An economic analysis of liability for continuing corporate disclosures in English law

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Abstract

I analyse and evaluate the effectiveness of the English law regime governing public companies' continuing disclosures with a focus on the incentives it creates. In this area, EU regulation stipulates most of the disclosure content as well as the process for how and when to disclose, while the design of disclosure liability is left almost entirely to member states. Nonetheless, perceptions of an increasingly strained relationship between EU regulation and the common law caused the UK to introduce in 2006 its first statutory regime for issuer liability for continuing disclosures. The design of this regime provided the original motivation for this inquiry.

I make four principal claims that I believe to be new to the literature. First, the statutory liability regime fails to address the main problem it was introduced to solve – preventing an expansionary development of the common law tort of negligent misstatement into the corporate disclosure context – and both heads of liability could now be available in many cases.

Second, the substantive rules of the EU's continuous disclosure regime are well-designed to support the work of information traders and this is also a suitable policy goal for disclosure regulation.

Third, issuer liability regimes (such as the new UK regime) will be ineffective in deterring disclosure misstatements, but could potentially have some compensatory justification by protecting information traders. However, information traders do not need issuer liability and should perform a more useful role in the markets when not offered such protection. The new regime is therefore unnecessary and unhelpful.

Fourth, the FCA's recent initiative of requiring that a misstating issuer establish an investor restitution scheme is a significant development. Investors may find such schemes attractive compared to private litigation since the FCA appears to consider itself unrestrained by the doctrine preventing shareholder compensation for corporate losses.

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Table of Abbreviations

CA	Companies Act 2006
CSMAD	Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse [2014] OJ L173/179.
DTR	The FCA's Disclosure and Transparency Rules
ECJ	European Court of Justice
FCA	The UK Financial Conduct Authority
FSA 2012	Financial Services Act 2012
FSMA or FSMA 2000	Financial Services and Markets Act 2000
LR	The FCA's Listing Rules
MAR or Market Abuse Regulation	Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse [2014] OJ L175/1.
NPI	Non-Public Information
PR or Prospectus Regulation	Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC [2017] OJ L 168/12.
TD or Transparency Directive	Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market [2004] OJ L390/38, as subsequently amended up to and including

	the TD Amending Directive.
TD Amending Directive	Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market [2013], OJ L294/13.

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Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse [2014] OJ L173/179

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Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, [2014] OJ L175/1

Regulation (EU) No 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC [2017] OJ L 168/12

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1. Introduction

1.1. Motivation

Disclosure has long been recognised as an important tool in company and securities law, both in the UK and the EU.[1] The UK and other European regulators and scholars have, however, mainly focused on the nature of the information to be disclosed and not on the design of any associated liability regime.[2] The limited prior attention given to the liability regime motivates this thesis' enquiry: to analyse and evaluate the function of liability for corporate disclosures and the incentives that result. I will focus on the regulatory framework in English law, which necessarily includes EU law since it provides much of the background, with the aim of offering recommendations for future

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1 Leonard Sealy, 'The Disclosure Philosophy and Company Law Reform' (1981) 2 Company Lawyer 51, (arguing that disclosure is *the* principle of company law in the UK). Jaap Winter et al (eds), *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (2002) (arguing that disclosure requirements can be more efficient than substantive regulation and recommending that the EU in future rule-making should carefully consider whether it could use disclosure requirements). Klaus. J. Hopt, 'Corporate governance in Europe: A critical review of the European Commission's initiatives on corporate law and corporate governance (2015) 12 New York University Journal of Law & Business 139, 202 (noting that, in the EU Commission's 2012 action plan on company law and corporate governance, seven of sixteen measures were founded on the principle of disclosure).

2 The US literature is much richer than its European counterpart and I will seek to reference arguments presented in the US literature where they offer useful insights for European purposes.

policy-making.[3] The analysis may also be useful to regulators in other jurisdictions who may be considering adopting (or revising) applicable issuer liability frameworks.

My interest in the topic stems from English law's introduction in 2006 of statutory civil liability for continuing disclosures. While liability for prospectus disclosures has been a feature of English law since the Directors Liability Act 1890, and successive Companies Acts contained statutory obligations to produce annual reports and accounts, this was the first time that the continuing disclosure obligations of listed companies were linked to a civil liability framework.

That 2006 framework was only ever intended as an interim regime to ensure compliance with the EU's Transparency Directive, and the Government appointed Professor Paul Davies to review it and propose improvements before it had even come into effect.[4] While Davies conducted an impressive

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[3] The statutory regimes discussed herein apply to the whole of the UK, but I will focus on English law specifically since the underlying civil law is not uniform across the UK.

[4] The HM Treasury announced already in October 2006 that it would appoint Professor Davies to conduct a full review of the issuer liability regime. *See* HM Treasury, 'Written Ministerial Statement: Disclosure Rules under the Transparency Obligations Directive (2004/109/EC)' (25 October 2006). Professor Davies delivered a discussion paper and a final report in 2007. *See* HM Treasury, Davies Review of Issuer Liability – Liability for misstatements to the market: A discussion paper by Professor Paul Davies QC, March 2007 (hereinafter the "Davies Review Discussion Paper") and HM Treasury, Davies Review of Issuer Liability: Final Report by Professor Paul Davies QC, June 2007 (hereinafter the "Davies Review Final Report").

review in a short space of time, he also noted that his mandate did not allow for a full review of the English disclosure system. For example, he was not asked to consider how the system for continuing disclosures interacted with the system for prospectus disclosures or the impact of directors' and officers' liability insurance.[5] He also considered himself bound by the realities of the enforcement practices of the Financial Services Authority ("FSA"; since 2013 the Financial Conduct Authority, or "FCA"), meaning that he assumed that the UK financial market regulator would continue on its path of a "relatively modest level of public enforcement activity".[6]

Following Professor Davies's review, and further consultation, a new statutory regime for issuer liability was introduced in section 90A FSMA, with the substantive rules in a new Schedule 10A.[7] I refer to this new regime as the "90A regime" herein. The 90A regime now applies to information that issuers of securities traded on a securities market in the UK publish by "recognised means", regardless of whether the publication was required or not.[8] Its main liability provision states that an issuer is liable to pay compensation to a person who *acquires, continues to hold or disposes of securities in reasonable reliance on the issuer's*

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[5] For example, Professor Davies said that "it would be far beyond my terms of reference to devise a comprehensive liability regime for market disclosures" in the Davies Review Discussion Paper (n 4) 30.

[6] Davies Review Discussion Paper (n 4) 29.

[7] The current regime was introduced through Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2010, SI 2010/1192.

[8] Schedule 10A FSMA, s. 1, 2.

information and suffers loss as a result of an untrue or misleading statement or the omission of information required to be included in a statement.[9] (The text of the 90A regime is reproduced in "Appendix A: The 90A regime in FSMA" for convenience.)

More than a decade has passed since the introduction of the 90A regime, permitting meaningful reflection on how it works in practice. It seems appropriate both to evaluate its effectiveness and to consider its place in that "larger picture" of the overall system for disclosure liability without the restrictions placed on Professor Davies's review.

1.2. Relevance of topic

A thorough understanding of corporate disclosure regulation is increasingly important for at least two reasons.

First, the UK government is increasingly using corporate disclosure as a regulatory technique to affect corporate behaviour. Rather than introducing affirmative obligations on companies to undertake or refrain from particular actions, the government has instead opted to require that companies disclose certain information. New disclosure obligations introduced in the last few years relate to issues as diverse as:

- supply chain transparency,[10]
- transparency of companies' beneficial ownership,[11]

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[9] Schedule 10A FSMA, s. 3.

[10] Modern Slavery Act 2015, s. 54.

[11] Small Business, Enterprise and Employment Act 2015, Pt 7-8.

- statistics and data on the company's payment terms, such as the length of time for payment of invoices and the average number of days to make payment from receipt of invoice),[12] and
- the ratio of the chief executive officer's pay to that of the company's UK employees, together with a justification for the difference.[13]

Secondly, the UK is seeing more disclosure litigation, with well-known names such as RBS and Tesco recently becoming subject to disclosure lawsuits and the latter also the target of the FCA's first-ever investor restitution scheme for market abuse. There are several further recent cases where UK companies have been accused of insufficient or dishonest disclosure practices. For example, in October 2018 one AIM-listed company discovered "significant, and potentially fraudulent" accounting irregularities which produced a £40 million difference between its actual and reported cash position.[14] In March 2018, another AIM-listed company, previously hailed for its growth, abruptly filed for administration after failing to pay a large tax bill.[15] The FCA is reportedly investigating claims that two publicly traded companies created a false market

[12] The Reporting on Payment Practices and Performance Regulations 2017 (SI 2017/395).

[13] Companies (Miscellaneous Reporting) Regulations 2018, SI 2018/860.

[14] Leila Abboud, 'Patisserie Valerie had nearly £10m in unreported loans' Financial Times, 14 October 2018.

[15] Murad Ahmed, 'Conviviality suspended after surprise tax bill triggers profit warning' Financial Times, 14 March 2018.

in their shares.[16] Furthermore, the well-publicized collapse of Carillion plc coincided with an FCA inquiry into the timeliness and content of its public disclosures.[17]

This increased focus by regulators on corporate disclosures has not yet produced any significant analysis of the design of the UK legal framework. This is arguably needed, however, since the UK is home to one of the world's largest stock exchanges where shares worth several billion change hands each day.[18] There are also lingering questions which deserve a deeper inquiry than that which Professor Davies was able to produce in a few months ten years ago, for example in relation to the state of the pre-existing tort of negligent misstatement in light of the new 90A regime[19] or the scope of the new 90A regime itself.[20] The last decade has also seen enforcement initiatives of the FCA, such as the use of restitution schemes, which may warrant a

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16 Murad Ahmed and Caroline Binham, 'FCA studies claim bookmakers created 'false market' in shares' Financial Times, 16 March 2018.

17 Cat Rutter Pooley, 'Carillion falls as much as 8% on FCA investigation' Financial Times, 3 January 2018.

18 Data based on December 2018, sourced from London Stock Exchange, *Secondary Market Factsheet* (December 2018).

19 See Paul Davies & Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn. Sweet & Maxwell 2016) 720 and labelling it "very unclear" whether the tort of negligent misstatement may operate to hold companies or their directors liable for corporate disclosures).

20 See Davies & Worthington (n 19) 720 (expressing uncertainty about whether the narrative reports of the annual report are subject to the 90A regime).

reconsideration of the availability of private actions. These factors together justify this study.

This is not to say, however, that UK disclosure litigation is expected to increase significantly in the near term. Several reasons make a sudden increase seem unlikely, at least in the short-term. Apart from the design of the disclosure regime itself, which will be evaluated in this thesis, the UK justice system is notably different to that of the United States, the jurisdiction where we see most disclosure litigation. First, the UK system does not allow for class actions that automatically include all potential claimants unless they choose to opt out. The UK offers an opt-in procedure called a Group Litigation Order ("GLO"), which allows courts to consider claimants' shared or related issues at the same time for purposes of economic case management, but each claimant still maintains their own individual claim. GLOs allow claimants to share costs for the litigation of issues that they have in common, but, since each claimant still has to file their own claim, it is far from the US opt-out class action. Secondly, litigation funding rules in the UK do less to promote disclosure litigation than their US equivalents. The UK justice system operates on the "loser pays" basis (sometimes called "the English rule"), whereas the US system requires parties to litigation to bear their own costs. The English rule discourages claimants from bringing frivolous cases and encourages defendants to settle meritorious cases. The UK system also prohibits lawyers from working on a contingency fee basis, which has formed a significant part in encouraging the US system of entrepreneurial litigation.[21] US plaintiffs' lawyers are able to work on a "no win, no fee" basis, and instead charge a percentage (up to 30%) of the damages payable when they win or, as is usually the case, extract a settlement from the corporate defendant. However, the UK has recently seen a rise in professional third-party litigation funders and they may act to facilitate the bringing of disclosure litigation cases should the legal system encourage them.[22] I will comment on the likely development of private disclosure litigation in the Conclusions of this thesis, once the substantive rules have been examined.

1.3. Prior work

There is no comprehensive work on current corporate disclosure regulation and the applicable liability regimes in English law; the Davies Review itself is probably the prior work closest to this thesis in coverage. A subject as significant as corporate disclosure will, however, naturally be a regular topic of academic inquiry, with notable recent monographs including the following.

- Villiers' *Corporate Reporting and Company Law* (2006)[23] describes the UK disclosure framework in effect at that time with a broad social science focus, viewing existing disclosure requirements as suffering from a

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21 For a detailed treatment of the topic, see John C. Coffee, Jr, Entrepreneurial Litigation (2015).

22 An increased provision of third-party litigation funding may bring other concerns, as discussed in Australian Law Reform Commission, Integrity, Fairness and Efficiency—An Inquiry into Class Action Proceedings and Third-Party Litigation Funders (2018).

23 Charlotte Villiers, *Corporate Reporting and Company Law* (CUP 2006).

"financial interest bias" and offering suggestions for greater stakeholder involvement.

- Schammo's *EU Prospectus Law* (2011),[24] is focused on the institutional setting of the EU, offering as its final conclusions proposals to strengthen the role of ESMA.
- Willemaers' *The EU Issuer-Disclosure Regime* (2011)[25] offers an outline design for an EU-wide civil liability regime, but without questioning (as this thesis attempts to do) the overall purposes of imposing liability and the resulting incentives of different regimes.[26]
- Ben-Shahar & Schneider, *More Than You Wanted to Know* (2014), is an important contribution about the failure of mandatory disclosure as a regulatory strategy in many contexts; however, it does not directly analyse or comment on corporate disclosure.[27]

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[24] Pierre Schammo, *EU Prospectus Law: New Perspectives on Regulatory Competition in Securities Markets* (CUP 2011).

[25] Gaëtane Schaeken Willemaers, *The EU Issuer-Disclosure Regime: Objectives and Proposals for Reform* (Wolters Kluwer 2011).

[26] For example, Willemaers (n 25) 263 introduces the issue of civil liability for continuing disclosures by concluding as follows. "It would not be appropriate to exonerate issuers from liability with respect to periodic reports and ad hoc disclosures […] In any case, there seems to be wide agreement among Member States as to the possibility to make the issuer liable in those cases." In contrast, this thesis is focused on establishing the appropriateness of different liability regimes.

[27] Omri Ben-Shahar & Carl E. Schneider, *More than you wanted to know: The failure of mandated disclosure* (PUP 2014). It may be that the authors do not apply their argument to corporate disclosure since their general argument – that the costs of attempting to analyse and understand disclosures outweigh the

- North's *Effective Company Disclosure in the Digital Age* (2015),[28] offers a comparative overview of corporate disclosure regulation in eight countries and highlights common problems, but its broad jurisdictional coverage prevents it from engaging with the issues on the level of granularity offered in this thesis.
- Dombalagian's *Chasing the Tape: Information Law and Policy in Capital Markets* (2015),[29] a study of the role of the various sources of information (that is, not only that disclosed by companies themselves) in securities markets against the backdrop of increasing automation and globalisation.

Several important contributions to the field have also been made in the form of articles which may be found in the bibliography. However, the existing literature does not offer an in-depth analysis of current English disclosure law and the incentives it produces. This thesis aims to fill that gap.

1.4. Scope and delimitations

The focus in this thesis will be on equity markets. This is for two complementary reasons. First, limiting the scope of the enquiry facilitates greater analytical depth. Second, we focus on equity markets, rather than debt markets, because equity securities are more information-sensitive. Since equity

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benefits – do not necessarily apply in the context of professional investors reading corporate disclosures.

[28] Gill North, *Effective Company Disclosure in the Digital Age* (Wolters Kluwer 2015).

[29] Onnig H. Dombalagian, *Chasing the Tape: Information Law and Policy in Capital Markets* (MIT Press 2015).

securities represent the residual value of a company after debt securities have been repaid, any change to a company's value will first be reflected in the valuation of its equity securities. If a company announces that it has detected a material misstatement of its prior disclosures which inflated its profits, we can be sure that the value of its equity securities will be reduced, but the value of its debt securities will not necessarily be affected. Consequently, changes to the liability regime may be expected to have the greatest significance in relation to equity markets.

In considering substantive rules, we will take as our starting-point EU regulation, since it takes precedence over national law. However, since the EU does not make detailed prescriptions for a liability regime, questions of liability will be examined on the basis of the EU regime as implemented in the UK and, where applicable, supplemented by further statutes and rules. The focus will be on the civil law, with criminal and administrative law only mentioned very briefly in section 2.7 and then as applied in the Tesco misstatement case study in chapter 8.

As for the substantive disclosure obligations, the focus will be on the continuing disclosure regime that a company becomes subject to after it lists on a stock exchange. I will not spend much time on prospectus liability, other than as it interacts with the continuing disclosure regime.[30]

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[30] See section 2.6.2.

The legal status of EU financial regulation in the UK is subject to uncertainty since the terms on which the UK may leave the EU are not known. For purposes of this thesis, however, those terms are not important. No part of the analysis or conclusions herein hinge upon the UK and the EU establishing a certain type of future relationship. The aim of this thesis is instead to draw general conclusions about how to structure corporate disclosure liability, and for that reason they should remain relevant to future policy discussions both in the EU and the UK.

1.5. Methodology

In order to be able to compare different regulatory alternatives, some form of measurement criterion will be necessary. This thesis will adopt the criterion used in the leading work on comparative corporate law – the maximization of overall societal welfare within acceptable bounds of distribution.[31] This is closer to the Kaldor-Hicks measure of efficiency than the Pareto measure.[32] While an outcome is Pareto optimal if a departure from it would make a party worse off, Kaldor-Hicks efficiency prefers the outcome that maximizes the utility to society (i.e., the sum of costs and benefits for all individuals) even if

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[31] This is a standard approach in the analysis of corporate law; *see* John Armour, Henry Hansmann and Reinier Kraakman, What is Corporate Law?, in R. Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, OUP 2009), 28-29 (describing itself as "pursuing Kaldor-Hicks efficiency within acceptable patterns of distribution").

[32] *See* N. Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 The Economic Journal 549 (1939); J.R. Hicks, *The Foundations of Welfare Economics*, 49 The Economic Journal 696 (1939).

some individuals are made worse off, on the basis that they may be compensated out of the larger pie that is created. Kaldor-Hicks efficiency thus maximises the overall societal welfare regardless of distributional effects – focusing on creating the largest pie possible, but offering no guidance as regards the question of how to divide it into slices (say, between shareholders and employees). This is why the caveat above of "acceptable bounds of distribution" may be added. I recognise, however, that it would be highly artificial to place actual numerical values on the costs and benefits to the many actors that may be affected by the actions of other actors and regulators in the corporate disclosure setting, so this thesis aims to analyse possible policy options in terms that elucidate the trade-offs involved. As regards individual behaviour, a general assumption that the main actors are self-interested and economically motivated will take the analysis as far as necessary. I believe this to be a realistic assumption since the corporate disclosure setting is of an economic nature, which may make it easier to estimate utility than in other areas of life.

1.6. Structure

Chapter 2 aims mainly to provide the necessary details of the legal framework governing EU and UK disclosure regulation for the analysis to follow in later chapters. It situates the issuer liability framework introduced through the 90A regime in the context of the pre-existing statutory and common law.

Chapter 3 analyses the role of corporate disclosure, arguing that it is aimed at supporting information traders and that this is a suitable goal for disclosure regulation.

Chapter 4, thereafter, focuses specifically on the functions of disclosure *liability*. It offers a sceptical view of the benefits of issuer liability, but sees merit in placing some liability on directors and officers. It also presents a sceptical view of third-party (gatekeeper) liability, taking the view that such schemes that introduce liability for purposes of enhancing *ex ante* deterrence of misstatements typically devolve into mere *ex post* compensation schemes. The reason for this is simple: no-one wants to end up with concentrated risk exposure to a corporate misstatement, so those singled out by any regime as holding such liability risk rationally seek to avoid it through either *internal* insurance arrangements (diversification and/or pooling) or by purchasing *external* insurance. But when no-one has significant exposure, no-one monitors, and deterrence devolves into compensation. The end result is that both issuer liability and third-party liability systems become insurance policies for shareholders, which hardly any shareholder actually needs. Against that background, I suggest that we should consider how to achieve deterrence through other regulatory tools than liability, and that whistleblower schemes may be effective as they harness pre-existing, non-diversified stakeholders (employees) with superior access to the relevant information.

Starting with Chapter 5, I will proceed to offer a more concrete examination of the current UK rules in *practice* with a focus on incentives. Chapter 5 will examine the incentives within companies for delegation of disclosure duties in light of the statute only designating directors as relevant subjects. Having examined the relevant case law, I submit that issuers may be held liable also for intentionally fraudulent or reckless acts of non-directors.

Chapter 6 then considers the regime from the perspective of investors. Since information traders are important to the efficiency of the stock market, I ask how the liability framework supports their work of incorporating information into share prices. I find that they should still be able to base claims in the tort of negligent misstatement, but that the doctrine of "no reflective loss" (requiring that shareholders are not compensated for their companies' losses) limits the attraction of all private actions.

Having examined the incentives that the current English law provides for insiders and investors, Chapter 7 then examines how insiders use information in practice, the resulting agency problems, and how insiders and investors exchange information in private forums for mutual benefit.

Chapter 8, the final substantive chapter, offers reflections on a notorious recent example of a disclosure misstatement. In 2014, Tesco plc announced that it had misstated its earlier profit projections and proceeded to dismiss several members of staff. This misstatement has allowed us to see various elements of the UK enforcement regime in action. This included the FCA requiring, for the first time, that an issuer establish a restitution scheme to compensate investors. I argue that the FCA was overly generous in designing this scheme, since it allowed reimbursement for investor losses which were merely reflective of Tesco's, thereby contravening the theoretically applicable corporate law doctrine that shareholders may not be compensated in cases of "reflective loss".

I draw preliminary conclusions at the end of each chapter – noting down findings that I consider important analytical elements for any final conclusions.

Some such preliminary conclusions also serve the purpose of connecting overarching issues, such as the role of information traders. In Chapter 9, I then synthesize my preliminary conclusions into final conclusions and recommendations.

2. The new issuer liability regime in context

As Professor Davies has noted, our current disclosure regulation can only be understood in context.[33] This chapter aims to present that context – mapping what the applicable law actually is and how it arrived there – and explain why the 90A regime was introduced in order to provide the foundation for the analysis in the rest of the thesis.

