should mandate the continued use of the PIP/SIP regime for issuers for whom the UK is the home Member State?***

50. Yes.

**Question 16**

***Do you have a preference for either of the storage models (commercial OAMs or FSA operated OAM ) or suggestions for further alternative model(s)?***

51. We prefer commercial OAMs as storage models as competition is likely to lead to better service and more efficiency (and we recognise that the FSA has limited resources).

**MINOR POINTS**

52. DTR1A.2.2R(2)(d): should "disclosure rules" read "transparency rules"?

53. DTR4.1.9-4.1.12R: these repeat the requirements of the TOD for the business review, but for UK companies there will be an enhanced requirement under the current CLR Bill proposals. We suggest that the FSA liaises with the DTI to align the requirements with company law, using cross-referencing instead of duplication where possible. Assistance could also be given to other EEA and non-EEA companies through guidance and references to the Directive.

54. DTR5.4.1: it would help if the reference was made to the requirement to aggregate holdings - i.e. where it comes from and what it says - before setting out the exemptions.

## APPENDIX: ANALYSIS OF LIABILITY ISSUES UNDER THE TOD FOR DIRECTORS AND AUDITORS

### Introduction

The following analysis considers the likely civil liability position of directors and auditors, assuming that the rules currently under consideration by the FSA to implement the TOD into the UK are finally put in place. It also assumes that the current proposed Section 899 of the CLR Bill will be enacted in due course (hence inserting a new Section 90A into FSMA 2000).

In summary, our view is that the duty of care to third parties of neither directors nor auditors is extended by the proposed changes beyond the current legal situation as exemplified in what is still the defining case, namely *Caparo* (*Caparo Industries plc v Dickman [1990] 2 A.C. 608*). However, issuers, i.e. the companies themselves, will be exposed to new claims from current and potential investors under proposed FSMA 2000 Section 90A. Where the directors and/or auditors are responsible for the misstatement etc giving rise to such claims, the issuer may choose to pursue them to make good some or all of its losses, which *Caparo* would allow them to do. Therefore the risk of action against directors and auditors may have increased, in spite of the extent of their duty of care remaining unchanged.

### The Current Legal Position

The current UK legal position derives from the House of Lords decision in *Caparo*, which established guidelines for the duty of care owed by auditors under the basic principles of the law of negligence/negligent misstatement. The *Caparo* guidelines have been applied and to some extent refined in a number of cases. A recent exposition of the relevant principles can be found in the Judgment or Moore-Bick LJ in *MAN Nutzfahrzeuge AG & Others v Ernst & Young [2005] EWCH 2347*.

The effect of these decisions is that, in broad terms, auditors owe a duty of care to the company (their client) and to shareholders as a body to provide them with an accurate record of the company's performance so that they can scrutinise the conduct of the company's affairs. Auditors do not, however, owe a general duty of care to shareholders or potential investors in respect of their investment decisions (i.e. in respect of their sale or purchase of the company's shares). They may, however, assume responsibility to a particular investor where they know (1) the investor's identity, (2) the purpose for which that investor is to be provided with the audit report, and (3) the fact that the investor is likely to rely on the audit report for that purpose, and where it is fair and reasonable that liability should be imposed.

These principles governing the assumption of responsibility to a third party apply to directors as well as auditors: see, for example, *Williams v Natural Life Health Foods Ltd [1998] 1 WLR 830*.

**Liability of the Issuer**

CLR Bill Section 899 imposes liability on an issuer in relation to annual reports, half yearly reports and interim management statements issued under Articles 4, 5 and 6 respectively of the TOD. This extends those to whom a company may be liable for financial information beyond the current UK legal position. This is, however, required by the TOD itself as a minimum (Article 7) and as such the UK Government must implement it.

**Liability of the Directors**

In fact, Article 7 states that (emphasis added):

"Member States shall ensure that responsibility for the information to be drawn up and made public in accordance with Articles 4, 5, 6 and 16 lies at least with the issuer or its administrative, management or supervisory bodies and shall ensure that their laws, regulations and administrative provisions on liability apply to the issuers, the bodies referred to in this Article or the persons responsible within the issuers."

The UK Government has thus chosen to impose the liability requirements on the issuer only, not on company boards or on directors (who would be classed as persons responsible within the issuer). It appears therefore that the UK Government did not intend to extend the liability of directors, given the silence of proposed Section 90A on the liability of the directors in the light of the possibility of them being made liable under the TOD.

Proposed Section 90A does bring in the concept of fault by "persons responsible within the issuer" through sub-section (3), but only to the extent that by their actions the issuer may become liable; they themselves would not be liable to the investor. This may be seen to go beyond the minimum requirements of the TOD; nevertheless it is advantageous for the issuer company because it means no claim can be made against it without fault being proved against a director as outlined in Section 90A(3). In practice, however, a director will be at risk where any claim succeeds against the issuer if it is his actions that have caused Section 90A(3) to be proved and so he would be exposed to a claim by the issuer company under the normal *Caparo* principles.

**Liability of the Auditors**

The auditors are not "persons responsible within the issuer" and so would apparently not be affected by Section 90A(3). Nevertheless, the above analysis will apply equally to them as, if the issuer company has paid a claim to an investor under Section 90A and the issuer company believes the auditors too have been at fault, then the company could pursue the auditors to compensate it for its losses, again under the current *Caparo* principles.

In this context, Section 90A(3) would also appear to be of advantage to the auditors, who could claim a contribution against the director(s) found to be at fault as joint tortfeasors. The proposed limitation of liability agreements envisaged by the CLR Bill may also come into play in this context in determining what is fair and reasonable for the auditors to bear. Further, findings against the directors under Section 90A(3) could be helpful to auditors on causation.

None of the above removes the risk of criminal sanction under Section 397 FSMA 2000.

**Impact of Proposed Section 447 CLR Bill**

This proposed section purports to offer a so-called "safe harbour" for statements made in the directors' report (DR) and directors' remuneration report (DRR) and has arisen from the debate over narrative reporting in the UK, which is also an element of the TOD. Without this proposed section, it is presumed that the above analysis would apply in relation to liability of directors and auditors as the "management report" required by the TOD to be included in the Annual Report can be equated to the DR.

What then is the likely impact once Section 447 is enacted? The extent of the duty of care of the directors under *Caparo* remains unchanged: i.e. it is to the company (and shareholders as a body but not as investors) only. It is arguable that the hurdle the company would have to overcome to prove liability by a director is raised a little higher than it otherwise would have been through the operation of Section 447(3) and the requirement to demonstrate recklessness. This will depend on whether a court equates recklessness in this context with negligence or whether it adopts some other test (such as the test in *R v G [2004] 1 AC 1034*, where it was held a person my be reckless where, in the circumstances known to him, he is aware of a risk or a circumstance or result and it is unreasonable for him to take that risk). Otherwise, the proposed Section does not appear to alter the actual liability of the directors in practice. (For avoidance of doubt, Section 447(4) seems to be intended to ensure that there is definitely no chance of an investor suing a director directly in relation to statements made in the DR or DRR.)

**Other Material Published by Issuers under the TOD**

Issuers often publish other information within the annual (and other) reports, both through a legal requirement, e.g. a DRR, and voluntarily, e.g. an OFR. They will also issue other information separately from the annual report, half-yearly report or interim management statement, e.g. in future a voluntary preliminary announcement. The drafting of Section 90A(1) makes the liability situation in relation to both types of other information unclear. The FSA needs to clarify both what "published in response to a requirement …" encompasses in Section 90A(1) and also what the situation is in relation to other financial information issued to the market.

nsj/kc 4 July 2006