THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

Our ref: ICAEW Rep 36/07

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

By email

Dear Anthea

DAVIES REVIEW OF ISSUER LIABILITY

We are pleased to attach the formal response of the Institute of Chartered Accountants in England and Wales (‘the Institute’) to your request for comments on liability for misstatements to the market.

Thank you also for the opportunity to discuss our views at our meeting with you and Professor Davies on 25th April. We hope that this paper formalises and clarifies our views in a way which is helpful in reaching the final conclusions of the review, but we also note that further views will be welcome, if they can reach you in a short enough time frame. In particular, we will be seeking further views from our members working in an insolvency function, and other representatives of insolvency practitioners, in connection with the answer to question 6 on the subordination of the claims of market participants to unsecured creditors.

Please contact me should you wish to discuss further any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS
IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 36/07

DAVIES REVIEW OF ISSUER LIABILITY

Memorandum of comment submitted in April 2007 by The Institute of Chartered Accountants in England and Wales, in response to the discussion paper on the Davies Review on Liability for Misstatements to the Market published by HM Treasury in March 2007

Contents **Paragraph**

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute') welcomes the opportunity to comment on the discussion paper, the *Davies Review of Issuer Liability* (the Review), on the liability for misstatements to the market.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members whether working in public practice, as auditors or advisers, or in business is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

Support for the initiative

4. We congratulate Professor Davies on a well argued and logical paper, which clarifies the issues surrounding this complex topic. Change is inevitable, not only because of the Transparency Directive requirements, but also because generally ways of protecting investors are increasingly compared and coordinated across jurisdictions. The Review is timely, and will assist in ensuring that the capital markets in the UK continue to operate in a flexible and pragmatic way, with the burdens imposed on issuers no greater than is necessary to maintain appropriate levels of protection for investors.

5. Nevertheless, some very complex and far reaching questions of public policy have been raised. It will be difficult to ensure that all views have been taken into account in drafting the final report, especially given the short period allowed for public comment. It is to be hoped that both formal and informal consultation will continue, after Professor Davies's work has been completed, and that continued debate in the more complex areas does not stand in the way of speedy reform in the areas for which there is a good consensus and where changes in law and/or regulation are straightforward to implement, discrete and in the public interest.

6. The thrust of the arguments given in the Review tend to the effect that:

   - change to the existing system of liability should be limited in order, to avoid upsetting those aspects of the current UK regime that are well-understood and operate well in the public interest, in particular the common law position under Caparo and subsequent cases. Undesirable change could produce more onerous and undesirable levels of litigation or reduced levels of information made to the markets, or information which is slower and more expensive to produce;

- However, the implementation of the Transparency Directive has already inevitably introduced some change, and the opportunity should be taken to promote the development of a fairer and more consistent regime overall. For this reason, we agree with the conclusion that it would be desirable to extend the coverage of Section 90A of the Financial Services and Markets Act to circumstances outside the scope of the Transparency Directive, such as non-listed markets and ad hoc announcements, to produce a more consistent framework without the risk of unnecessarily onerous liabilities.

7. We would support action being taken to amend the law on that basis but we would not support any further widening of the existing regime, which we would consider to be unnecessary. The very existence of the new liability regime set out in section 90A of FSMA, which has clarified the liability position of the company, may increase the number of cases brought against the company. This in turn is likely to increase the number of claims made by the company against those responsible for making the false or misleading statement – the directors and/or advisers – on the current, established common law basis. Further, codification of the derivative actions procedure has provided both clarity and publicity for this mechanism by which shareholders can bring claims on behalf of the company, and so this codification is also likely to give rise to more claims by the company against the directors or advisers. We are therefore concerned that the Review is overly optimistic in its conclusion that an increasing number of claims would not be brought by the company against the directors or advisers.

8. In our view, the proceeds of any claims against directors and advisers should go to the company, rather than to individual shareholders or classes of shareholder, especially in cases of an insolvent company where shareholders are likely to use any right to claim directly against directors and advisers to circumvent the insolvency regime. We are also concerned that allowing direct claims by shareholders against directors and advisers would lead to US levels of unmeritorious litigation in this country, and we understand that US legal firms whose mode of business relies on this kind of action have begun to set up establishments in the UK.