2.1. Selected developments in early English disclosure law

The British Parliament has exerted control over the issuance of securities since it passed the Bubble Act in 1720.[34] Preceded by a period of widespread speculation and fraud, the Bubble Act offered investor protection by requiring the prior approval of Parliament for the formation of any joint stock company. The Bubble Act was repealed in 1825 and, while the number and importance of companies increased significantly in a short time thereafter, so did the amount of fraud where company promoters sold worthless stock to the public. To curb this undesirable behaviour Parliament again turned to legislation, but changed regulatory technique to a disclosure model rather than "merit"

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[33] Davies Review Discussion Paper (n 4) 30.

[34] This paragraph draws generally on David F. Hawkins, 'Corporate Financial Disclosure 1900-1933' (1962), chapter 1, and Jonathan Barron Baskin & Paul J. Miranti, Jr., 'A History of Corporate Finance' (1997), chapter 4.

review.[35] To raise funds from the public, the Companies Act 1844 required that a prospectus with certain prescribed disclosure items was drawn up and filed with the Board of Trade, that annual reports were sent to shareholders thereafter, and established that directors or officers who knowingly misstated the required disclosures would commit a misdemeanour under the criminal law.

While some of those provisions were subsequently made voluntary, the requirement to draw up a prospectus remained, and the courts started to establish the contours of a liability regime. In 1873, for example, the House of Lords considered the issue of whether investors who bought shares in the market were entitled to damages for prospectus misstatements on which they had relied.[36] Of even more fundamental importance, however, was the 1889 case of *Derry v Peek*, in which the House of Lords firmly settled the elements of fraudulent misrepresentation at common law (often referred to as the "tort of deceit").[37] The case concerned a shareholder who had subscribed for shares in alleged reliance on a prospectus containing misstatements, but it was unclear whether the directors had acted with intent to deceive or simply had been

[35] Merit review implies that a regulator reviews a submission (for example, an application to conduct an initial public offering) on its merits rather than just for compliance with requirements (such as prospectus disclosure contents).

[36] *Peek v Gurney* [1873] LR. 6 HL 377. The answer was no. This legal issue, of whether secondary market investors may have a liability claim if they rely on primary market disclosures, is analysed in section 2.6.2.

[37] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (4th edn, Sweet & Maxwell 2017) 137.

negligent. The House of Lords took the opportunity to clearly distinguish deceit from negligence. Lord Herschell summarized the law as follows:

> 'First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. To prevent a false statement being fraudulent, there must, I think, always be an honest belief in its truth. And this probably covers the whole ground, for one who knowingly alleges that which is false, has obviously no such honest belief. Thirdly, if fraud be proved, the motive of the person guilty of it is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made.'[38]

The House of Lords did not find any evidence that the directors did not believe the statements in the prospectus, so the shareholder's action was dismissed. Parliament considered this outcome undesirable and legislated in order to reverse *Derry v Peek* as regarded prospectus disclosures. The Directors

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[38] *Derry v Peek* (1889) 14 App. Cas. 337, 374.

Liability Act 1890 provided for liability for negligent misstatements in prospectuses, and this provision has survived to the current day where it is found in s. 90 FSMA.[39]

After the *Derry v Peek* decision, an investor wishing to sue for misstatements made outside of the context of prospectuses could still base the claim in the tort of deceit, but in stating that claim would need to show that:

- the defendant had fraudulently made a false representation;
- the defendant intended for the investor to act upon that representation;
- they actually relied on the defendant's representation; and that
- they suffered a loss as a result.

This set of requirements have been described as presenting "formidable hurdles to liability" and it appears that *Derry v Peek* effectively precluded investor actions for misstatements.[40]

The tort of deceit has remained substantially the same since *Derry v Peek* – subsequent important common law developments have instead been the expansion of the tort of negligence to cover misstatements. The first notable step toward recognition of a possible duty of care in making statements was taken by Denning LJ (as he then was) in a dissent in the Court of Appeal. In *Candler v Crane Christmas & Co*, a would-be investor had met privately with the

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[39] A history of the evolution of this provision is found in *Possfund v Diamond* [1996] 2 All ER 774.

[40] Davies & Worthington (n 19) 854.

subject company's auditors to study the accounts in order to decide whether to invest.[41] The accounts were negligently prepared (for example, they included assets which did not actually belong to the company), the investor lost his entire investment, and sued the auditors. The majority in the Court of Appeal held that the auditors did not owe the investor a duty of care in the absence of contract. Denning LJ dissented, arguing that professional persons who prepare statements on which third parties customarily rely may owe them a duty of care if they know that the third party will receive their statements for a particular purpose or transaction.

Twelve years later, the House of Lords endorsed Denning's view in *Hedley Byrne v Heller*.[42] In this case, Hedley Byrne (an advertising agency) caused its bank to inquire from another (Heller & Partners) whether one of its customers (Easipower Ltd) would be good for an advertising contract of a certain amount. Heller & Partners replied to the inquiring bank as follows:

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41 *Candler v Crane Christmas & Co.* [1951] 1 All ER 426.

42 *Hedley Byrne & Co v Heller & Partners* [1963] 2 All ER 575.

'CONFIDENTIAL

> For your private use and without responsibility on the part of the bank or its officials. […] We beg to advise: Re Easipower Ltd. Respectably constituted company, considered good for its ordinary business engagements. Your figures are larger than we are accustomed to see.'

Easipower went into liquidation and Hedley Byrne sued Heller & Partners for negligence. The House of Lords held, for the first time, that statement makers could incur a duty of care towards statement recipients, but that Heller & Partners' disclaimer of responsibility was operational and would prevent a duty of care from arising.[43] The court did not, therefore, need to decide whether or not a duty of care existed in that particular case. The tort of negligent misstatement was, however, now established as a separate cause of action, and the House of Lords would elucidate its attributes further in *Caparo v Dickman*.

2.2. *Caparo v Dickman*

The background to *Caparo v Dickman* is as follows.[44] Caparo Industries plc had purchased shares in Fidelity plc in the market in reliance on its audited accounts. When it was discovered that the accounts had been misstated, Caparo sued the auditors for negligence. The question for the House of Lords was whether the auditors owed Caparo a duty of care when conducting their

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[43] For a discussion of the potential role of liability disclaimers today, see section 6.3.5.

[44] *Caparo Industries plc v Dickman* [1990] 2 AC 605 (HL).

audit work. Their lordships articulated important tests for finding a duty of care, such that *Caparo v Dickman* now is the leading authority on this head of tort liability. Drawing on *Hedley Byrne* and its progeny, Lord Bridge articulated a threefold test for imposing a duty of care on a statement maker for the benefit of a statement recipient:

> "In addition to the **foreseeability of damage**, necessary ingredients in any situation giving rise to a duty of care are that there should exist between the party owing the duty and the party to whom it is owed a relationship characterised by the law as one of '**proximity**' or 'neighbourhood' and that the situation should be one in which the court considers it **fair, just and reasonable** that the law should impose a duty of a given scope on the one party for the benefit of the other.[45]

He noted, however, that these terms "amount in effect to little more than convenient labels" that need to be examined to establish whether a duty of care exists in the individual case. As a result, there is significant room for judicial interpretation and discretion around these terms.[46] Referencing the famous

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[45] *Caparo Industries plc v Dickman* [1990] 2 AC 605, 617-18 (emphasis added).

[46] In the words of Lord Bridge, "the concepts of proximity and fairness […] amount in effect to little more than convenient labels to attach to the features of different specific situations which, on a detailed examination of all the circumstances, the law recognises pragmatically as giving rise to a duty of care of a given scope" *Caparo Industries plc v Dickman* [1990] 2 AC 605, 618.

"floodgates" analogy in *Ultramares Corp v Touche*,[47] Lord Bridge continued by requiring "as an essential ingredient of the 'proximity' between the plaintiff and the defendant, that the defendant knew that his statement would be communicated to the plaintiff, either as an individual or as a member of an identifiable class, specifically in connection with a particular transaction of a particular kind (e.g. in a prospectus inviting investment) and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter on that transaction or a transaction of that kind".[48]

Lord Oliver articulated similar principles, and with a higher degree of precision. His lordship deduced from *Hedley Byrne* four requirements for finding a "special relationship" that created a duty of care from the statement maker to the recipient:

> "What can be deduced from the *Hedley Byrne* case, therefore, is that the necessary relationship between the maker of a statement or a giver of advice (the adviser) and the recipient who acts in reliance on it (the advisee) may typically be held to exist where (1) the advice is required for a purpose, whether particularly specified or generally described, which is made known, either actually or inferentially, to the adviser at the time when the advice is given, (2) the adviser knows, either actually or inferentially, that his advice

[47] 174 N.E. 441 (1932).

[48] *Caparo Industries plc v Dickman* [1990] 2 AC 605, 638 (Lord Bridge).

> will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose, (3) it is known, either actually or inferentially, that the advice so communicated is likely to be acted on by the advisee for that purpose without independent inquiry and (4) it is so acted on by the advisee to his detriment."[49]

While differently articulated, Lord Oliver's requirements also appear to address the issues of foreseeability and proximity addressed by Lord Bridge. Lord Oliver notably referenced the *purpose* of the statement in each of his three requirements, making it a crucial factor in determining whether a duty of care may be held to exist.[50]

Other concepts have been employed in the courts' inquiries into the existence of a duty of care. For example, the "assumption of responsibility" concept was prominent in *Hedley Byrne* itself and is by some considered a stand-alone alternative to the threefold test.[51] This test was adopted in circumstances where a principle was sought to enable an extension of the tort of negligent

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[49] Id. 638 (Lord Oliver). As noted by Professor Cartwright (n 37, p 195), while the fourth item on this list (actual reliance) is necessary for liability, it should not form part of the finding of a duty.

[50] Each speech in *Caparo* explicitly referred to the purpose of the information given; *Caparo Industries plc v Dickman* [1990] 2 AC 605, 621 (Lord Bridge), 628-29 (Lord Roskill), 629-30 (Lord Oliver) and 655 (Lord Jauncey) (Lord Ackner did not deliver a speech).

[51] *See*, generally, Andrew Robertson & Julia Wang, 'The Assumption of Responsibility', in K. Barker and others (eds), *The Law of Misstatements – 50 Years on from Hedley Byrne v Heller* (Hart 2015) 57-59.

misstatement beyond mere statements to also cover negligent actions.[52] The "assumption of responsibility" test may be functionally similar to Lord Oliver's threefold test in *Caparo*,[53] or even a re-articulation of the proximity limb of that test.[54] Regardless of which formal test is ultimately preferred, it is likely that factors functionally similar to the threefold test in *Caparo* will be employed, since the ultimate goal is to undertake a fact-specific inquiry into the relationship between the statement maker and the recipient.[55] The issue of the purpose of the disclosure is thus central to the analysis.

Ultimately, the House of Lords declined to find a duty of care in *Caparo v Dickman* on the basis of a lack of proximity. Caparo (as an investor in the market) did not have a sufficiently proximate relationship with the company's auditors, on the basis that the auditors' report was deemed to have the purpose of informing the shareholders in general meeting so that they could decide whether or not to approve the accounts.

Since *Caparo v Dickman* established the purpose of the annual report, the case is generally regarded to shield not only auditors but by analogy also issuers and insiders from liability in negligence to stock market investors for annual report

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52 Cartwright, (n 37) 278.

53 *Customs & Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, 270 [36] (Lord Bingham; including fairness and policy into the assessment of assumption of responsibility).

54 See, e.g., Robertson & Wang (n 51).

55 Compare Lord Bingham's speech in *Customs & Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, 263 [8] (finding the outcomes of the leading cases correct, regardless of the test applied).

disclosures.[56] The basis for such an interpretation must be that the purpose of the annual report is that which the House of Lords established in *Caparo*, regardless of whether a particular section in that report was contributed by the auditors, directors, or others. That is probably the better interpretation, although there may be two possible arguments for why *Caparo* should be limited in application to auditors. First, one might argue that the relationship between the directors and the shareholders is of a more proximate nature than that between the auditors and the shareholders, since the auditors are engaged to perform a limited service to the company.[57] Secondly, it may be possible to show that the purpose of annual report disclosures has changed over time so that they are now more investor-focused.[58]

Nonetheless, in attempting to draw principles from *Caparo* to help provide certainty as to when disclosure liability may extend to investors at large, Gullifer and Payne have offered a helpful frame of analysis.[59] They argue that we can evaluate corporate disclosures based on their purposes: either they are

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56 Davies Review Discussion Paper (n 4) 21.

57 That is to say, while *Caparo* is now often described as a case which limits liability to third parties for negligent misstatements, it is only so described because the court declined to find a direct party relationship between the auditors and the investors. We cannot, based on *Caparo v Dickman*, rule out that a relationship of privity could be found between a listed company and its shareholders or investors when assessing the company's disclosure and the recipients' consequent trading.

58 This second argument could receive some support from the approach of Lightman J in *Possfund v Diamond* [1996] 2 All ER 774., discussed in text accompanying notes 61 and 62 below.

59 Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, Hart 2015) 558-562.

governance-focused – having the purpose of informing shareholders to enable them to exercise their governance rights in the company – in which case *Caparo* would protect against liability in negligence, or *investor-focused* – having the purpose of informing investors at large to help them price the company's shares more accurately – in which case the principles articulated in *Caparo* would not protect from liability.[60]

An important detail in *Caparo* is that their Lordships did not rely on any particular statement in the Companies Act or by the legislature for their finding that the purpose of the annual report was to protect shareholders *qua* shareholders. They established the purpose of the provision themselves. When Lightman J six years after *Caparo* was required to determine whether a prospectus could have the purpose of informing after-market purchasers, he therefore (in consonance with *Caparo*) considered himself unrestricted by the wording of the statute.[61] For purposes of defeating an issuer defendant's motion to strike out an after-market purchaser's action for a negligent prospectus misstatement, Lightman J invited the plaintiff to submit an affidavit to substantiate that the purpose of the prospectus included informing secondary market purchasers.[62] The plaintiff submitted a statement from a senior investment banker which explained that market participants considered

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60 The analysis on what losses investors may be compensated for is provided in Chapter 6.

61 *Possfund v Diamond* [1996] 2 All ER 774.

62 Ibid, 785-86.

prospectuses important also for encouraging secondary market investors, and this was influential with Lightman J who allowed the claim to proceed.

2.3. The reasons for the new liability regime

After the decision in *Caparo*, fifteen years of relative stability ensued in the English law of disclosure liability. Then the UK was required to implement the EU Transparency Directive (TD). As part of this process, concerns were raised that EU regulations could have the effect of expanding the tort of negligent misstatement in English law.[63] While *Caparo* limited the application of this head of liability by finding that the purpose of an audit report was to provide information to shareholders *qua* shareholders (assisting them in their exercise of governance rights in the company) and not to be used by investors buying shares in the market, the TD stated that the intended recipients of its prescribed disclosures were not just existing shareholders but investors in general. Its recital (11) states, for example, that the purpose of half-yearly reports is to allow investors to make a more informed assessment of an issuer's situation, and several references are made in the directive to information being available "to the public".[64] (Stated purposes for MAR disclosures are similar.[65])

[63] For helpful background and a comment on the regulatory framework at the time, see Lachlan Burn, 'Only Connect – the importance of considering disclosure requirements in the light of their legal consequences' (2007) 2 Capital Markets Law Journal 41.

[64] See, e.g., TD Art. 4 (audit report shall be disclosed "to the public") and TD Art. 5 (half-yearly reports shall be available "to the public" for a certain time).

As a result of the TD's statements indicating that the disclosures required were aimed at a broad audience, concerns were raised that the introduction of the TD could extend the liability under the tort of negligence for directors and auditors to not only shareholders but investors at large. The House of Lords heard evidence where Mr Lachlan Burn, a partner at Linklaters, argued as follows.

> 'the draft [TD] significantly extends the established limitation in English case law on the civil liability of directors and auditors arising from the publication of a company's annual accounts and audit report. As a result, if implemented in its current form, the [TD] would mean that directors and auditors would not only be liable to shareholders (as is presently the case) for any errors in the published financial information, but that they would also be liable to the general public. This substantial amendment to the current position on civil liability under English law is contrary to the Commission's stated intention that the [TD] should not have such an effect in Member States.'[66]

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[65] For example, MAR Recital (2) references market efficiency, Recitals (31) and (55) investor protection, and Article 1 states that the goals of the MAR include market integrity and investor protection and confidence.

[66] House of Lords, Select Committee on the European Union, 'Towards a Single Market for Finance: The Financial Services Action Plan' (18 November 2003) 19-20.

Following correspondence with the European Commission and the Treasury, a final report from the House of Lords Select Committee concluded that it was "not satisfied that the fears expressed by Mr Burn […] are without foundation" and that "legitimate uncertainty" remained as to whether disclosure liability under English law would be expanded by the TD as Mr Burn had indicated.[67]

The Financial Markets Law Committee (of which it appears Mr Burn was a member) also took the view that the stated purposes of EU law could change the English law on disclosure liability.

> 'As the purpose of the [TD] must be implemented into English law, there is a very real risk that, on *Caparo* principles, those responsible for the information (including the [i]ssuer and possibly the auditors) will be held accountable to investors who rely on the information and suffer loss as a result.'[68]

The FMLC also noted that "[t]he *Caparo* principle is likely to apply by analogy to the [i]ssuer and its directors" and that the proper person to sue in such a case would be the company itself.[69] It also argued that English legislation could prevent the application of the tort of negligence and instead fulfil the purposes of the TD by introducing regulatory sanctions, such as statutory fines, on those

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[67] House of Lords, European Union Committee, 15th Report of Session 2003-04, Directors' and Auditors' Liability – Report with Evidence (19 May 2004) 9.

[68] Financial Markets Law Committee, 'Issue 76 – Transparency Obligations Directive' (October 2004), para 3.6.

[69] Ibid para 2.11.

responsible for continuing disclosures.[70] In 2006, the FMLC wrote a letter to the European Commission reiterating its concerns. It noted that the draft TD had been revised, replacing references that said "information disclosed to the public" with "information to be made public", but argued that this did not address the problem of potentially expanding negligence liability to investors in the UK.[71] The FMLC therefore asked the Commission to articulate the view that the TD did not involve any intention to expand national liability regimes.[72] The commissioner replied that:

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[70] Ibid para 4.3.

[71] Financial Markets Law Committee, 'FMLC Issue 76 – Transparency Obligations Directive' (Letter to Alexander Schaub, DG Internal Markets) 23 March 2006.

[72] Ibid.

> '[As already explained to the House of Lords,] the [TD] does not aim at extending the scope of existing liability regimes in the Member States. It is for Member States, under Article 7 of the [TD], to determine the scope of the responsibility for the information contained in the [reports required by the TD]. This is expressly confirmed by Recital 17 which provides that 'Member States should remain free to determine the extent of liability'. The Directive takes no position as to the scope of the liability regime, nor does it prescribe the persons who should be benefiting from such a regime. This matter is entirely for Member States. The Directive does not modify the situation currently prevailing in the Member States.'[73]

It ought to be noted here that Mr Burn's claim in the House of Lords that companies would be liable under English law if the TD had been implemented in its then-current form was questionable.[74] No English court had then, nor have they now, been willing to extend the tort of negligent misstatement in this way and it would certainly not take place in such an automatic way as Mr Burn suggested. It should also be noted that the FMLC's request for a formal statement from the Commission about the intended effect of the TD appears to be based on a questionable interpretation of English law. Both *Caparo v*

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[73] European Commission, Letter from Commission Alexander Schaub to Lord Woolf of the Financial Markets Law Committee, MARKT/F2/FFP/se D(2006) 5006, 3 May 2006.

[74] I am referring to the quote accompanying note 66.

Dickman and *Possfund v Diamond*[75] demonstrate that courts will conduct their own analysis into the purpose of a statement in order to establish whether or not the statement maker may owe a recipient a duty of care. The attempts to change the wording of the TD, or draw up additional statements about the intended effect of the TD, therefore appear futile because, regardless of the purpose stated in any official legislative document requiring certain statements to be made, UK judges would be free to determine for themselves the purpose of that statement and impose a duty of care on the statement maker. The only way to limit negligence liability for TD disclosures would therefore have been to legislate to bar *Caparo* actions in the setting of continuous corporate disclosures.

In the end, the EU's assurances did not convince UK regulators that *Caparo v Dickman* could not be extended to TD disclosures, so the Treasury decided to add a liability regime into the Companies Bill very late in that process, shortly before it was passed by Parliament.[76] Even at its introduction, that regime was considered an interim measure, however, and it was made clear from the outset that it would be subject to review (later known as the Davies Review).

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75 *Possfund v Diamond* is discussed above in the paragraph containing notes 61 and 62.

76 HM Treasury launched a targeted consultation on the issue of a statutory damages regime in August 2006, and issued a feedback statement on that consultation in October 2006. The Companies Bill received Royal Assent on 8 November 2006. *See* HM Treasury, 'Extending the scope of the statutory damages regime for disclosures required under the Transparency Directive' (9 August 2006); HM Treasury, 'Approach to Transparency Directive Implementation – Major Shareholdings Notifications, Periodic Financial Reporting and Equal Treatment Obligations' (2 October 2006).

2.4. The Davies Review

The interim regime for continuous disclosure liability enacted as part of the Companies Act 2006 completely excluded any liability in negligence to investors and adapted the tort of deceit into a statute for issuer liability. The Government and Parliament recognised that this interim measure had not received sufficient consideration as a long-term solution and therefore provided in s. 90B FSMA authority for the Treasury to conduct a more thorough review of the issues and to amend the law as appropriate.[77] The Treasury appointed Professor Davies to conduct the review, and he quickly produced a discussion paper in March 2007 and a final report in June 2007.[78]

The Davies Review's Terms of Reference provided a broad mandate to design (or recommend not to introduce) a liability regime for continuous disclosures, although (as noted in section 1.1) this mandate did not (at least not explicitly) include considerations of the interaction of prospectus and continuous disclosure liability, or the impact of directors' and officers' liability insurance.[79] Davies also considered himself bound by the realities of the enforcement practices of the FSA (now FCA), meaning that he anticipated its policy of a

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[77] Indeed, the HM Treasury announced already in October 2006 that it would appoint Professor Davies to conduct a full review of the issuer liability regime. *See* HM Treasury, 'Written Ministerial Statement: Disclosure Rules under the Transparency Obligations Directive (2004/109/EC)' (25 October 2006).

[78] Those documents are, of course, the Davies Review Discussion Paper and the Davies Review Final Report referenced in note 4.

[79] The Terms of Reference are appended in the Davies Review Discussion Paper (n 4) 56.

relatively low amount of public enforcement of corporate disclosures to continue. As further discussed in section 4.4 below, Davies appears to have self-imposed a restriction to not significantly question the overall need for, or the desirability of, an issuer liability regime. Perhaps due to unfortunate time pressures, it appears that Davies took the design of the stop-gap, interim regime as his starting point; a choice which would have limited the range of his review's possible recommendations and caused the law to continue down a path chosen in haste for an interim regime.

In the discussion paper, Davies analysed the concerns raised about the potential impact of the transparency directive and agreed with the conclusion of the House of Lords' European Committee that, while there could be policy arguments against any new judicial imposition of liability to investors at large, the concerns that had been raised about investor disclosures becoming subject to the negligence regime were not without foundation.[80] The Davies Review recommended that the new s. 90A regime should not prejudice *Caparo* liability for governance purposes as developed in the common law, and that the *Caparo* regime should be left untouched by the new regime.[81]

Davies also offered another reason for the introduction of the 90A regime which does not appear to have been considered by legislators at the time,[82]

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[80] Davies Review Discussion Paper (n 4) 23.

[81] Davies Review Final Report (n 4) 22.

[82] In a document from the Treasury issued shortly before the 90A regime was added into the Companies Bill (then section "1234"), the key concern was an extension of *Caparo*. The "effectiveness" issue

namely that the UK could possibly have been in breach of EU law if it had not put *some* liability regime in place.[83] However, this appears perhaps overzealous: the TD requirements for liability are low, and were diluted during its drafting from requiring 'civil liability' to only require 'appropriate liability'.[84] So, given that the TD only required the existing liability laws of member states to apply to issuers, directors, managers *or* persons responsible, and that the UK already enabled investors to sue in the common law of deceit, empowered public enforcement, and introduced a new procedure for shareholder derivative claims in the same Companies Bill (under which shareholders arguably can pursue directors for disclosures issued in breach of their duty of care), it would seem very unlikely that the UK could have been found not to comply with the TD had it opted not to create the new 90A regime.

Based on the Davies Review, the Government prepared legislation in 2008 which it subjected to another consultation before amending the regime.[85] The resulting Sch. 10A FSMA appears to allow investors to sue either under the

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was not mentioned. *See* HM Treasury, Feedback statement: Approach to Transparency Directive Implementation – Major Shareholdings Notifications, Periodic Financial Reporting and Equal Treatment Obligations (2 Oct. 2006).

[83] See Davies Review Discussion Paper (n 1) 26 or, more recently, Davies & Worthington (n 19) 885. Davies also made this claim in Paul Davies, 'Liability for misstatements to the market: Some reflections' (2009) 9 Journal of Corporate Law Studies 295, 298-99 and Paul Davies, 'Liability for misstatements to the market' (2010) 5 Capital Markets Law Journal 443, 444.

[84] *See* Eilis Ferran, *Building an EU Securities Market* (CUP 2004) 189.

[85] HM Treasury, 'Extension of the Statutory Regime for Issuer Liability' (July 2008) and HM Treasury, 'Extension of the Statutory Regime for Issuer Liability: A Response to Consultation' (March 2010).

90A regime or in negligence, since suits based on "a person's having assumed responsibility, to a particular person for a particular purpose" are preserved in the 90A regime.[86] The Government explained that it sought "to ensure that an issuer will remain liable for negligent misstatements where such liability would exist under the rule in *Caparo v Dickman*, as subsequently developed by the courts." It thus appears clear that *Caparo* is preserved in the 90A regime but left open to further interpretation by the courts. This conclusion is however not universally accepted and will be further analysed in section 6.2.

2.5. An overview of corporate disclosure obligations

This section will briefly outline the regulatory frameworks that impose disclosure obligations on issuers of publicly traded shares, following which the potential avenues to liability under English law are examined. This section will consider four categories of corporate disclosures:

(i) the framework governing admission to trading in the UK;

(ii) prospectuses, which are required when issuers raise capital from the public;

(iii) periodic disclosures – annual and interim reports – which listed companies are required to publish regardless of whether or not anything of significance has occurred; and

(iv) other episodic disclosures, which companies are required to publish when events of particular importance occur.

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[86] s. 7(3)(a)(v) Sch. 10A FSMA

2.5.1. Admission to trading

Early EU securities law focused on companies with an 'official listing', a concept that aimed to cover issuers with shares quoted on the main stock exchanges of each member state.[87] Since the EU's adoption of the Financial Services Action Plan (FSAP) in 1999, regulatory focus has shifted to 'regulated markets'. The Prospectus Directive (PD), for example, requires a prospectus to be drawn up for admission to trading on a regulated market, as well as for public offers of shares, and so does the Prospectus Regulation (PR) which replaces it. The TD applies to issuers with securities admitted to trading on regulated markets, and so did the old Market Abuse Directive, while the MAR which replaced it extends coverage to also cover multilateral trading facilities (MTFs) and other venues.

Generally, therefore, EU disclosure regulation now distinguishes between regulated markets (such as the Main Market of the LSE) and other venues (such as the Alternative Investment Market of the LSE). In order to list their shares on the Main Market, issuers need to be approved both by the UKLA[88] (a part of the FCA) and the LSE itself. The FCA has established Listing Rules (LR) for this purpose, allowing issuers to choose between a standard listing (including only the minimum EU rules required) and a premium listing (which contains additional rules for issuers that wish to bond themselves to a higher-

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[87] See generally Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 360-364.

[88] Section 74 FSMA.

quality regime). The premium listing regime includes, for example, additional requirements on issuers to send circulars to their shareholders for approval of significant transactions and related party transactions, as well as rules on the contents of such circulars.[89]

2.5.2. Prospectus Regulation (PR)

The PR requires a prospectus for the admission of shares to trading on a regulated market and for public offers of shares.[90] If shares are to be admitted to a non-regulated market such as AIM (an MTF in EU terms), the first trigger will not be pulled but a prospectus will still be required if a public offer of shares occurs.[91] This second trigger can, however, also be avoided in certain circumstances, such as if only qualified investors are targeted, if the offer is directed to fewer than 150 non-qualified investors per EEA member state, or if the offer falls below prescribed amounts. Companies can thus engage in offerings, or admit their shares to trading on an MTF, without having to draw up a prospectus. The resulting liability regime will differ, as we will see in section 2.6.

While the EU has devoted a great deal of energy to establishing requirements for the exact contents of prospectuses, it has not attempted to harmonize civil

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[89] See LR10, LR11, and LR13.

[90] Section 85 FSMA.

[91] In *Hall v Cable & Wireless* [2010] 1 BCLC 95 at 103, it was held that a document drawn up to list on an unregulated market was not covered by s. 90 FSMA.

liability regimes in a meaningful way.[92] Thus, the PR only requires in its Article 11 that Member States ensure that responsibility for the information in a prospectus attaches to at least the issuer or its administrative, management or supervisory bodies and that the persons responsible for the prospectus are clearly identified therein.

Civil liability is thus left to member states – at least for now. ESMA has prepared a report comparing member states' prospectus liability regimes which found that most countries did not have a specific prospectus liability regime in place. It is however not clear whether any attempts at harmonization will be made.[93]

2.5.3. Transparency Directive (TD)

The TD requires firms to make annual and semi-annual financial reports available to the public.[94] In addition, the TD used to also require an "interim management statement" to be made public on a quarterly basis. This requirement was, however, removed in 2013 due to concerns that such statements imposed a significant burden on small- and medium-sized issuers and that such frequent reporting could discourage firms from taking a long-term view.[95] In its place was instead inserted a requirement for issuers in

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[92] PR art. 38 also requires member states to have a system for imposing administrative sanctions.

[93] ESMA, *Comparison of liability regimes in Member States in relation to the Prospectus Directive*, ESMA/2013/619.

[94] TD Arts 4, 5.

[95] See, e.g., TD Amending Directive, Recital 4.

extractive or logging industries to annually report on payments made to governments.[96]

As for civil liability, the TD is similar to the PR in that it does not require much from member states:

> '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.'[97]

This vague and seemingly innocuous provision, which does not appear to require the creation of new legal instruments providing for disclosure liability to investors, was the basis for significant debate in the UK which triggered the introduction of the new 90A regime on issuer liability for continuing disclosure obligations.[98] In addition to the 90A regime, the TD is also the reason for the introduction in s. 463 CA 2006 of a "safe harbour" provision on liability for false or misleading statements in certain narrative reports that usually form part of the annual report (those being the strategic report, the directors' report, and

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[96] TD, Art 6. See section 7.4.2 for a further discussion of the short-termism problem.

[97] TD Art 7 (Art 16 referred to in the quote requires disclosures if rights of equity instruments are altered).

[98] See section 2.3.

the directors' renumeration report).[99] Section 463 CA stipulates that only the company itself is entitled to compensation for false or misleading statements in these reports, and that directors are only liable to compensate the company on a fraud basis (statements they knew were untrue or for which they were reckless as to the truth). The exclusion of civil liability for fraudulently made statements other than to the company itself offers directors significant statutory protection and commentators have questioned why such significant legal protection for directors should be necessary.[100] It is difficult to think of a justification for removing from investors the ability to sue directors in the common law of deceit where this head of liability would otherwise have been available.[101]

It is unclear how s. 463 CA and s. 90A FSMA interact for those disclosures by public companies that appear to fall under both regimes. Annual reports should be subject to the 90A regime, since that framework covers statements made to the market (or where the availability of the document is announced to

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99 CA s. 412 (Directors' renumeration report), CA s. 414A (Strategic report), and CA s. 415 (Directors' report).

100 Davies and Worthington (n 19) 720. Cartwright (n 37, 139 fn 17) also appears to question the appropriateness of this approach.

101 While reference could be made to the principle that the company is the proper claimant in cases where both the company and a shareholder have a claim against a director, so that shareholders therefore will be unable to extract individual compensation if they would be made whole by compensation to the company (the basis and application of this principle to misstatements is analysed further in Chapter 6), this rule would have been operational in deceit cases without legislation of this type.

the market), but s. 463 CA removes all potential investor liability for the narrative reports under its purview. Section 463(4) CA reads:

> 'No person shall be subject to any liability to a person other than the company resulting from reliance, by that person or another, on information in a report or statement to which this section applies.'

If the "No person" at the start of s. 463(4) CA is read to include the company itself, then it would appear to preclude liability to investors under s. 90A FSMA for these statements.

Both provisions were implemented into UK law as a result of the TD, but the 90A regime was thereafter made subject to the Davies Review, which did not address this issue. The uncertainty about the liability status of these statements may be illustrated by the authoritative company law textbook which Davies co-authors: the previous edition proclaimed that the 90A regime "includes" liability for these narrative reports, but the current edition has tempered that conclusion to state that it "might include" them (despite there being no obvious legal development to trigger a reassessment).[102] It is, naturally, difficult to attempt a conclusion that offers more certainty than that of these accomplished scholars, but three observations can be offered.

First, the purpose of s. 463 CA is to limit director liability; it is not focused on issuer liability. Its subsections (2)-(3) only relate to directors, and while the

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[102] *Compare* Paul L. Davies and Sarah Worthington, Principles of Modern Company Law (9th ed. 2012) 783 *and* Davies and Worthington (n 19) 720.

terminology is widened in (4) to "No person", this is to ensure that auditors and others will only be liable to the company.[103] The legislature does not appear to ever have considered that s. 463(4) should (or, potentially, *could*) have the role of restricting issuer liability under the 90A regime. A teleological interpretation would thus suggest that it does not. Secondly, s. 463(4) CA excludes liability to *a person other than the company*. It consequently preserves liability to the company. It would be nonsensical for this to be read as extending to liabilities *of the company*. Thirdly, on a literal interpretation s. 463(4) CA is clear: there is no liability to third parties for the reports covered by the provision. But s. 4 of Sch. 10A FSMA is equally clear: only information for which s. 90 FSMA applies (or information which is not published via a RIS) is excluded from its scope. Here, a literal interpretation of each statute would yield conflicting results. It is submitted that the better view is that s. 463(4) does not override the 90A regime: the 90A regime is a specialised rule for those few companies whose shares are admitted to a trading venue, and it is also the more recent rule.

The TD requires that both annual and semi-annual reports contain responsibility statements where the persons responsible for drawing up these reports certify that, to the best of their knowledge, the financial and narrative statements in such reports give a true and fair view of the company.[104] The requirements for responsibility statements have in the UK been implemented

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[103] Companies Act 2006 c 46 (Explanatory Notes) 113.

[104] TD, Articles 4(2)c and 5(2)c.

in the FCA's Disclosure and Transparency Rules (DTR) in a way that makes it clear that these statements are not intended to cause liability to be incurred by the persons named in them.[105] Each rule in the DTR is followed by another, which states that "The issuer is responsible for all information drawn up and made public in accordance with this section". Liability is thus dealt with through s. 90A FSMA and s. 463 CA. The requirement to publish responsibility statements is presumably intended to instead have the effect of raising the awareness of their importance to those directors or officers who sign them.

2.5.4. Market Abuse Regulation (MAR)

The purpose of MAR is "to protect the integrity of the financial market and to enhance investor confidence, which is based, in turn, on the assurance that investors will be placed on an equal footing and protected from the misuse of inside information."[106] Under MAR, firms have to make inside information publicly available "as soon as possible" "in a manner which enables fast access and complete, correct and timely assessment … by the public". The fact that this obligation is placed in the MAR, and not the TD, tells us that its main objective is not to enable investors to use the information but to disable insiders within the firm from taking advantage of it by neutralising their

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105 DTR 4.1.12R (annual reports) and DTR 4.2.10R (half-yearly reports).

106 MAR, Recital 24.

incumbency advantage.[107] MAR also requires the public disclosure of directors and senior officers' transactions in the firm's shares.[108] This is also primarily motivated by market abuse prevention and, secondarily, by informing investors.[109]

Like the TD, the MAR contains only vague requirements about liability. Recital 40 articulates a perceived need to leave the question of attribution of liability to member states.

2.6. Civil liability

2.6.1. The statutory rights of action compared to tort liability

An interesting issue is how the statutory rights of action in s 90 and 90A FSMA relate to each other. If a misstatement formed part of a prospectus (or 'listing particulars'), s. 90 offers a comparatively investor-friendly framework with a negligence standard and a reverse burden of proof, so that the issuer needs to show that it was not negligent in order to avoid liability. Further, s. 90 does not require investors to show that they relied on the prospectus (or even that they read it), which results in a 'fraud-on-the-market' approach: the investor's loss stems from the link between the misstatement and the effect on the share price, and the individual investor does not need to show reliance on the misstatement. Presumably, however, investors will need to demonstrate

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[107] See also MAR Recital 49, which first justifies the rule by "avoid[ing] insider dealing" and, secondly, by it "ensur[ing] that investors are not misled".

[108] Such disclosures are disseminated to the public via the firm. See MAR Art. 19(1) and 19(3).

[109] MAR Recital 58.

that their losses are caused by the misstatement, although this should not be too difficult: in a case where the company announced and corrected a previous misstatement, the FCA recently used the decrease in share price upon correction (with minor adjustment for market-wide movements on the same day) as a proxy for investors' losses.[110]

The 90A regime is less investor-friendly. To qualify for compensation, investors (i) need to show that a 'person discharging managerial responsibilities' within the issuer knew that (or was reckless as to whether) the statement was untrue or misleading; (ii) carry the burden of proof (as opposed to s. 90 FSMA); and (iii) they need to show actual reliance (that is, they do not get the benefit of a 'fraud-on-the-market presumption' as in s. 90 FSMA) and that such reliance was reasonable in the circumstances.

Section 90 FSMA, further, does not affect any liability which may be incurred apart from this section.[111] When the 90A regime is applicable, on the other hand, the issuer is not subject to any other liability and other persons are not subject to any liability other than to the issuer. This is then slightly relaxed by allowing for five specified forms of civil liability to co-exist with the new regime in five specific situations:[112]

(i) under section 90 FSMA,

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[110] Financial Conduct Authority, Final notice: Tesco plc, Tesco Stores Limited (28 March 2017).

[111] s. 90(6) FSMA.

[112] s. 7(3), Sch. 10A FSMA.

(ii) [the power of the Takeover Panel to order the payment of compensation],

(iii) for breach of contract,

(iv) under the Misrepresentation Act 1967, or

(v) arising from a person's having assumed responsibility, to a particular person for a particular purpose, for the accuracy or completeness of the information concerned.

This section also makes clear that the new regime does not affect the potential liability to a civil penalty, criminal liability, or the power to make a restitution order.[113]

The tort of deceit (upon which the 90A regime is based) will thus not be applicable where the 90A regime is operational since it is not preserved in the list above. Item (i) means that an investor who finds that s. 90 FSMA and s. 90A FSMA both apply can use the more favourable s. 90.[114] Item (iv) above renders the Misrepresentation Act available, but this statute is only applicable when a misstatement preceded the formation of a contract between the parties, which is not the case in the continuous corporate disclosure situation.[115] It

113 Ibid. All three measures were considered in relation to the Tesco misstatement, see Chapter 8.

114 This could arguably be the case for an investor who purchased shares in the market on the basis of prospectus disclosures; more on this in the next subsection.

115 The Misrepresentation Act was recently found inapplicable to an investor's purchase of a debt claim in the market based on the issuer's representations. See *Taberna Europe CDO III plc v Selskabet* [2016] EWCA Civ 1262, [2017] 3 All ER 1046, 1062-63.

could be applied to documents falling under s. 90 (or an AIM admission document),[116] but s. 90 would be preferable for a claimant when it is simultaneously available. The Misrepresentation Act is curiously constructed, effectively requiring the claimant to prove all the elements of the tort of deceit apart from the defendant's mental state (a lack of honest belief in the statement), that is: a false representation by the defendant, which he intended the claimant to act upon, thereby causing the action producing the loss.[117] If the claimant establishes these elements, the defendant can avoid liability only if he can show (that is, the burden of proof is reversed here) that the had reasonable grounds to believe that his statement was actually true.

The intention of item (v) above appears to be (as discussed in section 2.2) to preserve the tort of negligent misstatement. Since many continuing disclosure obligations have the purpose of informing the market rather than to improve corporate governance, the availability of a *Caparo* claim for investor-focused disclosures could be useful for aggrieved investors, since the 90A regime requires knowing or reckless misstatements.[118] Distinguished commentators

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[116] There are two reasons a document could be subject to the s. 90 regime: (i) it is a document for admission to a regulated market (which AIM is not) or (ii) it is documenting an offer to the public. When an issuer lists on AIM without making a public offer, neither s. 90 trigger would apply.

[117] Cartwright (n 37) 267.

[118] Davies Review Discussion Paper (n 4) para 43-45. For a similar view, see Davies & Worthington (n 19) 949.

consider it "very unclear" whether *Caparo* could apply;[119] I analyse this in chapter 6.

2.6.2. Distinguishing primary and secondary market disclosures

Drawing a clear line between primary and secondary market disclosures can be difficult if not only primary, but also secondary, market investors use prospectus disclosures as a basis for investment decisions, or if liability for prospectus disclosures is deemed to extend to secondary market investors.

It is clear that a prospectus may influence secondary market investors as well as primary market investors, and in this sense the regime for prospectus liability will arguably functionally overlap with that for continuing disclosures. The most obvious example is the first time a company lists its shares for trading: during the initial period of trading the prospectus will be the source of all relevant information for investors. The prospectus will then gradually be replaced by continuing disclosures as the company issues periodic financial reports and episodic MAR disclosures when material events occur.

Secondary market investors have long sought to be included under the prospectus regime. In *Peek v Gurney* in 1873, "a proceeding [in equity] similar to an action at law for deceit",[120] a secondary market investor argued that the statements in the prospectus were intended to deceive not only subscribers of shares but also secondary market investors:

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[119] Davies & Worthington (n 19) 720.

[120] *Peek v Gurney* (1873) L.R. 6 H.L. 377 HL, 384 (Lord Chelmsford).

> "The mischief done was like that occasioned by a person throwing a lighted squib into a crowd, not one particular person but any or all might suffer from it; it was therefore an act for which, wherever it occasioned mischief, the wrongdoer was by law held responsible to the person, injured."[121]

The House of Lords did not agree. Lord Cairns said that secondary market purchasers were not entitled to damages on the following basis.

> "The allotment having been completed, the prospectus, as it seems to me, had done its work; it was exhausted."[122]

In *Andrews v Mockford*,[123] it was instead held that if a secondary market purchaser could show that the prospectus was meant to induce market transactions, he would have a claim. Commentators, however, generally considered the earlier case of *Peek v Gurney* as containing the main rule.[124] Professor Gower took issue with this approach and argued that prospectuses were typically aimed at, and used by, both primary and secondary market investors:

[121] *Peek v Gurney* (1873) L.R. 6 H.L. 377 HL, 380.

[122] *Peek v Gurney* (1873) L.R. 6 H.L. 377 HL, 410 (Lord Cairns).

[123] *Andrews v Mockford* [1892] 1 Q.B. 372 CA.

[124] For a review of earlier sources, see, e.g., L. C. B. Gower, The Principles of Modern Company Law (1st ed. 1954), 317.

> "[T]his fails to recognise the result of modern issuing techniques. […] [O]n a prospectus issue or offer for sale the prospectus will, under the Stock Exchange Rules, have to be published as an advertisement to lead to the grant of a quotation and those responsible for the issue will arrange with the company for its publication for this purpose. This being so, it seems impossible to argue that they did not intend it to influence purchasers on the market. […] Under modern conditions, those who publicly advertise a prospectus know that it will be relied on indiscriminately by investors who apply on allotment and by those who buy on the market."[125]

The House of Lords subsequent decision in *Derry v Peek* meant that the common law tort of deceit would not be available in cases where only negligence (not intentional behavior) could be proven, a significant hurdle for aggrieved investors to meet. Parliament reversed *Derry v Peek* by providing a statutory negligence-based right of action for prospectus misstatements in the Directors Liability Act 1890; a solution now found in s. 90 FSMA. First, however, the older common law cases of *Peek v Gurney* and *Andrews v Mockford* find their modern-day equivalent in two cases from the 1990s. These newer cases were not actions in deceit, but in negligence, after the decision in *Hedley*

[125] L. C. B. Gower *The Principles of Modern Company Law* (1st ed. 1954) 317.

Byrne v Heller had opened the door to tortious actions for negligent misstatements.