9. The UK currently has a wide and sophisticated range of sanctions available to deter misstatements by issuers. The role of regulation and the criminal law are mentioned below, but the role of market forces in deterring misbehaviour should not be undervalued. Issuers that make erroneous statements to the market resulting in later "surprises" will find themselves punished by a higher risk factor built into their market value. This will operate at an appropriate level, judged by market perceptions, and will fully take into account the degree of culpability between lack of anticipation, through negligence to criminal levels of fraud.

10. The Review only makes passing reference to regulatory sanctions and almost none to the criminal law. Though neither of these is a good means of providing redress, they do represent important means of providing protection to market participants and providing a disincentive to misstatement. In particular, the investigation and prosecution of criminal fraud has been

undergoing significant investigation by the Government in recent years, primarily by means of the Fraud Review. The criminal offence of fraud has been systematised in the Fraud Act 2006, which was brought into force early this year. Any concerns that the retention of a relatively lenient regime for issuers' liability would result in insufficient means for bringing dishonest directors or advisers to justice should be set against the increased opportunities for action to be taken under this new regime.

11. It should be noted that the Fraud Act defines fraud in a criminal sense - as requiring dishonesty, in contrast to the use made of the term in the Review, which could also include recklessness (as it is applying a civil test). This divergence in language could be confusing, and should be avoided where possible, particularly as most lay people will think of the term in the context of criminal wrongs rather than civil ones.

12. A similar problem with the use of language occurs in relation to the measure of damages. Following the terms of the Review, our recommendations would be that liability should be imposed on the basis of intention or recklessness ("fraud") but that the measure of damages should be assessed on the basis of "negligence", not "deceit". At first sight, this could appear to be inconsistent, but that is not in fact the case. The terms used, which apply to the previous legal situation are not appropriate to the new situation, where liability is being extended for the benefit of classes of person who were not previously covered. The new situation demands a new and more consistent terminology.

RESPONSES TO SPECIFIC QUESTIONS

Question 1: What should be the basis of liability? Should the basis of liability be simple negligence? Would gross negligence be available as a possible basis for liability in the British context? Is fraud an appropriate basis for liability?

13. We believe that issuers should not be liable for statements made through simple negligence or even for gross negligence. Gross negligence is not a concept currently recognised in UK civil law, and its introduction would risk more uncertainty rather than less.

14. Liability is judged after the event, where the benefit of hindsight can make things appear obvious, which were not in fact so before the event. To introduce liability on the basis of negligence would inevitably lead to increased levels of attempted litigation by market participants where it appears (with the benefit of hindsight) that issuers should have been able to anticipate matters better than they could. In addition, we share the view that such a standard for disclosures would reduce the amount of information that issuers would be prepared to supply voluntarily, and would substantially increase the cost of that which was supplied, to allow for due diligence before it is published. Delay would also be introduced, for the same reason, which would increase the chances of disorderly and premature disclosure before a formal announcement is made.

15. Intention or recklessness would be an appropriate trigger for liability, equal to but not beyond what is currently available under the tort of deceit. We question whether the term "fraud" should be used for this basis, for fear that

this will cause confusion with the criminal offence of fraud, though we do recognise that the term is already used in the civil context.

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

16. We note that while the Transparency Directive does not require market protections for ad hoc statements, the Market Abuse Directive might well be interpreted as doing so, leaving a danger that the Courts will interpret the latter as requiring compensation in cases of negligence. In addition, as stated, there will be many circumstances in which information which is originally given in an ad hoc statement is repeated (identically or possibly repackaged) in periodic statements. We would therefore concur with the conclusion that intention or recklessness should be introduced as a basis for liability for ad hoc statements as well as for periodic statements.

17. The arguments against negligence as a basis for liability are even stronger for ad hoc statements than for periodic ones. Whatever the outcome in relation to Question 1, no liability for damages should become due in relation to negligent statements made on an ad hoc basis.