The first of these two modern cases was *AI-Nakib Investments v Longcroft*,[126] in which Mervyn Davies J declined to find a duty of care from directors of a public company to secondary market investors, on the basis that the prospectus did not have the purpose of informing them. Six years later, Lightman J in *Possfund v Diamond* indicated that the opposite approach was possible as he declined to strike out a claim by secondary market investors seeking to establish that persons responsible for a prospectus had a duty of care towards them.[127] Lightman J held that such a duty could arguably be found if the investors could prove that the persons responsible for a prospectus had intended for them to rely on it. He focused particularly on the purpose of the prospectus and, having invited and reviewed testimony on the point, was sufficiently persuaded as to allow the case to go to trial.

The above cases are as far as the common law has come, so we do not have any clear answer to the question of whether a court would consider a prospectus to have an after-market role as well when it comes to the tort of negligence. Davies and Worthington have argued that courts may wish to consider issuers' purposes with prospectus disclosures, specifically that companies issuing securities have a strong interest not only in ensuring that the

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[126] *Al-Nakib Investments Ltd v Longcroft* [1990] 3 All ER 321.

[127] *Possfund Custodian Trustees Ltd v Diamond* [1996] 2 All ER 774.

issue is fully subscribed but that the secondary market for the shares is liquid.[128] It is hard to refute their argument on that basis: an issuer should get a better price for its 'primary' sale of shares if the 'secondary' market for those shares is liquid.

Section 90 FSMA has moved further than the common law in this respect. The first provision in the Directors Liability Act 1890 only mentioned that subscribers were entitled to compensation, but the language was broadened in the Financial Services Act 1986 to cover "any person who has acquired the securities in question".[129] This language remains in s. 90 FSMA today and is generally interpreted to include not only primary market investors but secondary market investors as well.[130] There is no doubt that investors who can establish a claim under s. 90 will prefer this to s. 90A, given that s. 90 offers a negligence threshold (rather than fraud), places the burden on defendants to prove they were not negligent, and does not require reliance. The issue of how long for, exactly, a prospectus may be relied upon has not been answered. A reasonable answer, however, would appear to be that the prospectus may be relied upon for as long as it is the guiding reference document on a particular

[128] Davies and Worthington (n 19) 856.

[129] A history of the design of the prospectus liability provision from its first occurrence in 1890 onwards may be found in *Possfund v Diamond* [1996] 2 All ER 774, 781-783.

[130] See, e.g., remarks *obiter dicta* by Lightman J in *Possfund v Diamond* [1996] All ER 774, 783; Cartwright (n 37) 293; Davies and Worthington (n 37) 851.

issue – that is, as long as there is no information in the issuer's continuing disclosures which change or update the prospectus disclosures.[131]

Davies and Worthington have argued that it is artificial to distinguish between primary and secondary market investors when both rely on the prospectus.[132] If one favours a distinction between primary and secondary market liability, however, there are really only two alternatives: (i) a literal view which draws the line between those who purchase shares from the company and those who transact with other investors in the market, or (ii) a functional view which draws the line between those who transact in reliance (actual or inferred) on the prospectus disclosures and those who do not. There is a trade-off: the first alternative offers issuers clarity and foreseeability in predicting their potential liability, the second alternative does not and extends the more investor-friendly negligence liability into the secondary market. Further analysis of this issue will be offered in section 4.3.6 after first considering the position articulated in the Davies Review.

2.6.3. Private rights of action?

Separate to the statutory rights of action under FSMA just discussed is the question of whether investors may have a private right of action if issuers or

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131 For misstatements that persist for a long time, the statute of limitations may come into play, as in *Hall v Cable and Wireless plc* [2009] EWHC 1793 (Comm).

132 Davies and Worthington (n 19) 856.

directors breach their statutory duties to exercise due care in issuing disclosures or if they engage in market abuse.[133]

A statutory duty claim could make reference to the FCA Handbook which provides that an issuer "must take all reasonable care to ensure that any information it notifies to a RIS is not misleading, false or deceptive and does not omit anything likely to affect the import of the information" and the issuer's directors to "carefully and continuously monitor whether changes in the circumstances of the issuer are such that an announcement obligation has arisen under article 17 MAR." [134] Section 138D(2)-(3) FSMA sets the framework and allows for suits of private individuals who suffer loss as a result of contravention of FCA rules, but also stipulate that the FCA may exclude private rights of action for specified provisions of its rules. The statute itself, further, makes clear that it does not apply to so-called "Part 6 rules",[135] a term which covers the FCA's listing rules, disclosure rules, transparency rules, prospectus rules, and corporate governance rules.[136]

Since we have seen that the 90A regime explicitly preserves certain forms of liability and breaches of statutory duty are not amongst these,[137] it is clear that

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[133] See *Customs & Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, 267 (Lord Bingham), 271 (Lord Hoffmann).

[134] DTR 2.2.8G, DTR 1A.3.2.

[135] Section 138D(5)(a) FSMA.

[136] Section 73A FSMA.

[137] Sch. 10A FSMA, s. 7(3).

the intention of the UK legislature is that actions for breach of statutory duty are not allowed where the 90A regime applies. Further, the mere existence of a statutory duty to take care when issuing investment disclosures does not create a parallel common law duty of care enabling a Caparo action.

A separate issue is whether there is a private right of action for market abuse. Under the prior framework in s. 118 FSMA, *Hall v Cable & Wireless* established that there was not.[138] However, s. 118 FSMA has now been replaced by the MAR, which means that the issue is open for argument: if MAR would be found to provide a private right of action, it would trump the 90A regime and prior English case law. Such a private right of action could arguably be based on Article 12(c) MAR, which bars:

> 'disseminating information through the media, including the internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the […] price of a financial instrument, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading.

There is no clear precedent in this area and it is possible that EU courts could find a private right of action.[139] If this were the case, it would arguably upset the balance the 90A regime seeks to achieve. By protecting disclosures that fall

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138 *Hall v Cable and Wireless plc* [2009] EWHC 1793 (Comm), [2010] 1 BCLC 95, 103-104.

139 In *Muñoz v Frumar*, C-253/00, the Advocate General opined that regulations would give rise to a private right of action as a general rule, but subject to several conditions.

under its purview, the regime incentivizes issuers to publish as much information as possible via a RIS to activate the regime and protect them from other forms of liability (except for those enumerated in Sch. 10A FSMA, s. 7(3)). If it were possible to override the 90A regime by a MAR action this would no longer be the result.

2.6.4. The lack of EU liability rules

While EU disclosure regulation has a strong focus on prescribing the exact items to be disclosed (such as those to be included in a prospectus), there is a curious void of harmonized liability rules. One US commentator has labelled the resulting patchwork of European national liability frameworks a "crazy quilt".[140] We have seen above that member states are free under the TD and the MAR to determine the extent of liability for their continuous disclosure regimes. Clearly, the EU is not aiming for any meaningful harmonization of liability.

It is perplexing why EU regulators appear to believe that harmonization of substantive disclosure rules without similar harmonization of liability can bring about an integrated capital market. In order to accomplish a similar standard of corporate disclosure across the EU, the incentives for insiders who consider whether and how much to disclose would need to be harmonised as well. Since such insiders' incentives relating to disclosure will depend on the consequences

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[140] Merritt B. Fox, 'Initial Public Offerings in the CMU: A US Perspective' in Danny Busch, Emilios Avgouleas and Guido Ferrarini (eds, OUP 2018) *Capital Markets Union in Europe* 268, 296.

of non-compliance, both the design of liability and the intensity of enforcement would need to be harmonized to create a truly unified playing field. If issuers in country A are liable for ongoing disclosures on a negligence basis and subject to significant monitoring by their financial supervisory authority but issuers in country B are liable only on a fraud basis and the supervisory authority does not prioritise corporate disclosure, we should not expect the same disclosure quality from issuers in these countries. Presumably, EU regulators are harmonizing only disclosure obligations and not the associated liability provisions because the latter is politically unachievable,[141] but this significantly limits the overall effectiveness of the system. It is arguably questionable whether there is any benefit in continuing to revise and refine the disclosure obligations on EU level without considering liability provisions.

2.7. Administrative and criminal liability

The focus of this thesis is not to extensively cover criminal law or the administrative framework, so this section will simply note these rules at a high level.

Under ss. 382-384 FSMA, the FCA can require restitution for market abuse or breaches of its rules. This power has been used once in the disclosure context (Tesco; chapter 8). The FCA can also impose penalties for breaches of FSMA or its Handbook under s. 91 FSMA.

[141] See, e.g., Ferran (n 73) 188-193.

The 90A regime does not have any effect on criminal liability.[142] Relevant statutes which could be deployed would include the Theft Act. The Serious Fraud Office applied s. 17 of this act ("false accounting") to enter into a deferred prosecution agreement with Tesco plc after their 2014 misstatement to the market. Section 19 ("false statements by company directors") could also be relevant. The Tesco executives were also charged with "fraud by abuse of position" under the Fraud Act 2006. Sections 89 and 90 FSA 2012 render criminal the acts of knowingly making false and misleading statements and creating misleading impressions, respectively. Part V of the Criminal Justice Act criminalizes certain types of market abuse, including improper disclosure of information.[143]

2.8. Preliminary conclusions

The purpose of this chapter was to understand the reasons behind the introduction of the 90A regime and place it in the context of other possible civil remedies to aggrieved investors. In drawing these preliminary conclusions, we may ask what the addition of the 90A regime has achieved.

An initial reflection on the debate surrounding the introduction of the 90A regime is that it appears to have been based in part on a questionable interpretation of the tort of negligent misstatement. The 90A regime was precipitated by arguments to the efffect that *Caparo* actions could be pre-

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[142] Section 7(3)(c) Sch. 10A FSMA.

[143] This will not be discussed further herein. For further details see Sarah Clarke, *Insider Dealing: Law and Practice* (OUP 2013).

empted if the EU changed the wording of the TD. In my opinion (explained in section 2.3), this was never the case.

Section 2.4 outlined why it is not convincing to claim that the UK needed to implement a particular disclosure liability regime to fulfil its obligations under EU law. The remaining reason for introducing the 90A regime would then be that it was needed to ensure that the judiciary would not use the TD to significantly expand negligence liability (notwithstanding that *Caparo v Dickman* itself was an example of how reticent courts are to make sweeping changes in the application of this head of liability). The 90A regime does, of course, provide additional legal certainty to issuers in that certain other causes of action are barred when it applies.[144] For example, actions in deceit are precluded,[145] but this is hardly a paradigm shift since the 90A regime is modelled on that head of liability. However – and this *is* surprising – the 90A regime may not have achieved its main purpose, which was to prevent an expansionary interpretation of *Caparo*. Section 2.6.1 above only offered a high-level treatment of this issue, which stems from the fact that *Caparo* liability appears to be preserved as one of the causes of action that remain available in parallel to 90A actions. This issue requires a more significant review, not

144 Section 7(1) Schedule 10A FSMA stipulates that other causes of action are not available when the 90A regime applies, apart from those explicitly mentioned in s. 7(3)(a) of that schedule.

145 This is because this head of liability is not among those preserved through s. 7(3)(a) of Schedule 10A FSMA.

suitable for this introductory chapter, so I will analyse this in detail in chapter 6.

The 90A regime applies to all information disclosed via an RIS. Issuers can therefore, in theory, use the 90A regime as a "safe harbour" by opting to disclose via an RIS. This gives them the benefit of a relatively high hurdle to liability (where a plaintiff would need to prove that a director was reckless) in return for broad public disclosure of the information. This is neat, but it is not much of a "safe harbour" if *Caparo*-liability remains.

Compared to the situation before its introduction, the 90A regime offers a clear statutory structure, includes all RIS disclosures, and provides standing to investors who would not have standing in a deceit action (such as investors who continue to hold shares), but these appear to be relatively modest changes. Since fraud was already illegal, the question of whether the introduction of the 90A regime was actually necessary lingers.

3. The function of corporate disclosure

3.1. Introduction

The purpose of this chapter is to examine the function of the ongoing disclosure regime. One may ask why an ongoing disclosure regime is desirable at all. This question has at least three different aspects, which will be answered briefly:

- "Why should issuers *disclose information*?"
- "Why should *issuers* disclose information?" and
- "Why is a *regime* (involving a mandatory component) necessary?"

To answer the question of why disclosure is necessary at all, we note that commentators have attributed many benefits and purposes to corporate disclosure. As a matter of taxonomy, these purposes are frequently subsumed under two broad categories: improvement of securities price accuracy and improvement of corporate governance,[146] but it is difficult to disentangle the

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[146] See, e.g., Reinier Kraakman, 'Disclosure and Corporate Governance: An Overview Essay', in G. Ferrarini, K. Hopt & E. Wymeersch (eds) *Reforming Company and Takeover Law in Europe* (OUP 2004) 95-96, Eilis Ferran, *Building an EU Securities Market* (CUP 2004) 127-28. Other ways of classification exist – Fox has distinguished between an investor protection function and a corporate governance function; see Merritt B. Fox, 'Required Disclosure and Corporate Governance' (1999) 62 Law and Contemporary Problems 113, 115.

two.[147] Fox has argued that an important role of corporate disclosure is to reduce agency costs between investors and insiders. Disclosure relating to transactions in which managers have a conflicting interest, such as the determination of executive compensation or other transactions between managers and their firms, are an obvious example of how disclosure can act to reduce agency costs.[148] Corporate disclosure also acts in a broader way to limit managerial agency costs. The regular supply of financial statements, for example, informs shareholders of how managers run the firm and enables an informed assessment of the quality of management, the use of the firm's resources, and the likelihood of shirking. Such general disclosures consequently also serve to limit the scope of potential managerial opportunism. Enriques and Gilotta have summarised the benefits of public disclosure, and also focus on its role in reducing managerial agency costs.[149] They also argue that it enhances price accuracy, which improves liquidity, decreases share price volatility and the cost of capital, and promotes allocative efficiency. Standardisation and comparability are also important benefits, as it enables investors to compare different investments.

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[147] We will see, for example, in section 3.2.5 that improved price accuracy may provide useful signals to managers deciding on real resource allocation within firms, meaning that the market price itself can have governance implications.

[148] Paul G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 University of Chicago Law Review 1047.

[149] Luca Enriques & Sergio Gilotta, 'Disclosure and Financial Market Regulation' in Eilís Ferran, Niamh Moloney and Jennifer Payne (eds), *The Oxford Handbook on Financial Regulation* (OUP 2015) 512-536.

As regards the second question above, the analysis in this thesis assumes that issuers disclose information. It is difficult to imagine a situation where this would not be the case because of the effects of the information asymmetries that would otherwise arise. In a world where outside investors did not have any information about the characteristics of available investment opportunities, they would likely never invest in the first place. They would face a "market for lemons" where higher-quality firms would not be incentivised to participate, and such a market would never form or unravel.[150] Information about issuers is consequently required to make the market work. And the least-cost providers of such information are clearly the issuers themselves. It would be more costly for shareholders to acquire and verify information than it is for issuers to distribute information about themselves that they will often already have available.

This conclusion does not imply, however, that issuers would volunteer to disclose information, which leads us to the third question above. One may think that the information asymmetry problem that would arise without issuer disclosure would be simple: those seeking to sell shares of higher-quality companies will "signal" their quality to buyers in ways that vendors of inferior products are unable to replicate. Some commentators have indeed suggested that firms would voluntarily disclose the information investors require to overcome information asymmetries and that mandatory disclosure obligations

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[150] George A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism', 84 Quarterly Journal of Economics 488 (1970).

therefore are unnecessary.[151] Mahoney has presented a more nuanced version of this argument: mandatory disclosure obligations were originally introduced to address agency problems between the issuer's insiders and outside investors and should generally be limited to such concerns.[152] Fox has further developed Mahoney's argument by arguing that *all* disclosures have an agency component since managers may only receive small personal benefits from disclosures in relation to the social benefits available.[153] Fox's argument is persuasive and appears better grounded in practice, as will be further analysed and substantiated in Chapter 7 in relation to insiders' strategic use of information (such as selective disclosure).

Commentators in favour of mandatory disclosure rules, including Bebchuk and Fox,[154] have emphasised the positive externalities they produce in the form of information that may be used by other firms. Davies has similarly characterised mandatory disclosure regimes as a 'subsidy by companies to analysts working

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151 See, e.g., Roberta Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 Yale Law Journal 2359 and Jonathan R. Macey, 'Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty' (1994) 15 Cardozo Law Review 909.

152 Paul G. Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995), 62 University of Chicago Law Review 1047.

153 Merritt B. Fox, 'Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment' (1999) 85 Virginia Law Review 1335, 1355-57.

154 See, e.g., Lucian Arye Bebchuk, 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law' (1992) 105 Harvard Law Review 1435, 1490-91; Fox (n 153).

in the securities markets',[155] which makes sense if we consider 'analysts' to mean investors and those who do research work on their behalf, whether on the buy-side or on the sell-side. Enriques and Gilotta conclude that without mandatory disclosure rules, less information than socially desirable would likely be produced. [156] In summary, most commentators agree that mandatory disclosure obligations are positive although their exact scope can be debated.[157]

3.2. The mechanisms of investor protection

3.2.1. A model: From issuer disclosure to investor protection

One important reason why a firm's shareholders may choose to list its shares on a trading venue and make them available for investment by the general public is that the firm may be able to raise capital more cheaply. This will obtain because investors will have a secondary market for the shares they buy, so the investment will be more liquid, and also because the firm's commitment to an ongoing disclosure regime reduces investors' risk. In turn, this helps society mobilise capital for projects.

Investor protection is one of the most prominent reasons for disclosure rules in EU capital markets regulation.[158] The term "investor protection" is typically

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[155] Davies Review Discussion Paper (n 4) 8.

[156] Enriques & Gilotta (n 149).

[157] See, e.g., John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer & Jennifer Payne, *Principles of Financial Regulation* (OUP 2016) 166-67.

[158] TD Recitals 1, 5, 7, 27 and 36, MAR Art. 1 and PR, Recitals 3, 4, 7, 10, 15, 21, 51, 56, 71, 74 and 78 emphasise investor protection.

used to refer to legal strategies that protect unsophisticated investors from being taken advantage of,[159] and is an umbrella term that includes other techniques such as the regulation of the design of investment products or their distribution. In the public capital markets, however, the EU has focused on disclosure, on the basis that it provides "protection" by neutralising information asymmetries between insiders (who know the strengths and weaknesses of the firm) and outside investors (who do not).[160]

EU regulations refer to various concepts as prerequisites for investor protection. Among them are "investor confidence", "market efficiency", "market integrity", and an "informed assessment [of information]". The TD, for example, motivates its disclosure requirements as follows:

> "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. This enhances both investor protection and market efficiency."[161]

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[159] Niamh Moloney, *How to Protect Investors* (CUP 2010) 46; Enriques & Gilotta (n 149) 514. One commentary explicitly regards the "investors" as passive investors; see Gerard Hertig, Reinier Kraakman & Edward Rock, 'Issuers and Investor Protection' in Reinier Kraakman et al, *Anatomy of Corporate Law* (2nd edn. OUP 2009) 275.

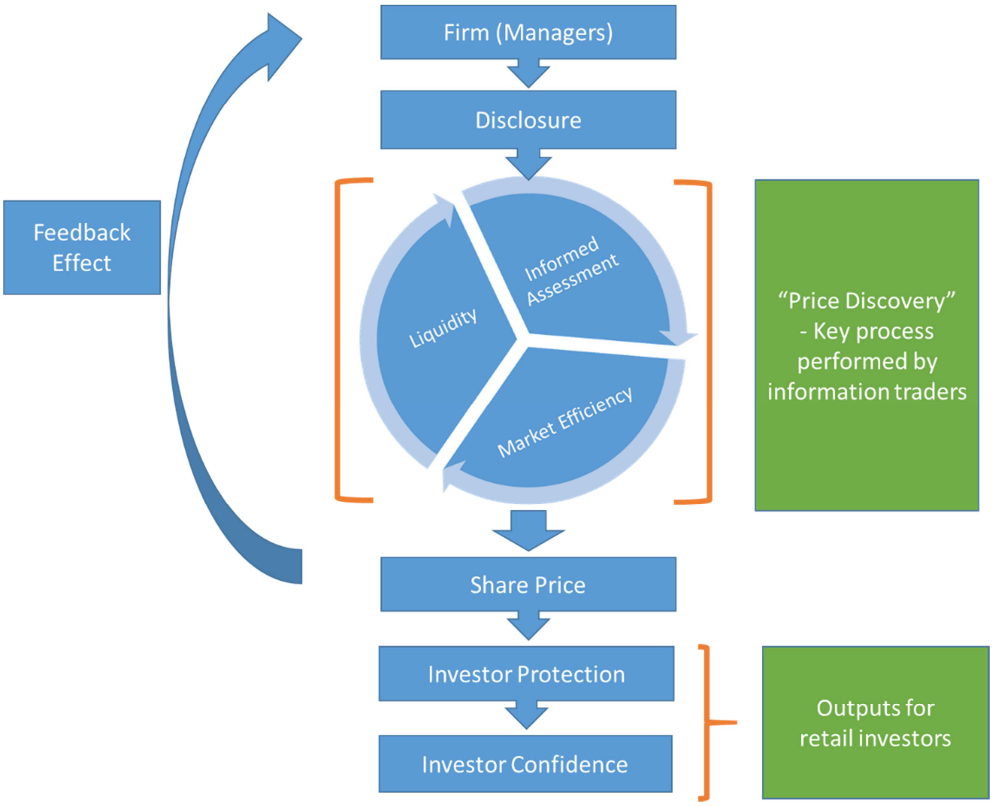
[160] See, e.g., Armour et al (n 157) 62.

[161] TD Recital 1. Its recitals 5, 7, 27 and 36 also emphasise the goal of investor protection.

Similar to the model proposed in this Chapter, the quoted motivation views the informed assessment as a step to investor protection, although the causal connections are unclear. The directive recognises that the "informed assessment" does not occur automatically, but the relationships between the building blocks of "investor confidence", "informed assessment", "investor protection" and "market efficiency" are vague.

This chapter will offer a simplified model to integrate these concepts in a functional way. In this model, "investor protection" is the outcome of a process which is not well described in EU capital markets regulation. The level of investor protection will depend on the quality of the inputs to this process and the quality of the process itself. The key process is "price discovery", where information traders analyse the impact of new information disclosed by firms to decide whether to buy or sell shares, and the price and volume at which to do so. Through their trading, the share price will adjust to incorporate the new information. Retail investors who do not have the capability to evaluate the valuation impact of new information will not influence the price but will be protected by trading at the same price as information traders. This model is sketched out in Figure 1 and the components will now be discussed in more detail.

Figure 1: The mechanisms of investor protection



3.2.2. Model input: Information disclosed by the firm

The process starts with information disclosed by the managers of the firm. There are of course information from other sources that can be relevant to the pricing of shares, but the corporate disclosure regime is the focus here.

The investors that conduct an "informed assessment" (in the words of the TD) may assess disclosures in more than one dimension. Some information that issuers disclose may be considered not to have any relevance to the share price at all, while some types of information may be relevant both for purposes of trading and for exercising shareholder rights in relation to the firm. Further, investors are heterogeneous, so the assesment of what is relevant to share price may vary depending on the identity of the investor. Some investors may, for example, have investment criteria that make them sensitive to disclosures about environmental impact or prohibit them from investing in certain sectors (such as tobacco products). Information traders may therefore make different assessments of the value-relevance of disclosures, and it is through a process of trading between several heterogeneous information traders that the new price is "discovered".

3.2.3. Price discovery and the importance of information traders

The "Jesus nut"[162] of a well-functioning market is that there are capable investors willing to review corporate disclosures to assess the impact on the firm's value and then trade on the basis of that assessment so that the share price adjusts to reflect it.[163] This activity – information trading – requires special expertise in financial analysis and corporate valuation, as well as an understanding of the stock market's current pricing and expectations of individual issuers. It therefore requires significant resources and is performed by active investors, sometimes assisted by sell-side financial analysts whose

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162 The critical nut that ensures the rotor blades stay affixed to the helicopter.

163 For corporate disclosure requirements aimed at facilitating shareholder voting, such as disclosure in relation to related party transactions, the information trader may assess both the trading aspect of the information and whether to exercise shareholder rights. How shareholders use information as the basis for active investment decisions and may be compensated when firm disclosures are misstated is the subject of Chapter 6. For purposes of this chapter, we will just note that information that may appear to predominantly have a corporate governance function will also be analysed for information trading purposes and can have a price impact.

business model includes researching and disseminating investment ideas. A typical example of an active investor is an institution such as a mutual fund.

Retail investors, on the other hand, lack by definition both the expertise and the resources of information traders. They lack the expertise of translating disclosures into a view on securities pricing and it is not cost-effective for them to attempt to acquire such expertise given the amounts they invest. As a result, they do not read corporate disclosure documents. For retail investors, it is more efficient to invest in a mutual fund and pay an active investor to manage their funds for them.

The quality of the inputs to the price discovery process is important since it will affect the ultimate output, the level of investor protection achieved. While it does not appear as a prominent rationale in the EU's disclosure rules, these rules appear well-designed to promote a competitive market among information traders.[164] EU regulation stipulates four attributes of corporate disclosures, namely that they shall be:

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[164] For the argument that US securities regulation is aimed at protecting information traders, see Z. Goshen & G. Parchomovsky, 'The essential role of securities regulation' (2006) 55 Duke Law Journal 711.

- accurate;[165]
- comprehensive;[166]
- timely;[167] and
- equally distributed.[168]

The requirement that information be *accurate* is, naturally, fundamental to information traders. In order to be willing to trade on the information they receive, they need to be able to rely on it without further research or inquiry.[169] Where information traders receive accurate information disclosed by firms, trust it and trade promptly, the informational efficiency of prices will be high. Such informational efficiency is usefully portrayed as a relative concept rather than a binary measurement. Different types of information will become incorporated into share prices through different mechanisms and, as a result, with varying speed or "relative efficiency".[170] Public disclosure of information by firms is a type of information which will be incorporated into prices with high relative efficiency, since all information traders will receive the information without cost. It must be recognised, however, that an informationally efficient market price is not the same as the fundamental value

165 TD Recital 1 ("accurate"), MAR, Art. 17 ("correct").

166 TD Recital 1 ("comprehensive"), MAR, Art. 17 ("complete").

167 TD Recital 1, MAR Art. 17.

168 TD Recital 22, MAR Article 17(1) (issuer shall ensure equal treatment).

169 The liability regime naturally plays a role here as well; this will be analysed in chapter 4.

170 Ronald J. Gilson & Reinier H. Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Rev 549, 558-60 (introducing the concept of relative efficiency and, among other things, arguing persuasively that the size of the group of initial recipients of information will impact how quickly it becomes incorporated into price). See further chapter 7.

of the security, i.e. the present value of all future cash flows.[171] Informational efficiency only requires that the available information is incorporated into prices, but it does not speak to the amount of information available. If very little information is available, the share price may therefore deviate significantly from the hypothetical price that investors would reach if they had all the privately available information. A larger amount of public information will not have any direct impact on the efficiency of the market, but its incorporation into prices will reduce the dispersion in estimates of the value of the security. However, even with very little information, the share price will be "unbiased" if the market is efficient that is, it will reflect the best market estimate of value.

Another important requirement is therefore that disclosures be not only accurate but also *comprehensive*. If they were fragmented, leaving out significant pieces of information, the absence of information would deter information traders from trading aggressively to incorporate the bits of information they have received, out of fear that others in the market could have a better picture. Such asymmetries of information thus lead to the incorporation of a risk premium into share prices, which means more cautious trading. When disclosure is both accurate and comprehensive, however, and the market is

[171] See, e.g., Ronald J. Gilson & Reinier Kraakman, 'Market Efficiency after the Financial Crisis: It's Still a Matter of Information Costs' (2014) 100 Virginia Law Rev 313, 321-26 (discussing informational efficiency and fundamental value).

efficient, the share price will exhibit less expected deviation from fundamental value.[172]

The requirement for *timely* disclosure similarly encourages information traders to trade because it protects them from asymmetries of information. Without a requirement for immediate disclosure of inside information, the risk of leaks (whether intentional or unintentional) increases, meaning that other traders in the market could already have access to the information. Timely disclosure therefore gives information traders more confidence to trade, which should improve the accuracy of the share price at any given time.

The fourth requirement that corporate disclosures be *equally distributed* also serves to reduce information asymmetries and allows traders to trade confidently on new information. While EU regulation emphasises "fairness" in information distribution for purposes of promoting the integrity of the capital markets and investor confidence,[173] this concept can be interpreted in many different ways.[174] The idea is that investors would abandon the markets if they were structurally disadvantaged. Unsophisticated retail investors *are* however structurally disadvantaged insofar that they do not have access to the amount

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[172] Fox (n 153) 1369-70.

[173] For example, MAR Recital 23 considers "[t]he essential characteristic of insider dealing" to be "an unfair advantage being obtained from inside information to the detriment of third parties who are unaware of such information and, consequently, the undermining of the integrity of financial markets and investor confidence." Recital 24 contains another strong statement about equality.

[174] See, e.g., Frank H. Easterbrook, 'Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information' (1981) Sup. Ct. Rev. 309.

of information that professional investors do. Further, they do not, by definition, spend their time uncovering profitable trading opportunities. While the regulatory objective thus may be described as fairness of *opportunity* insofar as firms' distribution of information is concerned, in reality this opportunity is only available to information traders who digest corporate news immediately upon release and incorporate it into securities prices. When information traders can be certain that information is equally distributed among market participants, they can confidently trade new information into prices without fearing that other traders know more than they do. Equal distribution of information thus motivates information traders to evaluate corporate disclosures and to trade as soon as possible after the information is released, lest the opportunity is taken by other information traders.

When corporate disclosures fulfil more of these four attributes, share prices will be increasingly accurate. When share prices are more accurate, the quality of capital allocation between different projects in society and investor protection will be improved. Share price accuracy is therefore a suitable policy goal for disclosure regulation.[175]

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[175] This does not mean that share price accuracy should be pursued at any price, however. The societal costs and benefits of corporate disclosure obligations have to be weighed against each other so that the companies subject to them do not end up unable to undertake beneficial, innovative projects that require some level of secrecy.

3.2.4. Model output: Retail investor protection

The PR offers clues to how EU capital markets regulation views the investor protection concept. It explicitly acknowledges that there are different types of investors: qualified investors, who can fend for themselves and do not need the disclosures it mandates, and the general public, who needs its protection.[176] The underlying view is that qualified investors know how to analyse and price investment opportunities and what information they need in order to do so. On that basis, they will not invest if they do not receive the information they need to fulfil this function, or if the price demanded is higher than warranted. The PR can therefore be said to view these qualified investors as "price setters".

At the same time, the PR appears to view retail investors as able to absorb financial information and price shares, that is not purely as "price takers".[177] This is a misconception.[178] While retail investors are unable to value shares even with access to the same information as professional investors, they do not need this skill as long as the market is efficient. In secondary markets, unsophisticated investors will trade at the unbiased market price on the same

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176 PR Recital 19.

177 For a critique, see Luca Enriques, 'EU Prospectus Regulation: Some Out-of-the-Box Thinking' (2017) 4 Revista Lex Mercatoria 39 (arguing persuasively that, in primary markets, retail investors can free-ride on the book-building process).

178 Armour et al (n 157) 162.

(or substantially similar) terms as professional investors.[179] Retail investors are consequently protected through the share price, and can free-ride on the work of information traders.

3.2.5. The feedback effect of share prices

Some disclosure obligations are directly aimed at enabling "direct" influence on corporate governance, such as shareholder approval of the annual report. But disclosure also allows for "indirect" corporate governance influence through the share price.

Accurate share prices will not produce any societal benefits until they affect the real economy. As secondary market trading does not directly impact resource allocation decisions within firms, we need to understand the mechanisms through which market prices can transmit information to guide the decisions of corporate managers.

The analysis of how the information content of market prices can affect real allocational decisions dates back to at least Hayek.[180] Hayek's examples were such that the change in price was the only signal necessary (e.g., a higher price for one input commodity induced producers to switch to other inputs). Attempting to decode a change in market price to learn the underlying reason, as is required in order for managers to learn in the stock market setting, will be harder. This difficulty will however be mitigated by the facts that (i) the

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179 For an extended version of this argument, see Merritt B. Fox, 'Securities Disclosure in a Globalizing Market: Who Should Regulate Whom' (1997) 95 Michigan Law Review 2498, 2533-39.

180 F.A. Hayek, 'The Use of Knowledge in Society' (1945) 35 American Economic Review 519.

immediate market reaction to firm disclosures will make it clear what the market assessment of a particular disclosure item is, and (ii) for market-based incentive compensation to work, the manager only needs to trust that the market price will take the firm's public disclosures into account.

Stock prices (and stock price reactions to company disclosures) can act as a signalling device since managers can use this information to affect project choice within the firm. As investors evaluate corporate disclosures and trade on their findings, they transmit information to managers that can assist them in making investment decisions and reward them for historical investment decisions through incentive pay. Stock price informativeness thus has both a retrospective function (reward managers for past incentive pay) and a prospective function (guide capital allocation).[181] Empirical studies support the proposition that managers can learn from stock prices when making investment decisions,[182] engaging in mergers and acquisitions,[183] and deciding

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181 See James Dow & Gary Gorton, 'Stock Market Efficiency and Economic Efficiency: Is There a Connection?' (1997) 52 Journal of Finance 1087.

182 Art Durnev, Randall Morck & Bernard Yeung, 'Value Enhancing Capital Budgeting and Firm-Specific Stock Return Variation' (2004) 59 Journal of Finance 65 (finding evidence which suggests that the more informative stock prices are, the more efficient is corporate investment); Qi Chen, Itay Goldstein & Wei Jiang, 'Price Informativeness and Investment Sensitivity to Stock Price' (2007) 20 Review of Financial Studies 619 (finding evidence suggesting that managers learn from private information in stock prices and that it affects their investment decisions).

183 Yuanzhi Luo, 'Do Insiders Learn from Outsiders? Evidence from Mergers and Acquisitions' (2005) 60 Journal of Finance 1951.

on corporate cash savings.[184] Increased informational content in stock prices, through corporate disclosure or otherwise, can thus lead to an improvement in societal capital allocation.[185] These empirical findings also support the argument that firms ought to disclose information relating to matters that information traders know less about than the firm itself does, since this reduces the uncertainty for information traders to trade more aggressively on their own information, which in turn increases the firm's ability to learn from market prices.[186]

When a firm's shares trade in a well-informed and efficient market, indirect corporate governance benefits are also generated. These include the disciplining effect of the market for corporate control and the availability of share price-based incentive compensation.

An accurate share price enables a more effective market for corporate control by pricing the shares of companies with less skilled managers lower than other firms. Firms with more skilful managers may then find it profitable to acquire

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184 Laurent Fresard, 'Cash Savings and Stock Price Informativeness' (2012) 16 Review of Finance 985.

185 James Dow & Gary Gorton, *Stock Market Efficiency and Economic Efficiency: Is There a Connection?*, 52 J. FIN. 1087 (1997). Share price efficiency is not a sufficient condition for efficient societal capital allocation, however. Theoretical models show that improved informational efficiency may not always lead to improved allocational efficiency; for a summary of these studies and the conditions under which they hold, *see* Philip Bond, Alex Edmans & Itay Goldstein, 'The Real Effects of Financial Markets' (2012) Annual Review of Financial Economics 339, 343-46.

186 Philip Bond & Itay Goldstein, 'Government Intervention and Information Aggregation by Prices' (2015) 70 Journal of Finance 2777, 2782.

the underperforming firm and combine it with theirs. In this way, managers are constantly evaluated through the market price of their firms. An accurate share price also increases the effectiveness of share price-based compensation. When managers know that the market for their firms' shares is well-informed and efficient, they can trust that their share price-based incentives will reflect their skill level in running the firm. They will thus see a link between how well they run the firm and their own payoffs. An efficient share price also helps bridge time horizon problems in managerial pay. As the expected duration of the firm is typically longer than that of the manager in the firm, a well-informed and efficient share price will also ensure that the share price will reflect the present value of the actions the manager has undertaken that will have an impact beyond his or her tenure.

3.2.6. Positive externalities and network effects

There may also be epiphenomenal benefits to corporate disclosure. Information that a firm makes publicly available is a public good, which may be of benefit to entrepreneurs seeking to understand how the market values different business projects.[187] Prospective investors also benefit by receiving information about public firms as investment options without paying for it.[188]

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187 See, e.g., William H. Beaver, The Nature of Mandated Disclosure, in *SEC Advisory Committee on Corporate Disclosure, Report of Recommendations* 618, 627 (1977). *See also* Thierry Foucault & Laurent Frésard, Learning from Peers' Stock Prices and Corporate Investment, Working Paper (March 2013) (showing that the stock market valuation of peers matters for firms' investment decisions).

188 Beaver (n 187) 627-28.

Despite such benefits to others, disclosure may be under-produced since the disclosing firm is unable to internalise the benefits it provides or charge the beneficiaries.[189]

Perspective is crucial, however. A public firm that is forced to make disclosures itself benefits from such systematic externalities provided by other firms. Thus, the overall impact on a firm participating in a mandatory disclosure system could be net positive or negative. The obvious net beneficiaries of a mandatory disclosure regime will be non-reporting firms. It is not clear, however, that any current disclosure obligation is so intrusive as to actually confer competitive disadvantages on reporting firms.[190] US commentators have argued that this potential competitive concern is solved in practice by granting managers discretion in disclosures so that they do not need to disclose competitively sensitive information.[191] It is an interesting question whether this is also the case in the EU – certainly, information which is not material enough to qualify

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189 Beaver (n 187) 626-32.

190 Fox has argued that inter-firm costs were a strong reason for imposing mandatory disclosure in the US and that US disclosure obligations now contain plentiful disclosure requirements that "could seriously hurt the issuer", but did not seek to show any practical impact of the US disclosure system; *see* Fox (n 172) 1353-54.

191 Mahoney (n 152) argues that no sensitive information actually has to be released under the US mandatory disclosure system. Even if this were the case, corporate disclosures can still bring positive externalities. For example, even basic company data such as financial statements combined with the market's valuation of the company provides entrepreneurs and others with information of how the market values the company, which they may use for private transactions or in deciding whether or not to embark on a particular project.

as "inside information" is not required to be disclosed, and Chapter 7 will further explore how the practical application of the materiality concept appears to allow for a similar solution here.

Another way to consider the issue would be to argue that by going public, a firm elects to bond itself to a regime which requires such disclosures. Firms with information-sensitive operations, perhaps with a disruptive innovation project, will thus not opt into the regime of financing themselves in the public markets if it requires them to disclose an amount of information that would prematurely alert their competitors.[192]

Finally, disclosures by one firm may contribute to network effects. The more firms in a certain industry that have publicly traded securities, for example, the more economies of scale will be offered to financial analysts to review their disclosures and undertake information trading. For example, there is evidence that firms choose to list on the exchange where its industry peers are already listed, which indicates that there may be positive network externalities to firms of subjecting themselves to similar disclosure requirements.[193] Increased

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192 This is a point which Mahoney (n 152) does not make. His argument is focused on the lack of objection to disclosure requirements among managers of already listed firms; Mahoney (n 152) 1103.

193 Shane A. Corwin and Jeffrey H. Harris, 'The Initial Listing Decisions of Firms That Go Public' (2001) 30 Financial Management 35.

liquidity may in turn lower the cost of capital as it reduces the component of the risk premium consisting of illiquidity risk.[194]

3.3. Preliminary conclusions

The four attributes that EU securities regulation requires of corporate disclosures – accuracy, comprehensiveness, timeliness, and equal distribution – support information traders. The positive law thus appears to be aimed at supporting the work of information traders. This is further supported by the MAR's definition of inside information to be such that a "reasonable investor" would use for its investment decisions, where the reasonable investor is assumed to make a complete assessment of the relevant information in light of all of the firm's other public disclosures, the reliability of the source, and other market variables likely to affect the financial instrument in question.[195] It is not reasonable to expect a retail investor to have the resources and insights to be able to perform such an evaluation.

By facilitating the work of information traders, retail investor protection is also achieved, but not through the disclosures themselves (as sometimes is claimed) but through the share price mechanism: retail investors transact in the market on terms broadly similar to informed institutional investors.

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194 The more liquid the market for a company's shares is, the lower will the illiquidity risk be, meaning that investors will on the margin pay more for a security with higher liquidity. See, e.g., Merritt B. Fox et al, 'Securities Market Issues for the 21st Century: An Overview' in Merritt B. Fox et al (eds) *Securities Market Issues for the 21st Century* (2018) 11.

195 MAR Article 7.4 and Recital 14.

The positive effects of accurate share prices mean that the support of information traders is not only the current *positive* situation but also a suitable *normative* goal for securities regulation: by encouraging information traders to take part in the market, share price accuracy is enhanced, which improves market efficiency and liquidity in a virtuous cycle as laid out in Figure 1 above. Recognizing that corporate disclosures should be aimed at professional information traders also has further implications: there is no need for EU regulators to prescribe detailed formats for prospectus summaries, but it may be important to provide data in a machine-readable format.[196] It also means that the focus on *equality of distribution* of information is not necessarily required, as long as companies provide an *equality of opportunity* to receive information. This will be discussed and analysed further in chapter 7 in the context of selective disclosure regulation.

The next chapter will explore the design of disclosure liability and will involve consideration of, among other things, the importance of supporting information traders with a robust liablity framework for corporate disclosures.

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[196] For similar thoughts, see Charles R. Korsmo, 'The Audience for Corporate Disclosure' (2017) 102 Iowa Law Review 1581.

4. The promise of issuer liability

4.1. Introduction

When high transaction costs preclude private contracting, the imposition of liability through regulation may be an efficient method to cause a party to internalise the costs of its behaviour. Capital market transactions are a good example: it is not feasible for all investors to negotiate terms and warranties with publicly listed companies (or each other) before buying and selling shares in the market. A civil liability regime offers a solution to this problem by providing standard terms of investment. A regime without civil liability would also provide standard terms of investment, however, and this chapter will therefore also consider alternatives to liability.

Established theory in the economic analysis of tort law states that our overall goal when evaluating alternative regulatory liability regimes ought to be to minimize the total costs of misstatements, the costs of avoiding misstatements, and the costs of the sanction regime itself, and this will be used as the guide for this chapter, albeit in an admittedly abstract way.[197] However, a public firm's disclosure is not an activity that allows for a straight-forward application of those theories for when and how to impose liability. This is because the standard models assume that the harm is a consequence of a productive

[197] *See*, e.g., Guido Calabresi, *The Cost of Accidents* (Yale 1970) 26; Steven Shavell, *Foundations of Economic Analysis of Law* (Belknap, HUP 2004) 178. Shavell, at least in this context, does not mention the cost of the sanction regime itself.

activity of the firm.[198] In the models, social costs are imposed in two ways: by performing activities in an excessively risky manner (a logistics company that has not trained its lorry drivers) and by engaging in too much risky activity (more driving leads to more expected accidents).[199] By imposing strict liability on logistics firms for their employees' accidents, we can ensure that the they will internalize all social costs associated with accidents and optimize their activity levels.

However, since this standard argument is focused on the productive activity of the firm, it does not translate easily to the corporate disclosure setting. Even though we may have concerns about excessively *risky* disclosure, we should have fewer concerns about excessive *amounts* of disclosure. While excessive amounts of disclosure may be inefficient, we would expect information traders to be able to find the pieces of information that are actually value-relevant with relative ease.[200] Further, it may be that liability can only ever be expected to play a minor role in ensuring that corporate disclosures are accurate. One reason is that it is difficult to design issuer liability so that it 'trickles down' with sufficient vigour to those insiders who actually draft and fact-check disclosures in the name of the company. Another is that the insiders responsible for a misstatement could not possibly be expected to have the

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198 *See*, e.g., Shavell (n 197) 193, 209.

199 Reinier Kraakman, 'Economic Policy and the Vicarious Liability of Firms', in J. Arlen (ed, Edward Elgar 2013) *Research Handbook on the Economics of Torts* 238.

200 Another reason why we should be less concerned about excessive amounts of disclosure is that managers appear to prefer to disclose as little as possible; see Chapter 7.

funds to compensate investors. This chapter will explore both issuer liability and director and officer liability, as well as possible alternatives.