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

18. Liability for dishonest delay should not be introduced, even in the narrow circumstances identified in the Review. Sufficient sanctions are already available through enforcement actions by the FSA. If this is insufficient, in the circumstances of serious and intentional dishonesty, further sanctions would be available against individual directors under Section 3 of the Fraud Act (Fraud by failure to disclose information). We consider that this is an area where public enforcement is adequate on its own and that there is insufficient public interest to justify the introduction of new legal uncertainties and other unintended consequences that could result from the extension of civil liability into this context. We are also concerned about the number of potential claimants. It is for good reason that the courts have been sensitive to "floodgates" arguments when asked to extend common law civil liability into new areas.

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

19. We do not find it easy to find the best option for the extent of the regime, but on the whole would prefer it to apply to all RIS announcements, for consistency, notwithstanding the consequent possibility of overuse of the RIS system. As implied in our answer to question 2 above, all ad hoc statements tend to be made with more urgency and less routine checking than for periodic statements, and it is important for adequate protection to be given to issuers to avoid any disincentive for announcements to be made promptly and comprehensively.

20. We recognise that this will lead to possible lightening of the regime as it applies to liability to shareholders for statements more related to corporate governance communication. We do not feel strongly about this, but if it is thought necessary to retain the existing basis for liability for them (eg in relation to a Class I Circular), a carve out from the general rule could be introduced. However, we do not see this as strictly necessary.

21. We would not support option (c) as it will be difficult for both issuers and market participants to easily identify to which statements the liability regime will apply, and those to which it will not. For example, annual reports contain material required by a variety of statutory and regulatory sources, including the Disclosure and Transparency Rules, the FSA's Listing Rules (including the Combined Code) and company law. Unless very well informed, readers will not be able to differentiate between the elements required by the Disclosure and Transparency Rules and other material, and so will not be able to judge their varying rights in relation to the material. Further, this option might cause some companies to issue separate reports – one containing the disclosures required under the Disclosure and Transparency Rules, with a separate annual report containing the DTR and all other required information addressed to shareholders only (a situation akin to the separate annual report and Form 20F that non-US SEC registrant issued by non-US SEC registrant companies). We think this would be a very undesirable outcome.

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

22. We are inclined to give a response to this question which is similar to that given to Question 2. That is, liability in the case of unlisted markets should be introduced on the basis of intention or recklessness, to the extent necessary to guard against a more onerous basis of liability being introduced.

23. However, it should be recognised that this conclusion must be reached on a tentative basis, as the public policy rationale for the regulatory levels and the balance between regulation and liability in the unlisted markets is not clear. In addition, it must be noted that these markets are not unregulated, though they may be described as such legally, for the purposes of the Transparency and other Directives.

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

24. The claims of investors should be subordinated to those of unsecured creditors. Though the company may have been equally or more at fault in its relations with investors than with other creditors, investors in the capital markets are generally providers of risk capital and are in a good position to manage their risks by diversification or a range of other techniques. This may not be true of unsecured creditors who will frequently be trade creditors. Damage to local or regional economic conditions could be unnecessarily aggravated, if the insolvency of a company is followed by consequent damage to its local or regional suppliers and other unsecured creditors.

25 This policy stance was outlined clearly by Kirby J in the High Court of Australia *Sons of Gwalia* case:

"*One can readily conceive why, as a matter of policy, strong arguments can be mounted that claims by persons such as the respondent should be postponed to claims made by the general creditors of the insolvent company. Putting it broadly, most general creditors, although not all, will be innocent of the business and entrepreneurial decisions of the company that led to its insolvency. Most will have dealt with the company as outsiders in good faith on the basis of its incorporation and, where applicable, its listing on the Stock Exchange and its subjection to regular and rigorous legal obligations. On the other hand, persons such as the respondent are investors. As such, they are not involved in the provision of goods and services to the company, as ordinary creditors generally are. Their interest in membership of the company is with a view to their own individual profit. Necessarily, their investment in the company involves risks, albeit risks increasingly informed by mandatory disclosures. In particular, where, as here, the company was involved in the extraction of gold, the acquisition of which notoriously and historically involves substantial risks and a significant degree of chance, the purchase of shares will commonly entail a measure - even a high measure - of speculation. Such speculation would ordinarily be expected to fall on the shareholders themselves, not shared with general creditors who would thereby end up underwriting the investors' speculative risks. ...*

Nevertheless, in the end, alike with the other members of the majority, I have concluded that a correct analysis of the statutory provisions in issue in these appeals does not sustain the arguments of the general creditors."