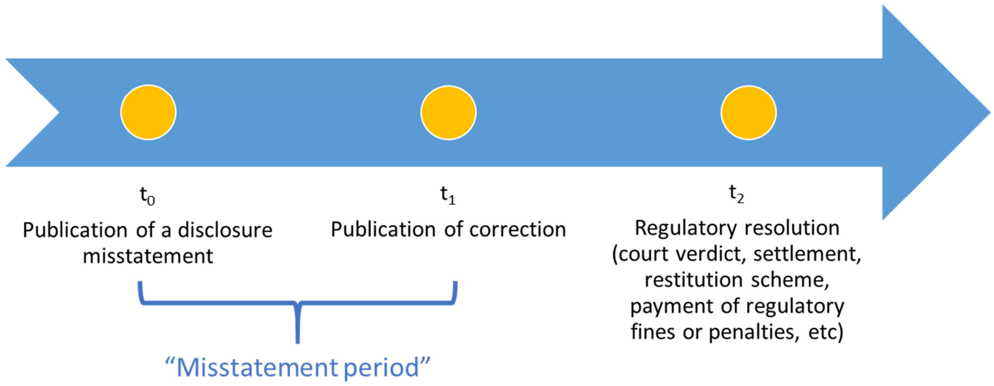
4.2. Anatomy of a disclosure misstatement

To analyse the effects of issuer liability, a typical but simplified timeline for a misstatement is presented in Figure 2 below. At t_0 the firm publicly discloses information containing inaccurate information – assume (as is the standard case) that the misstatement presents the firm in an overly positive light.[201] At t_1 the firm corrects its public disclosure by issuing a public statement that the previous information was wrong and releases the correct information instead. The efficient capital markets hypothesis implies that investors in liquid public markets incorporate new information into share prices more or less

201 Empirical observations suggest that it is reasonable to focus on attempts to overstate, rather than understate, the value of securities as the standard situation. In work on misstatements of US companies' ongoing disclosures, Arlen & Carney presented evidence from 1975 to 1990 on and found that only 9% of cases were attempts to understate the value of securities (typically when management and/or large shareholders were attempting to buy shares in the company). *See* Jennifer H. Arlen & William J. Carney (1992), Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U Illinois Law Rev. 691, 724-25. Institutional differences between the EU and the US, such as the EU regime's requirement for continuous disclosure (even of intermediate steps in protracted processes) may mean that an EU-specific form of breach will be the delay of positive disclosure and trading in the meantime, but the most publicized breaches to date have still been overstatements.

immediately, so information traders will trade to reflect the contents of the corrected statement in the share price at $t_{1.}$[202]

Figure 2: Simplified timeline of a disclosure misstatement



With issuer liability, the group of investors able to claim in a misstatement action will be those who purchased their shares between t_0 and t_1 (the "Misstatement period" in Figure 2) and still held those shares at t_1 (the end of that period).[203] When the correction is issued at $t_{1,}$ the share price will deflate and cause these investors a loss. Investors who bought their shares *before* t_0 and still held them at t_1 do not suffer any direct loss due to the misstatement, since the share price was both inflated and deflated during that period.

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[202] One could use Table 4 (p. 323) as a case in point. Before Tesco announced its misstatement had occurred, the shares traded at 230p. The market opened after the announcement at 204p, and after a full day of trading after the announcement it closed at 203p. The market did thus not need a day of trading to digest the information, it had done so immediately at the open.

[203] In the US, this period is referred to as the "class period" but this is not a suitable term in the UK since class action lawsuits are not available.

4.2.1. Categorizing investor losses

When the misstatement is corrected at t_1, the share price will adjust immediately to reflect the new information. The new share price will need to reflect the full impact on the company's value, which means that information traders will consider the valuation impact of several aspects and effects of the misstatement. The t_1 adjustment will comprise four different categories of losses and costs:

1. The correction in firm value as investors reprice the stock on the basis of the correct information. This loss is the difference in company valuation between what investors *thought* the company was worth (on the basis of the misstated information) and what it *actually* is worth (on the basis of the restated information).
2. Damages or restitution payments to investors and penalties payable to public authorities or regulators. This category of losses will also include the expected administrative costs for managing potential lawsuits and the opportunity cost of management time, although the latter will be hard to estimate.
3. A reputational cost to the firm (described below).
4. The expected cost of new remedial (and precautionary) measures by the firm aimed at avoiding future misstatements. This could, for example, include the cost of hiring more compliance staff or designing and implementing more robust accounting processes.

One main distinction can be made between the different categories of losses above. The loss in category 1 is a *direct loss* to the shareholders who own shares when the corrective statement is made public, which they bear as a loss in the value of their shares. It is not, however, a cost to the firm because there has been no change to the firm's conditions, only to the *reporting* of the firm's conditions. The other three categories (2-4) are, however, anticipated future costs to the firm, which will also be estimated at t_1 and incorporated into the new share price.

The legal costs in category 2 will be borne by the company in the future, so information traders at t_1 will estimate the future such costs, discount them to present value, and reduce the t_1 share price accordingly.

The reputational cost in category 3 is also a future cost to the firm and would often manifest itself as follows. The publication of the fact that the firm engaged in a misstatement will signal to investors that the firm had insufficient practices in place to review its disclosures. The quality of internal controls over disclosures is difficult for outside investors to ascertain, but the announcement of a misstatement incident provides a clear indication (signal) to investors that the firm is of poor quality, offering an investment product (securities) with inferior internal controls compared to investors' pre-existing expectations.[204] As a result of announcing the misstatement, the firm also revealed its type as a poorly managed firm, and investors will rationally show less trust in its historical disclosures as well as (ceteris paribus) its future disclosures, demanding a higher risk premium to invest in the firm. In an efficient capital market, the present value of this expected future cost to the firm will also be

[204] Akerlof (n 150).

incorporated into the firm's share price when the correction of the misstatement is made public.

Finally, the costs in category 4 consists of the remedial measures the firm undertakes to offset the losses in category 3. As the firm investigates why there was a misstatement, it may introduce further layers of management or controls to prevent similar occurrences in the future. The expected value of these remedial measures will also form part of the share price reaction to the t_1 announcement. Remedial measures may help mitigate the reputational costs noted in category 3 above, so the sum of those two categories of losses could be considered the net reputational cost. Costs in category 4 may also be part of settlements with regulators. For example, as part of Tesco's deferred prosecution agreement, it undertook to commission a report from Deloitte to:

> 'report on, and make recommendations for improvements to, the segregation of duties between relevant teams/functions and controls, governance and policies/training in respect of the recognition of commercial income; and review and comment on Tesco Stores Limited's implementation of those improvements.'[205]

Misstatements therefore hurt investors both directly (category 1) and indirectly through the firm (category 2-4). These losses may be substantial, and the realisation of such losses in an individual firm would be of particular concern for undiversified shareholders. A US study of the effects of financial

[205] Financial Conduct Authority, 'Final Notice: Tesco plc and Tesco Stores Limited' (28 March 2017) para 4.10.

misrepresentation found that, for each $1 that a firm had misleadingly inflated its market value, the stock market penalised it $4.08 when this was corrected. Of this amount, $1 was (by definition) attributed to the "category 1" loss, $0.36 was due to expected legal penalties (category 2) and the rest – $2.71 – was due to lost reputation (categories 3 and 4).[206]

In addition to these costs for shareholders and the firm itself, misstatements could impose opportunity costs on investors since a misstatement caused them to allocate capital to a firm which they, with the full facts, would have allocated to other firms with correct disclosures.

4.2.2. Losses of other stakeholders

Misstatements can and will also impose costs on other stakeholders. Where the shareholder losses are significant, the size of the equity cushion for creditors will be reduced, making their loans riskier and reducing their market value. In circumstances where a correction of a misstatement renders a firm insolvent, creditors will lose with certainty.

Employees of the firm can also be harmed. In the worst misstatement cases, firms become insolvent and cease to operate. Employees –unable to diversify their human capital investment in their employer – then lose their jobs and incur significant personal costs. If they are also invested in the firm through incentive schemes, their financial capital will be depleted as well.

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[206] Jonathan M. Karpoff, D. Scott Lee, Gerald S. Martin, 'The Cost to Firms of Cooking the Books' (2008) 43 Journal of Financial and Quantitative Analysis 581.

Customers, suppliers and competitors of a misstating firm may also be harmed through distortions that inaccurate disclosure can create. For example, Worldcom's fraudulent disclosure overstatements had huge negative externalities in that AT&T (and perhaps other firms) discontinued business lines as they believed themselves to be uncompetitive (which, in reality, they were not):

> 'AT&T fired tens of thousands in the late 1990s as it tried frantically to match WorldCom's infuriatingly low costs. Of course, those employees didn't need to be fired (at least not then), but it was too late for them once the fraud was revealed. Other telecom players did the same thing, and some did more. Qwest wound up committing accounting fraud, and Global Crossing was under investigation and ended up declaring bankruptcy, its value going to zero. Those companies had plenty of their own problems, but the relentless pressure to match a major competitor--which couldn't be legitimately matched--undoubtedly made matters worse.' [207]

AT&T's general counsel Jim Cicconi commented on the effect of the Worldcom fraud on the telecommunications industry as a whole:

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[207] Geoffrey Colvin, 'The other victims of Bernie Ebbers's fraud', Fortune Magazine, 8 August 2005.

> '[T]he ramifications of falsely reported Internet traffic numbers have had a devastating impact on the telecommunications industry. AT&T said that for years WorldCom fraudulently reported that its Internet traffic doubled every quarter. In fact, the US Department of Commerce and the Federal Communications Commission adopted the false Internet traffic figures, which then served as the benchmark for the industry. While WorldCom reaped tremendous financial rewards from the investment community for its false reports of business growth, the entire industry and investing public were harmed as WorldCom's false traffic numbers led to irrational and unjustified investments and the current fiber glut. AT&T said that a calculation of the cost of this aspect of WorldCom's fraud is conservatively estimated to be $1 trillion. "WorldCom's fraudulent activities have quite simply been the driving force behind the entire meltdown of the telecommunications industry," said Cicconi.'[208]

It is clear from the Worldcom example, regardless of what the exact figure may be, that inaccurate disclosure by a public firm can affect project choice within other firms and inflict significant costs on society. Misstatements in one firm can also divert capital away from other firms since they may be unable to raise capital on fair terms in competition with a misstating firm. These negative

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[208] PR Newswire, 'AT&T says Worldcom fine should fit the crime, calls proposed SEC settlement woefully inadequate' (6 June 2003).

externalities can be thought of as the rmirror image of the positive externalities discussed in section 3.2.6.

Since disclosure misstatements can lead to such large societal losses, there is good reason to design disclosure liability with the aim of deterring misstatements rather than to compensate victims after the fact. As the Worldcom example illustrates, there may simply not be enough funds available to compensate everyone harmed by a material misstatement in a large company, and that process will itself be tremendously costly. Deterrence – creating incentives to reduce risk – is therefore the most suitable regulatory goal.

4.3. Analysing the Davies Review's arguments on issuer liability

4.3.1. Overview

The Davies Review did not invite comments on the need for, or desirability of, an issuer liability regime; only whether disclosure liability ought to be extended to also cover the insiders responsible.[209] This restriction in scope appears self-imposed – its terms of reference were broad and did not preempt a more comprehensive evaluation of issuer liability – so Professor Davies was presumably already convinced of the benefits of issuer liability. While the Davies Review did not focus on the question of whether an issuer liability regime was appropriate, it is still the most comprehensive account of the issues within the framework of English law. In the remainder of this section 4.3, I

[209] Davies Review Discussion Paper (n 4) 41-42.

will offer a more granular treatment and critically ask whether, and if so why, the UK regulatory landscape has benefitted from the addition of issuer liability to the statute book. I will consider each argument raised in connection with issuer liability in the Davies Review under separate sub-headings (4.3.2 to 4.3.5 below).

As noted, the Davies Review treated the desirability of issuer liability as a threshold question already answered. It was, for example, only in the very last section of the Discussion Paper that it – on one page – raised the issue of the overall desirability of such a statutory investor compensation scheme and discussed the deterrence and compensation roles of issuer liability.[210] As regards *deterrence*, Davies argued that investor litigation will only deter the persons making statements in the company's name insofar as it imposed reputational or other costs on them.[211] As regards the *compensation* role of issuer liability, two concerns were highlighted. First, that the measure of damages may need to be specified in the legislation itself to ensure that it would not be over-generous. Secondly, that the US experience was that claims were settled for small fractions of their total amounts, suggesting that issuers may be accepting settlements even for non-meritorious claims. These incentives of issuers' directors in favour of settlement, he pointed out, "may be very near impossible" to change. Davies still favoured private litigation, however, because (i) it would make it easier for investors misled by fraud to seek

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[210] Davies Review Discussion Paper (n 4) 48-49.

[211] Davies Review Discussion Paper (n 4) 48.

compensation, (ii) it could be unwise to rely solely on public enforcement, and (iii) it could promote an equity culture.[212]

Despite not inviting comments on the issue of the overall desirability of issuer liability, some respondents expressed concerns. These were dismissed on the first two pages of the Final Report, which expressed support for a statutory issuer liability regime on the bases that it (i) would not 'penalise' shareholders not being compensated (as one commentator had claimed), (ii) followed from general principles of civil law (vicarious liability), and (iii) would preserve the reputation of British capital markets.[213] These points will all be analysed in the following sub-sections.

4.3.2. The circularity critique

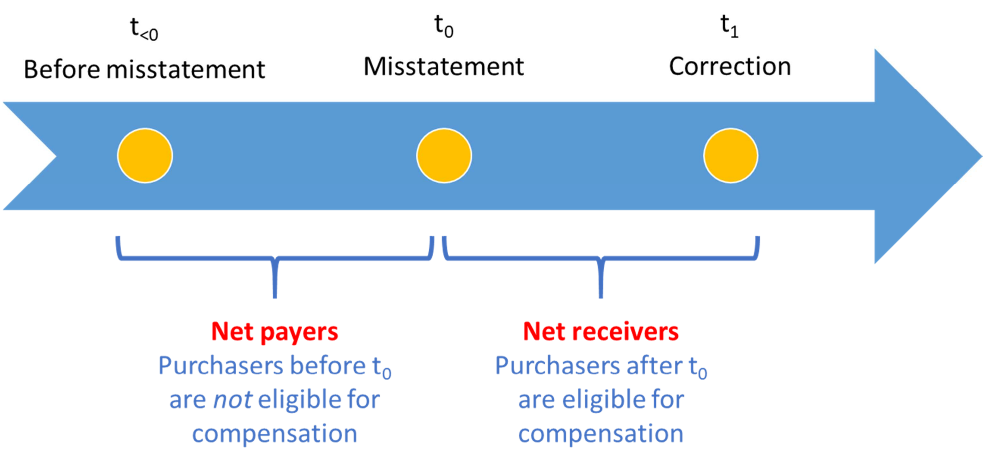
The circularity critique is focused on the compensatory role of issuer liability. It argues that issuer compensation to shareholders entails shareholders effectively paying compensation to themselves. Since shareholders are residual claimants of companies, the argument goes, any money paid out to compensate them for misstatements will decrease the value of the company's equity by the same amount. This has been described as "pocket shifting" – money is taken out of one pocket (the company's account) to put into another (the shareholder's personal account) – and could also be thought of as dividends or a partial liquidation of the firm.

212 Davies Review Discussion Paper (n 4) 48-49.

213 Davies Review Final Report (n 4) 7-8.

If that was the full story, issuer liability would indeed be a pointless mechanism, but the key to the circularity critique is to analyse which shareholders end up as "net payers" and which end up "net receivers". In this regard, see Figure 3 below.

Figure 3: The two groups of shareholders affected by a misstatement



All investors who are shareholders at t_1 are effectively paying (as residual claimants of the company), because that is when the share price corrects to account for future damages payments. However, out of those t_1 shareholders, only those who bought their shares after t_0 are eligible for compensation. All t_1 shareholders will belong to one of two groups: either they are net payers or net receivers, where the net payers effectively compensate the net receivers when the firm pays compensation. Those who have been shareholders in the firm for longer periods of time will generally be net payers and those who bought their shares more recently are the net receivers.

Building on this distinction, Professor Fox has emphasised that there will be a winner and a loser in every transaction in the misstatement period.[214] For every loser who purchased shares at an inflated price, someone sold those same shares to them at that same inflated price. Since the winner's gains from the inflated share price equal the loser's unfair losses from the same inflated share price, Fox described trading in the secondary market as a zero-sum game. He further argued that each winner and loser would have ended up winning or losing by chance, and could just as likely have been in the other group. He concluded that – for diversified investors, or even for non-diversified investors who buy and sell stock over time – the aggregate outcome of an issuer liability system is 'a wash' and the compensation justification for issuer liability is consequently 'very weak'.[215]

In order to briefly consider how shareholder compensation works in an issuer liability regime and what the distributional effects are, Table 1 sets out three scenarios.

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[214] Merritt B. Fox, 'Civil Liability and Mandatory Disclosure' (2009) 109 Columbia Law Review 237, 280.

[215] Ibid, 281.

Table 1: Shareholder dynamics with issuer liability

	% of shareholders who purchased before the misstatement ('net payers')	**% of shareholders who purchased in the misstatement period ('net receivers')**
Scenario A	100%	0%
Scenario B	50%	50%
Scenario C	0%	100%

The purpose of Table 1 is to provide some stylized scenarios for thought experiments regarding the make-up of the shareholder body and the dynamics within it. For these purposes, assume that each share is owned by a different shareholder, there being 100 shareholders with 1 share each.

In Scenario A, all shareholders are either so long-term, the misstatement period so brief, or stock liquidity so low, that there is no t_1 shareholder who purchased during the misstatement period. Thus, no-one is entitled to compensation.

In Scenario B, 50% of shareholders are entitled to compensation and the other half is not, meaning there will be a reallocation of value from one half of the shareholder body (the longer-term holders) to the other (the shorter-term holders). We could also change this scenario to assume that the 50% of investors who purchased before the misstatement are the same individuals as the 50% who purchased after. That is, the company had 100 shareholders with one share each before the misstatement period and 50 of the shareholders bought one additional share each during the misstatement period from the other 50, who at t_1 are no longer involved with the firm. In that case, the reallocation of value is pointless since each shareholder is effectively paying its own compensation. For passive 'index' investors whose strategy is to buy shares, reinvest dividends, but not sell unless the company's proportion of the index decreases – an increasingly common investor type – issuer liability really is pocket-shifting since they, by regularly adding to their holdings over time, will be paying compensation to themselves.

In Scenario C, all t_1 shareholders purchased their shares in the misstatement period. This could be due to the length of the misstatement period or a high turnover rate of the company's shares. Regardless of the underlying reason, in Scenario C all shareholders are entitled to compensation. Since – under the assumption of an efficient market – the cost of investor compensation will be paid *by* each shareholder at t_1 *to* each shareholder at t_1, and since there will be administrative costs for shareholders and the company, the shareholders will all be worse off here.

In Scenario C, issuer liability creates a collective action problem. All of the t_1 shareholders would qualify for compensation, but they would all be better off if they could commit to each other not to claim. Since everyone is entitled to a payout pro rata to their shareholding, an issuer payout would have the same function as a dividend, but would in reality be significantly more expensive given legal fees for investors and the company (a cost that , ultimately, also falls on the investors as residual claimants). However, in a system with mandatory issuer liability, shareholders will still be incentivized to claim unless they can all credibly commit to not doing so.

Another concern with the compensatory function of issuer liability which was discussed in the Davies Review is based on the US experience. Since class action law suits for issuer compensation are common there,[216] we must be careful, however, not to infer that a UK regime necessarily would function in the same way. In the US, 15-30% of settlements is typically paid to the plaintiffs' attorneys and an amount of the same magnitude, or more, is spent by the corporation on its defense.[217] The evidence shows that most such suits are settled for a small fraction of the actual harm that investors incurred.[218] We do not have corresponding UK litigation data, but estimates relating to the specific Tesco case will be provided in chapter 8. This *ex post* perspective shows that issuer liability can result in an expensive redistribution of

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[216] Approximately 8.4% of companies listed on NYSE or NASDAQ were subject to federal securities fraud class actions in 2017, and data from the first half of 2018 shows a slight increase. See Cornerstone Research, Securities Class Action Filings: 2018 Midyear Assessment, available at http://securities.stanford.edu/research-reports/1996-2018/Cornerstone-Research-Securities-Class-Action-Filings-2018-MYA.pdf.

[217] Donald C. Langevoort, *Selling Hope, Selling Risk: Corporations, Wall Street, and the Dilemmas of Investor Protection* (OUP 2016) 52. Coffee estimated that the actual amounts were at the top end of this spectrum, and potentially even higher; *see* John C. Coffee, Jr. (2006), "Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation", 106 Columbia Law Review 1534, at 1546.

[218] Coffee (n 217) 1545.

shareholder wealth since significant sums of money are lost in administration and not distributed to shareholders at all.

It is also informative to examine the *ex ante* desirability of issuer liability. Coffee has illustrated the importance of an *ex ante* approach by using a diversified pension fund as an example.[219] Assume this hypothetical investor owns shares in 1,000 companies and that, over a certain period of time, 100 of them become subject to investor disclosure litigation. Assume also that the investor purchased shares in the misstatement period on 50 of those occasions and was outside the plaintiff class on the other 50 occasions. This investor will be a net receiver on 50 occasions and a net payer on the other 50. This is a zero-sum game for shareholders in theory and negative-sum in practice (when the significant costs of litigation are factored in). Unless parties other than shareholders contribute to the payouts, Coffee views shareholder disclosure litigation as undesirable *ex ante* unless it produces 'high deterrent benefits'.[220]

Coffee proceeds to examine if these results change when investors are undiversified. According to Coffee, undiversified investors can gain from investor litigation if they are 'lucky enough' to be amongst the net payers and not the net receivers.[221] He notes, however, that small, undiversified investors are likely to trade infrequently, meaning that they are more likely to have purchased outside of the misstatement period than shorter-term investors who

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[219] Ibid, 1558.

[220] Ibid, 1559.

[221] Ibid, 1559.

trade more frequently. This state of affairs – that investors who buy shares and hold them for a long time may expect to pay out more than they gain over time, whereas investors who trade more frequently will have a higher chance of having purchased shares recently enough to be eligible for compensation – led Coffee to conclude that:

> "Ironically, the clear winner under such a system is the more rapidly trading, undiversified investor – which is the profile of the contemporary hedge fund. The clearest loser is the small investor who buys and holds for retirement – exactly the profile of the American retail investor. The other major category of clear losers is populated by the corporation's own employees, including its managers, who hold stock as the result of equity compensation and stock option plans."[222]

From a compensation perspective, Coffee's analysis is surely correct, but his dismissal of the 'ironic' outcome does not consider whether such a state of affairs could have *some* merit. The analysis in Chapter 3 outlined the central importance of information traders for public markets. Issuer liability could be considered another piece in the puzzle through which regulation supports the work of information traders. The argument would be that, by compensating information traders when significant unexpected negative events occur, they receive additional protection which provides a stronger incentive for them to trade information into prices. As a result, public markets should be more

[222] Ibid, 1560.

efficient. That *would* be the argument. However, I do not consider that argument determinative for reasons to be presented in section 4.3.5 below.

Davies did not accept a commentator's argument that issuer liability would 'penalise' the shareholders who ended up as 'net payers'.[223] This appears to be a question of perspective. If one thinks of the shareholders before t_0 as culpable in some way, then one is perhaps less likely to view liability as a penalty. Semantically, it is not clear why Davies took issue with the description of some shareholders as 'penalised'. The Discussion Paper noted that long-term only investors may find the benefits of issuer liability small because they will sometimes 'benefit' and sometimes 'lose out' from issuer liability. The phrase of 'losing out' ('being disadvantaged'[224]) means more or less the same thing as the commentator's 'penalised' ('put at an unfair disadvantage'[225]).

Other commentators have criticized corporate liability in a similar way to the commentator writing to Davies. Langevoort recently argued that corporate liability in the case of wrongdoing executives 'doesn't seem quite right given that investors are usually thought of as the victims of fraud rather than the perpetrators'.[226] It is easy to sympathise with this view – the shareholders that end up as net payers are neither the *beneficiaries* nor the *perpetrators* of the

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223 Davies Review Final Report (n 4) 7-8.

224 Oxford Online Dictionaries, *Phrasal Verbs: Lose* Out, available at https://en.oxforddictionaries.com/definition/lose.

225 Oxford Online Dictionaries, available at https://en.oxforddictionaries.com/definition/penalize.

226 Langevoort (n 217) 54.

misstatement. The beneficiaries are those investors who sold in the misstatement period, and the perpetrators are one or more insiders of the firm.

4.3.3. Issuer liability as a deterrence mechanism

As noted in section 4.3.1, the Davies Review Discussion Paper only considered issuer liability to deter misstatements to the extent it imposed reputational or other losses on the insiders actually responsible for such misstatements.[227] To evaluate the deterrence power of issuer liability, let us first consider the mechanisms of how issuer liability needs to work in order to deter corporate insiders from issuing misstated disclosures in the company's name. By imposing a cost on long-term shareholders (the "net payers") when their firms issue misstatements, the deterrence function of issuer liability must come from the power of these shareholders to take action against the insiders that were responsible for the misstatement. Since shareholders elect and remove directors, the envisaged shareholder action is, presumably, that they will replace directors that were either directly responsible for the misstatement or failed in their oversight of the company's senior executives. The deterrence will thus come from the fact that directors would like to keep their jobs. As a result, directors will monitor the company's disclosures to make sure they are not misstated for fear of otherwise being removed from office by the shareholders.

The idea with issuer liability as a deterrence device is, therefore, that the threat of disclosure litigation will impose meaningful additional costs (reputational or

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[227] See text accompanying note 210

financial) on corporate insiders so that the overall deterrence of disclosure misstatements is increased compared to a regime that does not have issuer liability. In the regime proposed by the Davies Review and now found in s. 90A FSMA, where only the issuer bears the *financial* cost of the litigation, the idea must be that a solely *reputational* cost on corporate insiders will still produce valuable additional deterrence.[228] To examine whether this idea is realistic in the UK setting, I will proceed by analysing the envisaged role of shareholders (section 4.3.3.1), the expected deterrent effect on insiders (section 4.3.3.2) and then offer brief conclusions in section 4.3.3.3.

4.3.3.1. The role of shareholders

A critical part of Fox's claim that the compensation rationale is weak lies in his argument that it is a random occurrence whether a shareholder ends up a winner or a loser from trading in a misstatement period.[229] Coffee takes the same view when he refers to 'luck' as being a factor in whether undiversified investors will be eligible for compensation.[230] It is useful to consider what this implies as regards their view of the role of shareholders. When Fox claims that shareholders end up in their position of 'winner' or 'loser' by chance alone, he

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[228] Reputational losses are also the focus of the deterrence function in the Davies Review Discussion Paper, 48.

[229] See section 4.3.2.

[230] Coffee (n 217) 1559. Langevoort takes the same view, *see* Donald C Langevoort, 'On Leaving Corporate Executives Naked, Homeless and without Wheels: Corporate Fraud, Equitable Remedies, and the Debate over Entity versus Individual Liability ' (2007) 42 Wake Forest Law Review 627, 632.

assumes that the losers are passive and unable to influence their position. Professor Gelter has presented a different view, arguing that shareholders can step in and monitor corporate behaviour if they fear misstatements, which, in his view, means that issuer liability can be used as a deterrence device.

Gelter argued that the typical US critique of issuer liability is less applicable in the European setting where blockholders are more common in public companies. [231] Shareholders in companies with very dispersed ownership structures will suffer from collective action and rational apathy problems, where it is not worth their time and effort to engage in monitoring. Gelter, however, observed that, since holders of larger blocks of shares will have more to lose from being "net payers" in issuer liability suits, the deterrence power of such suits may be significant for companies where the shareholder structure is more concentrated, such as in continental Europe.

Gelter's argument is important, even though it is presented with some implied but not clearly articulated assumptions. First, after discussing the presence of 'large' shareholders in European companies, Gelter adds without explanation the further attribute that these shareholders are 'undiversified'.[232] Secondly, the data he references for his ownership concentration figures include only the very largest companies in each jurisdiction, are only a snapshot taken as of

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[231] Martin Gelter, 'Risk-shifting through Issuer Liability and Corporate Monitoring' (2013) 14 European Business Organization Law Review 497, at 513.

[232] Ibid.

2004, and do not actually speak to the holding periods of investors.[233] As a result, for Gelter's deterrence claim to work we would need to make the further assumption that these large shareholders are long-term, so that they purchased their shares before the misstatement period. This does not seem unreasonable, but is nonetheless useful to spell out. Further, Gelter finds it important that these large, long-term shareholders are undiversified, although he does not describe why, or investigate whether, that is actually the case. Nevertheless, the underlying idea should be examined further: What attributes should investors have, in order for them to find issuer liability sufficiently risky so they choose to become active monitors to prevent corporate disclosure misstatements?

First, as already established, they would have to be longer-term investors so that they would expect to have purchased their shares (all or many) outside the misstatement period.

Secondly, do the investors need to hold a large proportion of the firm's shares, as Gelter claims? From the perspective of gaining influence in the firm, the answer would seem to be yes – no investor will be able to monitor the details of the disclosure process without a seat on the board of directors; a position which is difficult to reach without shareholder voting power. The shareholder's

233 Gelter references data by Pepper D. Culpepper, 'Quiet Politics and Business Power' (CUP 2011) whose data on 'stable shareholders' refer to shareholders thought to vote to support management. The definition does not specify anything about how long those shareholders held their shares; only the proportion of shareholders who at one date in 2004 had been estimated to support management.

proportion of firm ownership will therefore be a threshold to influence. But this says nothing about *actual* monitoring; it is only a threshold which *allows for* monitoring. The question is then if the shareholder *will* monitor. If we assume, reasonably in my view, that monitoring would cost the shareholder a fixed amount, and the upside from monitoring is a value added per share, then clearly a shareholder with a larger proportion of the firm will see a larger potential upside from monitoring and will be more likely to find that the per-share value increase from monitoring will outweigh the fixed cost. Still, however, this does not tell us whether the shareholder *will actually* monitor, it only tells us that the shareholder is more likely to monitor the larger their proportion of the firm. In the end, whether the shareholder monitors depends on the actual costs of monitoring and how efficiently the shareholder is able to engage in monitoring.[234] Since it is difficult to detect misstatements, the costs are high. A recent survey of sell-side financial analysts, who spend significant amounts of their professional time analysing corporate disclosures, found that they do not even *try* to detect misstatements.[235] The recent UK case of the misstatement in the AIM-listed company Patisserie Valerie, where the

[234] One example of a shareholder monitoring problem is that the shareholder will need to motivate the agents it appoints to monitor. The shareholder may find it difficult to write a contract with its monitoring agent that aligns its incentives with its own. Since fraud is so rare, the shareholder (as principal) may find it difficult to monitor that its agent actually investigates whether the issuer is engaging in fraud, rather than collecting pay for doing nothing and playing the odds that the firm is unlikely to be fraudulent.

[235] Lawrence D. Brown et al, 'Inside the "Black Box" of Sell-Side Financial Analysts' (2015) 53 Journal of Accounting Research 1.

Chairman owned 37% of the shares but still was unaware of reportedly intentional accounting misstatements by the CFO, indicates that it may not be easy to detect intentional misstatements, even from *inside* the firm. All we can say, therefore, is that Gelter is right that larger shareholders are, on the margin, more likely to monitor the more shares they hold, but we cannot say for sure that they will actually do so.

The third issue is the importance of a shareholder holding a large proportion of its own wealth in the firm's shares – that is, the relevance of diversification. To illustrate the difference between this and the prior issue (a shareholder owning a large percentage of one company's shares), consider the Norwegian sovereign wealth fund or the fund manager Blackrock. These are large investors in many public firms, but they are also diversified so that their total wealth is largely unaffected by developments in any individual firm. Thus, it is not clear that Gelter's model, which relies upon investors that own a large proportion of a firm's shares for deterrence of disclosure misstatements, is realistic. The reason is that, for shareholders who recognize that it is very difficult to detect disclosure misstatements, diversification is the solution. Portfolio theory teaches that there are two types of risk associated with securities: systematic (market) risk and unsystematic (idiosyncratic) risk.[236] The idiosyncratic risk of a security, such as the risk of buying a share while a persisting misstatement has inflated the share price, can be virtually eliminated by diversification. Diversification is thus an efficient way for a potential victim

[236] Beaver (n 187) 641 (discussing diversification as a cost-efficient way to prevent harm).

to prevent or limit the extent of their injury *ex ante*. As regards disclosure misstatements, diversification does not change the equation of whether it is worthwhile for an investor to engage in monitoring, but it may be a *response* to the difficulties of shareholder monitoring. The Norwegian sovereign wealth fund and Blackrock would be expected to monitor an individual firm when their expected benefit of doing so exceeds their costs, but investors engaging in diversification may be choosing to do so because this cost/benefit tradeoff is unfavourable.

In considering regulation, however, the question to ask is whether it is efficient *ex ante* to have an issuer liability regime for purposes of deterrence. Since shareholders are residual claimants and first to lose if firm value depreciates, they could (as Gelter identified) be a constituency with strong incentives to monitor for inaccurate disclosures. Issuer liability may be efficient if the shareholders before t_0 have the requisite influence over the firm to prevent misstatements from happening. That is, if the issuer's compensation payments are a penalty on those who could have prevented the misstatement but failed to do so, then an issuer liability regime may create the right incentives for shareholders to deter misstatements. Gelter is thus correct that, on the margin, issuer liability can mobilize long-term shareholders, and the more so the more undiversified they are, but it is not clear that shareholders – or that segment of longer-term shareholders who bought before t_0 and still hold their shares at t_1 – actually do so. If such shareholders are unable to discern *ex ante* whether or not an issuer in the stock market has already misstated (and thus is in a misstatement period when they invest), they will randomly end up as "net payers" or "net receivers".

In considering the strength of Gelter's claim in the UK setting, shareholder structure is also important. Generally, UK public companies exhibit dispersed share ownership, although this observation should be qualified by noting that institutional investors are able to coordinate to influence the overall environment.[237] It is less likely, however, that such coordination would overcome the inherent problems of monitoring disclosures of individual companies before they occur, however, since that would require investors to coordinate both director elections and subsequent investigations.

A further question relating to shareholder incentives is whether the addition of issuer liability to the statute book should be expected to meaningfully increase the costs of the "net payer" shareholders to actually mobilize them as monitors. While the marginal effect of issuer liability of course will be in that direction, it is not clear that issuer liability is a meaningful addition to the overall cost of a misstatement. Work by Karpoff, Lee and Martin in the US setting found that only 8.8% of the share price decline that firms suffered when they announced a misstatement was due to expected payments of legal penalties.[238] Instead, most of the share price decline was attributed to lost reputation. This suggests that the deterrence "value added" by issuer liability is low.

4.3.3.2. Issuer liability's ability to deter insiders

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[237] Paul Davies, 'Shareholders in the United Kingdom' in Jennifer G. Hill and Randall S. Thomas (eds.), *Research Handbook on Shareholder Power* (2015) 355.

[238] Karpoff et al (n 206).

In response to comments that the shareholders who end up as 'net payers' in an issuer liability regime are unfairly penalised, Davies presented in his Final Report a particular view on why disclosure missstatements occur:

> 'I think that fraudulent statements are often made in what the directors conceive (or misconceive) to be the interests of the issuer, for example, deceiving the market so as to keep the company's business alive for a while longer, in the hope that things will turn around.[239] This may be a foolish policy which ultimately inflicts harm on the company and thus on its shareholders, except those who are fortunate enough to sell out before the mistake emerges. However, in this respect it is no different from any other ill-advised or illegal policy adopted on behalf of the company by its directors, the company (ie the shareholders) being required, by law or for reputational reasons, to compensate those harmed by it.'[240]

In the quote above, Davies emphasises that the directors are appointed by the shareholders and that directors, in his view, act in what they believe to be the shareholders' interests even when they misstate disclosures. This appears to contradict the available evidence on disclosure misstatements. Arlen & Carney collected data from 1975 to 1990 on misstatement cases pertaining to US companies' ongoing disclosures. In contrast to Davies's claim that disclosure misstatements are published by the directors as a matter of corporate policy,

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[239] Here, Professor Davies referenced the case of *R v Bailey and Rigby* [2006] 2 Cr. App. Rep. (S) 36.

[240] Davies Review Final Report (n 4), 7.

Arlen & Carney found that this was not common – the typical disclosure misstatement was instead an act of individual agents within companies without board or shareholder approval.[241] Most cases were attempts to conceal bad news such as declines in earnings.[242] Arlen & Carney pointed out that shareholders do not actually want directors or officers to intentionally misstate the firm's disclosures, and explained misstatements as an agency cost where corporate agents take actions to further their own aims instead of those of shareholders.[243]

One important contribution by Arlen & Carney was to focus on the incentives for why rational managers would intentionally provide inaccurate disclosures. They hypothesised that for most managers the risks involved in attempting to misstate disclosures would greatly outweigh the expected benefits, which would only come from the manager profiting from a higher stock price.[244] A manager would not therefore be expected to engage in disclosure misstatements if they thought their employment was secure. This can also be described in terms of costs and benefits to the individual manager: a misstatement is likely to be uncovered at some point, and the manager would then not only lose any gains made on their shares but also their firm-specific human capital and reputation when charged with a criminal offense.[245] Instead,

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241 Arlen & Carney (n 201) 730.

242 Arlen & Carney (n 201) 730.

243 Arlen & Carney (n 201) 701.

244 Arlen & Carney (n 201) 702.

245 Arlen & Carney (n 201) 702.

Arlen & Carney contended that the managers who engaged in misstatements would only be those who found themselves facing a "last period" problem where their employment was no longer safe, at which point the benefit of a misstatement to buy them time to try and solve the problem would be considered to outweigh the costs if detected.[246]

While this 'last period problem' could be a risk of a potentially ruinous event for the firm, as in Davies's scenario, Arley & Carney amphasised that this is not necessarily the case. Since managers have shorter time horizons than firms (which as going concerns are expected to live forever), managers may consider themselves to be in their 'last period' when their firms are not. For example, managers who fail to meet their targets may fear that their superiors will fire them unless they manufacture improved metrics in circumstances where the overall viability of the firm is not at risk.[247] (It seems, for example, that the Tesco case which will be analysed in chapter 8 may be such a situation.) Further, Kraakman has argued that, in the time since the publication of Arlen and Carney's paper, corporate managers have been receiving increasingly larger high-powered equity incentive plans, which have had the effect that share price manipulation through misstatements can have significant payoffs even in

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[246] Arlen & Carney (n 201) 702-03.

[247] Bai, Cox and Thomas attribute 'much fraudulent reporting' to this phenomenon. *See* Lynn Bai, James D. Cox and Randall S. Thomas, 'Lying and getting caught: An empirical study of the effect of securities class action settlements on targeted firms' (2010), 158 Univ. Pennsylvania Law Review 1877, 1882-83 (also noting that stock options exacerbate the temptation of managers to engage in misstatements).

situations that are not last-period problems.[248] Finally, even where the firm may be in a last-period scenario, the shareholders (on whose behalf Davies consider the insiders to act) would not generally condone a misstatement, since it would be a project with negative expected value to them.

Before the UK introduced the new issuer liability regime, we did not necessarily expect insiders to misstate disclosures because other mechanisms would have imposed significant costs on them. The typical positive misstatements now covered by the 90A regime were already enforceable using civil law, criminal law, and administrative law through the financial regulator. Thus, if we think that shareholders are able to create incentives for deterrence within companies, then we must also think that such deterrence would already be strong in the absence of issuer liability. As a result, the cost-benefit tradeoff to insiders of misstating disclosures would already appear too costly for insiders to misstate disclosures in the normal course of business. When considering those insiders, it does not seem reasonable to expect issuer liability to add any meaningful amount of deterrence – if they were found to be responsible for a misstatement, they would lose their jobs, even if there was no additional cost to the longer-term shareholders in the form of issuer liability.

We should also consider those insiders who are not operating in the normal course of business, but facing exceptional situations such as the "last-period problem". These are cases where (hypothetical) insiders would consider misstating corporate disclosures, despite the high likelihood of losing their jobs

[248] Kraakman (n 146) 107.

if the misstatement is discovered and the negative reputational effects which may make it difficult for them to find new employment. It seems that, in most situations where these problems are present, it would be fanciful to expect the threat of corporate liability to add meaningfully to insiders' costs. For example, in the case of the Tesco misstatement, most directors announced they would stand down more than two years before the Serious Fraud Office and the Financial Conduct Authority declared that the company would be required to pay penalties.[249] All insiders suspected of participating in the misstatement had been suspended within days of Tesco's announcement. This is due to regular corporate governance mechanisms functioning well and not due to the threat of issuer liability. The expected deterrent value added of issuer liability, although marginally positive, is thus low.

4.3.3.3. Conclusions

The analysis in this section 4.3.3 has analysed the strength of the argument that issuer liability can deter disclosure misstatements. The Davies Review acknowledged that such deterrence, if it were to be more than illusory, would need to be created by imposing reputational costs on insiders. The analysis here has suggested that the added value of issuer liability is likely so low that it does not provide meaningful additional deterrence. Further, if the ultimate aim is, as the Davies Review suggested, to achieve a negative effect on the responsible insiders' reputation, this could be achieved through an FCA investigation combined with public statements about the state of firms' internal

[249] For the Tesco case study, see chapter 8.

controls, or if directors and officers simply bore personal responsibility for misstatements.

In conclusion, the claim that issuer liability is a useful tool to achieve deterrence of individual wrongdoing is not convincing. Instead, it seems more appropriate to place liability directly on the insiders whose actions the 90A regime is trying to influence. I will consider the design of such director and officer liability further in section 4.5.

4.3.4. Britain's reputation

Davies also argued that issuer liability would preserve the reputation of British capital markets.[250] It was not made clear, however, why or how statutory issuer liability would preserve Britain's reputation, which makes it difficult to analyse the claim further. The idea is presumably that other leading capital market jurisdictions offer issuer liability, so that investors would view Britain unfavourably if it did not do the same. The Davies Review noted that Germany offers continuing disclosure liability in cases of gross negligence with a reversed burden of proof, so that issuers will not be held liable if they can prove that they were not aware of a disclosure inaccuracy and that their lack of awareness was not grossly negligent.[251] It also noted that the United States took a similar approach, offering issuer liability on the basis of a scienter standard, located between gross negligence and recklessness in English tort law terms.[252]

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[250] Davies Review Final Report (n 4) 7-8.

[251] Davies Review Discussion Paper (n 4) 33 (referencing section 37c Wertpapierhandelsgesetz).

[252] Davies Review Discussion Paper (n 4) 32.

Professor Ferran has, however, argued that "an explosion of securities litigation […] could threaten the international competitiveness of the UK capital market", highlighting that there could also be negative reputational effects of issuer liability.[253]

The reputational argument in favour of issuer liability may be contrasted with the views in the United States, where most legal academic commentators appear unconvinced by its merits and the circularity critique resonates loudly. Perhaps more importantly, the available US evidence suggests that investors do not particularly value issuer liability. Cox and Thomas found that only one third of institutional investors eligible for class action settlements actually made the necessary filings to receive compensation, leaving billions of dollars unclaimed.[254] In another study, Bartlett analysed the effects of the unexpected *Morrison* decision by the US Supreme Court which held that US class actions were not available to US investors who had purchased non-US shares on non-US exchanges.[255] He examined whether US investors changed their trading behaviour towards US-listed ADRs of foreign companies rather than the

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253 Eilis Ferran, 'Are US-style investor suits coming to the UK?' (2009) 9 Journal of Corporate Law Studies 315, 317.

254 James D. Cox and Randall S. Thomas, 'Leaving Money on the Table; Do Institutional Investors Fail to File Claims in Securities Class Actions' (2002), 80 Wash. U. L. Q. 855; James D. Cox and Randall S. Thomas, 'Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements' (2005) 58 Stanford Law Review 411.

255 The decision was Morrison v. National Australia Bank Ltd., 561 US 247 (2010).

foreign share which would allow them to retain the ability to join possible US class action lawsuits. Based on a large data set which covered trades by almost 400 institutional investors, he found no evidence that they preferred to trade US-listed securities after *Morrison* and concluded that it was therefore doubtful whether investors attributed any value to the US issuer liability regime.[256]

In any event, and in conclusion, the reputation argument appears too vague and unsubstantiated to be determinative.

4.3.5. Culpability standards

In the Discussion Paper, Davies invited comments on whether fraud or negligence should be the standard for issuer liability, with the additional question of whether gross negligence could be a suitable middle way.[257]

The spectrum of possible culpability standards is broader than the choices offered on Davies's menu. Figure 4 below sketches an overview (with increasing degrees of culpability as we move to the right). The scale ranges from strict liability on the left (where misstatement liability will be incurred even if no fault was committed) to fraud-based liability on the right (where intentional behaviour is required for liability). In between are negligence, gross negligence, and recklessness, although (as we will see) these concepts are not always easy to separate.