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

26. No. The current regime whereby claims are made against the company and it is the company which makes claims against its directors or advisers, where appropriate, enshrines an important principle of corporate governance in this country. This has worked satisfactorily and should be retained. We hold this view, even in circumstances where the basis of the liability is fraud, rather than negligence, despite the high level of culpability that is implied, on the part of one or more of the directors or advisers. The company will have an adequate basis for recovering any damages against its directors and advisers on the basis of the decision in *Caparo* (and subsequent refining cases), which we do not believe should be undermined. In the 2005 White Paper that preceded the Companies Bill, the government consulted on the possibility of codifying *Caparo*. Codification of Caparo, and all the subsequent decisions that have refined this area of case law, would be fraught with difficulty and so at that time the Government wisely took the public policy decision not to do so. We also note the S90A FSMA liability regime deliberately does not cut across *Caparo*.

27. Besides the argument that change should not be made unnecessarily, it should be noted that if the proceeds of any claims against directors and advisers do not go to the company, but to individual shareholders or classes of shareholder, in cases of an insolvent company shareholders are likely to use the right to claim directly against directors and advisers to circumvent the insolvency regime.

28. We also believe the government should avoid any changes that could lead to the introduction of US-style class actions in the UK.

29. We are also concerned that allowing direct claims by shareholders against directors and advisers could lead to US levels of vexatious and unmeritorious litigation in this country, and the danger that this could lead to shareholders making or threatening claims against the directors in order to interfere with the proper running of the company should not be underestimated. For instance, claims could be made or threatened in order to force the directors into making certain decisions or entering/ending certain transactions or business relationships, which would interfere with proper corporate governance and could also lead to the oppression of the directors.

30. We note that paragraph 103 of the Review implies that auditors may be less concerned about being subject to fraud-based liability than negligence-based liability. However, we would not support this view. It is important to remember that audit is a risk-based process. Audits involve the exercise of professional, subjective judgment throughout the process and the concentration of work in areas with the greatest apparent risk. Even if auditors were to face liability under the higher standard of fraud (including recklessness), they would still be concerned about the difficulty of demonstrating why matters were not dealt with which only became apparent with the benefit of hindsight.

31. This does not imply that where individual directors or advisers are at fault that they should not be held to account, but there are sufficient means for this to be carried out , which we believe to be adequate to the situation. Existing sanctions include claims made by the company (including derivative claims instigated by shareholders) against directors or advisers for negligence or malfeasance (subject to any statutory or contractual restrictions such as under s463 CA 2006 or Liability Limitation Agreements), regulatory action and criminal prosecution.

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

32. We do not consider that statutory protection should be extended to the holders of securities. The Review clearly articulates the difficulties of establishing the damages which might be assessed against holders of securities who have not undertaken any transaction. In addition continuing shareholders have their own forms of redress.

33. On balance, we agree that statutory protection should be extended to the sellers of securities, in the interests of fairness because they have also carried out a market transaction in reliance on the information. In practice, however, this would represent a minor extension of the regime as loss would be harder to prove. As expressed in our general comments, extensions to the regime should otherwise be avoided where not needed, for fear of introducing unintended consequences.

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

34. Damages should be calculated on the “negligence” basis, in that they should be assessed according to the narrowly judged losses resulting directly from the misstatement, not the wider basis of including losses which may stem

from other unconnected occurrences. Investors in the capital markets are providers of risk capital, and when investing they hope for capital gain but accept the risk of market fluctuations, and that the market can go down as well as up. We believe it would be inappropriate to apply the "deceit" measure of damages, as this will lead to some investors obtaining direct recompense for market fluctuations that by coincidence happen to coincide with a false statement being issued to the market.

35. The terms in which these are formulated will need to be carefully judged, since using the terms employed in the Review suggests that damages should be due only in circumstances of "fraud" but should be assessed on the basis of "negligence". At first sight, this might be thought to imply a less than logical outcome. We do not believe this to be the case, however, since the basis of both the incidence of liability and their quantum are being imposed as new liabilities and for that reason the terms used are not applicable to the new circumstances.

36. In either case, the opportunity should be taken to make statutory provision for the assessment of issuers liability, for the sake of increased clarity in the law.

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