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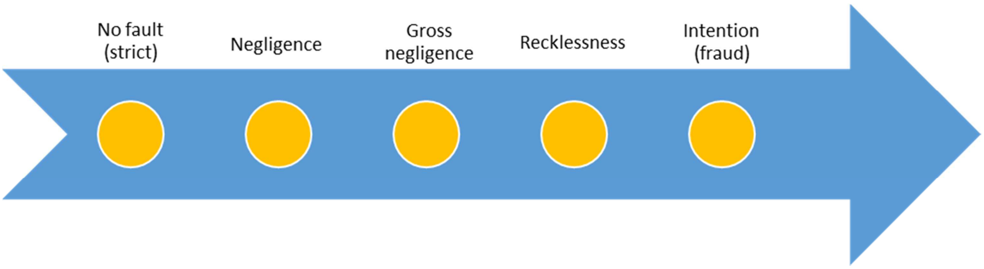
[256] Robert P. Bartlett III, 'Do Institutional Investors Value the Rule 10b-5 Private Right of Action? Evidence from Investors' Trading Behavior following Morrison v. National Australia Bank Ltd.; (2015) 44 Journal of Legal Studies 183.

[257] Davies Review Discussion Paper (n 1) 31-34.

Figure 4. Culpability standards (increasing severity of fault)



While Davies did not consider the merits of strict liability as part of his review, that is in fact the current standard in Australia. The no-fault provision appears to have been introduced without consideration of its potential effects, but the Australian Law Reform Commission (ALRC) has recently voiced concerns, noting that plaintiffs' lawyers investigate significant movements in share prices *ex post* in order to bring opportunistic suits which almost always are settled.[258] The emergence in Australia of strict liability class action suits has caused concerns in several respects: that non-meritorious claims are brought and settled, that the cost of directors' and officers' insurance has tripled in little over a year, that at least one such insurer has left the Australian market due to the significant amount of disclosure litigation, and that some Australian companies are considering redomiciling themselves to avoid the negative effects of easily available litigation. Generally, the ALRC discussion paper appears to consider the law suits based on strict liability to be opportunistic and does not discuss their potential benefits. As mentioned, however, Australia's choice of strict liability does not appear to have been a concious

[258] Australian Law Reform Commission, Discussion Paper: Inquiry into Class Action Proceedings and Third-Party Litigation Funders (June 2018), 29-33.

choice and, as a result, there were no justifications for this culpability standard at the time of its introduction.

In my opinion, the only argument that could possibly justify strict liability for disclosure misstatements would be to argue, with reference to the significant costs misstatements may cause investors as well as other stakeholders,[259] that issuers ought to be required to internalise the full societal consequences of their misbehaviour. However, it is difficult to measure the costs of the misbehaviour, and measuring societal costs by the metric of investors' losses would be both over- and under-inclusive. Over-inclusive because there are investor gains in the same amount and under-inclusive because the investor losses do not necessarily have any relation to the externalities caused by the misstatement. However, the current situation in Australian law does not seem desirable for the reasons given by the ALRC. Some of the arguments relating to a negligence standard, to be discussed next, will also apply – *a fortiori* – to strict liability.

Of the 30 respondents who submitted comments to the Davies Review on the choice between fraud and negligence, 29 favoured a fraud standard. In analysing the respondents' reasons for prefering fraud over negligence, Davies found three prominent reasons.

The main reason for preferring a fraud standard was that firms could end up with significant liability for relatively small deviations from expected behaviour

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[259] See section 4.2.

in a negligence regime since the amount of liability is measured by the claimants' losses.[260] The risk of large liability for comparatively small mistakes also led commentators to predict that the introduction of a negligence regime would cause companies to engage in 'defensive and bland reporting' to reduce litigation risk.[261] Negligence liability could, in other words, have a 'chilling effect' on the quality of corporate disclosures. For this argument to work, it would need to be the case that: i) companies did not already engage in bland reporting, and ii) the quality of corporate disclosures could not be sufficiently enforced. On the first point, if it were the case that companies already engaged in bland reporting,[262] a lower liability standard would not necessarily encourage meaningful reporting to any significant extent. A lower liability standard would then be a small carrot at best. On the second point (a lack of enforcement capabilities), the claim would be that we do not have any sticks so we have no choice but to trust our small carrot. Other regulators, however, use sticks to good effect. The US SEC actively and regularly reviews public companies' filings and requests additional disclosures of firms deemed not to comply with the spriit of its disclosure regulations.[263] The point here is that, if there is

260 Davies Review Final Report (n 4) 11.

261 Davies Review Final Report (n 4) 10.

262 This may be suspected from the analysis of agency problems in chapter 7.

263 SEC staff regularly reviews firms public filings and issues so-called "comment letters" requesting that additional supplemental information is made in firms' public disclosures. See generally http://www.sec.gov/answers/commentletters.htm. In contrast, the Conduct Committee of the UK Financial Reporting Council considers its ambit only to be to enquire into cases where "there is, or may be, a question whether the directors' report or accounts complied with the requirements

information that managers prefer not to disclose, it is not conceptually clear that a looser liability standard will make any difference as they decide how much and how useful information to disclose. If high-quality disclosure is the ultimate aim, a case could arguably be made for increasing the focus on enforcement (the stick) rather than to attempt to convince corporate insiders that the carrot of a fraud-based regime should encourage them to issue disclosures as helpful as possible.

The second reason why respondents preferred a fraud standard was that they feared that a negligence standard would result in over-enforcement.[264] If it were easy to bring disclosure actions, we could see the emergence of professional claimants who bring unmeritorious litigation to extract settlement payments. Several respondents noted that this was a significant problem in the United States and wanted to avoid this in the UK. A fraud standard would combat this since it presents more hurdles for unmeritorious lawsuits. For example, barristers are prohibited from pleading fraud unless they 'have reasonably credible material which establishes an arguable case of fraud'.[265]

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of the [Companies Act]." See https://www.frc.org.uk/Our-Work/Conduct/Corporate-Reporting-Review.aspx.

264 Davies Review Final Report (n 4) 10.

265 Bar Standards Board, Handbook (May 2018) 27.

Thirdly, respondents expressed general scepticism about the social utility of the risk-shifting that issuer liability entails.[266] Hermes, an active investor in the market, phrased it as follows:

> "From a simple public policy perspective, it is hard to see why short-term traders of stock should be advantaged by a liability regime to the detriment of long-term shareowners. If this were to take place, it would seem to run counter to the government's intent to encourage a longer-term outlook on the part of the UK investment industry."[267]

Davies noted that this argument could be used to argue against fraud as well as negligence, but concluded that fraud liability would have two functions. First, deterrence, because fraud is "so corrosive of the basic trust on which the market operates that civil liability for such statements performs a valuable public function in deterring fraud" and, secondly, compensation:

> '[Moreover,] fraud being less prevalent than negligence, even long-term investors may not think that, over a reasonable period of time, their gains from fraudulent statements will outweigh their losses.'[268]

As previously noted, Davies did not put much faith in a deterrence effect of issuer liability and argued that it would typically only be of value when it caused

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[266] Davies Review Final Report (n 4) 11-12.

[267] Davies Review Final Report (n 4) 16.

[268] Davies Review Final Report (n 4) 16.

a reputational loss to the misstating manager.[269] It is therefore unexpected to see Davies attribute importance to the deterrence argument in the Final Report.

As for the second argument quoted above, about compensation, it is not clear why long-term investors would consider themselves to be gaining from misstatements. We have seen that the effect of an issuer liability regime on long-term investors is that they lose when there *is* an issuer liability regime (because they end up as 'net payers' to more recently arrived shareholders). The analysis in this thesis points to *short-term* investors as the ones who may find themselves compensated more frequently in an issuer liability regime, the typical example being an active hedge fund. The typical loser from an issuer liability regime is an undiversified, long-term shareholder – retirees and employees are often mentioned as examples, since they may receive shares in incentive programs which they are not able to sell, buy the share for reasons of familiarity, or find that their corporate pension plan is overweighted towards the company's shares.[270] This second argument in favour of issuer liability therefore also fails to persuade.

If the choice of liability regime is between fraud and negligence, the choice between them ought to be based on an evaluation of the costs and benefits of

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[269] See the paragraph accompanying note 210 above.

[270] See, e.g. Bai, Cox and Thomas (n 247) or Langevoort (n 217) 51.

the available alternatives.[271] We have seen in section 4.2 that misstatements can cause significant costs not only for investors but also for other stakeholders. A misstatement can produce these costs irrespective of whether it was caused intentionally, recklessly, negligently or with due care from all involved. One could argue that intentional misstatements may cause larger losses since a person inside the company is deliberately concealing the true state of affairs. Negligent misstatements may be discovered sooner since there is no such deliberate cover-up. Seen from this perspective, discouraging intentional misstatements will only require convincing a wrongdoer not to engage in an activity while discouraging negligence will be more costly since it would require firms to invest in precaution. Investing in prevention of negligent misstatements is only beneficial on a societal level if the benefits outweigh the additional investments required. Such investments may consist of conducting internal and external review of statements before they are publicly released. Negligent misstatements can therefore be acceptable if the cost of deterring them is higher than the social costs they give rise to.

It may be argued that investors can expect some risk of harm from misstatements and consequently ought to take reasonable precaution and diversify. Usually, precaution is costly. But a quirk of disclosure is that precaution in the form of diversification is not costly but actually optimal investment behaviour according to finance theory. By saying, as the 90A

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[271] Compare Michael R. Darby & Edi Karni, Free Competition and the Optimal Amount of Fraud (1973) 16 Journal of Law & Economics 67, 83.

regime does, that negligent misstatements are a class of losses not eligible for compensation, the legislator would *both* encourage efficient portfolios and the taking of precaution.[272]

4.3.6. How issuer liability fits with existing law

In response to the critique of issuer liability that was submitted in response to the Davies Review Discussion Paper, Davies argued that damages payments from companies to shareholders were "not a novel proposition" since companies were already subject to liability both for prospectuses and for their managers' direct, fraudulent representations to investors. He also argued that issuer liability would follow from general principles of vicarious liability in civil law.[273]

Davies's argument is thus one of analogy – justifying issuer liability for disclosure misstatements by placing them in a particular context – but such reasoning is only as convincing as the context is appropriate. And I would respectfully submit that the chosen context is tenuous.

The first comparison – with the prospectus regime – is questionable because a prospectus is the basis for a transaction between the issuer and a subscriber for shares where the issuer receives a payment from the subscriber. Investor compensation for losses based on misstated prospectuses is therefore similar

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[272] I do not mean to say that long-term, diversified investors will be disinterested in the design of an issuer liability regime, if there is one. For any given level of cost, they will prefer the regime that most effectively deters misstatements.

[273] Davies Review Final Report (n 4) 7.

to damages for goods not meeting the specifications in the seller's brochure.[274] This close proximity between the issuer and the subscriber has been recognised as a relationship of privity by English law for over a century, but it offers little guidance for the design of a suitable liability regime for misstatements in continuing disclosures to secondary market investors. While Davies has argued that the statutory prospectus liability (s. 90 FSMA) should extend to investors who purchased shares in the after-market in reliance on the prospectus,[275] this, again, does not inform the design of a regime for continuing disclosure liability. Instead, it raises a fundamental question of how to reconcile Davies's argument that negligence liability for prospectuses should extend to investors in the secondary market,[276] and his argument that negligence liability in unsuitable for continuing disclosures. The period after an IPO is often a time of intensive stock market trading when investment banks conduct price stabilisation measures, hedge funds sell their IPO allocations, and long-only investors buy. Davies's concerns with a negligence-based issuer liability regime would thus apply *a fortiori* in the post-IPO period. The extension of primary market liability into the secondary market becomes increasingly uncomfortable

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[274] In some situations, there will not be a direct relationship between the issuer and the investors who trade in the market, such as if there is no sale of shares by the issuer (in which case investors will instead need to direct such a claim towards the selling shareholders) or if there is only a listing without a sale of shares. These situations will not be considered further herein.

[275] Davies Review Final Report (n 4) 7.

[276] Davies and Worthington (n 19) 856 also appear to recommend the extension of prospectus liability under the tort of negligent misstatement into the secondary market.

the more active the hypothetical issuer is in the primary market. Frequent issuers, such as those intended to make use of the new 'universal registration document' regime in the PR, could arguably end up with primary market liability to all secondary market investors if they issued new equity a few times per year.

As regards Davies's second comparison – liability for fraudulent representations to investors – this is probably a reference to actions in tort for deceit, which were mentioned in the Discussion Paper.[277] The argument makes reference to investor expectations: since the common law provided for fraud-based liability, investors had legitimate expectations to maintain it.[278] This argument neither establishes what the optimal regulation would be nor the need for the 90A regime. Further, the argument that a new rule should be introduced because there are already other rules with a similar effect raises more questions than it provides answers, and, it is submitted, could only be a valid argument if the Davies Review had demonstrated that there was a gap in the existing framework which needed to be filled.

The final civil law analogy in the Davies Review was to vicarious liability. In disagreeing with a commentor's claim that a regime with director liability but without issuer liability would be preferable, Davies stated that such a state of affairs would 'fly in the face of the principles underlying the general law of

[277] Davies Review Discussion Paper (n 4) 41.

[278] Davies Review Final Report (n 4) 16.

vicarious liability'.[279] Vicarious liability is undoubtedly a long-standing principle; employers have been subject to vicarious liability for employee fraud for more than a century.[280] However, an argument seeking to justify the 90A regime by extending the general applicability of vicarious liability appears incomplete without considering the specific realm of company law. Here, the 'rule against reflective loss' is central to the question of when compensation payments ought to be made from a company to one of its shareholders. This company law doctrine has developed specifically to address the question of when companies should be liable (whether directly or vicariously) to their own shareholders. Ordinarily, the reflective loss rule bars shareholder compensation from a company when the shareholder's loss merely reflects the company's loss. It does not automatically pre-empt shareholder compensation for misstatements, but could have that effect. It would have been helpful if the Davies Review had considered how the 90A regime is envisaged to relate to the reflective loss rule, but unfortunately it did not broach the subject.[281] I will offer an analysis of this issue in chapter 6.

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[279] Davies Review Final Report (n 4) 8.

[280] Lloyd v Grace, Smith & Co, [1912] AC 716. The scope of vicarious liability has been discussed recently by Lord Sumption in *Bilta v Nazir* [2015] 2 All ER 1083, 1107.

[281] The 'rule against reflective loss' is mentioned once in the Davies Review, describing the court's verdict in *Caparo v Dickman*. See Davies Review Discussion Paper (n 4) 20, fn41. It is almost mentioned in the Final Report (if such a thing is possible) where Professor Davies discusses historical arguments for shareholder risk-shifting, but the arguments does not proceed beyond general, non-specific terms. See Davies Review Final Report (n 4) 15.

The situation where shareholders seek compensation from their company also warrants more consideration than other liability statutes for the reason that, if a shareholder is successful with its suit, they may end up 'jumping the queue' of priorities in insolvency by becoming unsecured creditors. This issue was not discussed in the Davies Review either, since Davies preferred to leave this to future rule-making.[282] It may thus be said that Davies' reference to vicarious liability is on a level of abstraction where it is both entirely correct and completely unhelpful in determining the suitable design of a liability regime for continuous disclosures.

To conclude, the attempted justifications of issuer liability in the 90A regime through comparisons with the prospectus regime, the tort of deceit, and vicarious liability do not provide cogent rationales and fail to convince.

4.4. Do we need issuer liability?

An issuer liability regime offers *de facto* insurance to shareholders, but (since they are residual claimants) they will themselves end up effectively paying for that insurance. For shareholders with a diversified portfolio of shares, it is more efficient to accept that misstatements may lead to a loss on an investment in one company and a gain on an investment in another than to engage in issuer liability compensation payments. Diversified shareholders would view issuer liability as an insurance policy which they pay for but do not need, since their diversification has already addressed this concern.

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[282] Davies Review Final Report (n 4) 27.

If any investor type could be expected to be disadvantaged by a lack of compensation for issuer misstatements of continuing disclosures, it would be a large, undiversified investor that takes such positions for shorter periods of time (thereby increasing the likelihood that their investment pattern would place them inside a misstatement period). As Coffee pointed out, these are the characteristics of active investors such as hedge funds.[283] Having already concluded that other investors would not benefit from issuer liability, the question is then if hedge funds require issuer liability.

This seems unlikely, because information traders such as hedge funds have developed other precautionary mechanisms. In particular, they rely on *ex ante* due diligence (rather than, possibly lengthy,[284] *ex post* disclosure litigation). Chapter 7 presents data on private investor meetings in public firms indicating that information traders do not take significant positions in public companies without first meeting senior management, often several times. In other words, information traders do significant due diligence before committing capital and have the ability to ask any question they want from senior management. If they find management's answers persuasive, they can go long; if they do not, they

283 We can think of active investors such as hedge funds as a type of information trader. Whereas some information traders may have a focus on writing algorithms to analyse the content of corporate press releases and automatically trade on the information almost immediately after its release, active investors (such as some types of hedge funds) are focused on finding non-public information about a company on which to trade, through private meetings with insiders, industry experts, or their own analysis.

284 The private actions against Tesco for its 2014 misstatement are still ongoing as of early 2019.

can go short. If there are information traders that take significant positions in public firms and subsequently suffer large losses due to misstatements, they have either not done their due diligence or not done it well enough.

A regime *without* issuer liability would thus be based on enlisting *new* investors as corporate monitors, whereas a regime *with* issuer liability would enlist *existing* investors as monitors. I have argued above that it is doubtful whether existing investors have the opportunity to effectively monitor. Combined with the observation here, that the most sophisticated investors are conducting significant due diligence on companies before investing, it seems suitable to deny those investors issuer liability in order to activate them as corporate monitors.[285]

A regime without issuer liability requires of information traders that they perform their due diligence, since they will not get compensated by the issuer if

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[285] My argument that information traders have a chance of monitoring by asking questions in private meetings with management does not mean to imply that they cannot do so once they are shareholders. However, the typical information trader would only invest in a company's shares in order to monetize an information advantage, and would not remain as a shareholder for the long-term. In the job market for skilled information traders, we would expect the best ones to end up working for the institutions that do the most frequent and significant trading, such as hedge funds, rather than, say, mutual funds. Consistently with that idea, research on private investor meetings has found that hedge funds were the only investor type that consistently benefitted from private meetings. *See* David Solomon & Eugene Soltes, *What Are We Meeting For? The Consequences of Private Meetings with Investors*, 58 Journal of Law & Economics 325 (2015). Further, I do not mean to say that hedge funds necessarily will identify all misstatements before trading; only that they – as the only investor category remaining that could plausibly justify issuer liability – do not need it.

the investment loses value. This lack of issuer liability is not a bad deal for information traders, because they are able to (and *should*, as professional investors, be able to) protect the downside of any position they take by performing due diligence. In a regime without issuer liability, further, investors could not seek to blame the company for misstatements, since any losses they suffer would be deemed due to failures to investigate before investing.

Due diligence investigations, such as private meetings with senior management, are already a significant factor in active investors' identification of investment opportunities. The business model of these investors is to gather private information both to identify business opportunities and to protect their downside. This does not require an issuer liability regime – indeed the *absence* of a liability regime may encourage them to conduct *more* due diligence for the benefit of all investors – but it does require a regulatory environment that allows for these private due diligence meeting with managers to take place. Such a non-liability framework would be expected to work best when it allows for exchanges of meaningful information between senior managers of public firms and outside investors, since the active investors would otherwise not be able to gain profitable insights from the meetings. I will revert to this topic in more detail in Chapter 7.

4.5. Director and officer liability

As argued earlier in this chapter, the main justification for imposing disclosure liability should be the deterrence of misstatements (not compensation after the fact) due to the significant social costs misstatements can impose. Issuer liability in itself will not deter the individual directors or officers who produce disclosures, since they will not internalise the social costs of their misstatements.

The Davies Review argued against director and officer (D&O) liability on the basis that the company was best placed to determine whether or not to sue a director for the negative effects caused by breaches of duty.[286] This approach is subject to the usual reservations that directors may not be inclined to take legal actions against one of their colleagues. Davies nonetheless preferred that only the issuer itself faced external liability since its directors can design internal control structures to deter its employees from misstatements.[287] This is not an obvious conclusion to reach, since D&O liability is a more direct and targeted method for deterring insiders from misstating disclosures. The current issuer liability regime already requires attribution of intent or recklessness to specific insiders (further analysed in chapter 5), so in this respect the deterrence effect would be the same. However, the deterrence effect should be enhanced by placing liability directly on the responsible insiders.

However, D&O liability brings its own problems. The relevant individuals would rarely (if ever) have enough funds to compensate the large losses disclosure misstatements can cause. This does not mean, however, that D&O liability is inefficient; since the insiders are typically risk-averse and the firm would bear some of the costs for precaution, the effectiveness of D&O liability

[286] Davies Review Final Report (n 4) 25-26.

[287] Davies Review Final Report (n 4) 26.

as a deterrence mechanism is increased.[288] D&O liability, taking into account their ability to pay, should therefore be part of the legal framework that replaces issuer liability. One promising approach is to provide for clawbacks of compensation already received from the company, and/or mandatory deductibles, such as in §93(2) of the German Aktiengesetz, which makes directors liable for a deductible of 10% of damages payable up to an amount equal to 150% of their annual remuneration.[289] By stipulating that directors should pay compensation for oversight failures, they will be more incentivized to put in place strong internal controls.

Naturally, if directors were to become subject to disclosure liability, we would also expect them to try to minimise the risk of personal pecuniary losses, which would have two effects.

First, the "chilling effect" argument raised during the Davies Review would play out even more acutely for D&O liability than for issuer liability, if negligence is chosen as the appropriate culpability standard. The risk is that insiders would limit the usefulness of their companies' disclosures in order to ensure that they will not be found negligent. This could be countered, however, by public enforcement of the quality of disclosures in a more nuanced way than is done today. As we have seen, the US SEC ensures

[288] John Armour and Jeffrey N. Gordon, 'Systemic harms and shareholder value' (2014) 6 Journal of Legal Analysis 35. 70-72.

[289] This solution is mentioned in Paul Davies, 'Damages actions by investors on the back of market disclosure requirements', in Danny Busch, Emilios Avgouleas and Guido Ferrarini (eds, OUP 2018) *Capital Markets Union in Europe* 318, 332.

through regular review that companies comply not just with the letter, but also the spirit, of disclosure requirements.[290] The current UK system is not currently set up in this way – the Financial Reporting Council's Conduct Committee is only authorised to take action where disclosures do not comply with law.[291] More detailed UK enforcement would reduce insiders' ability to "chill" disclosures.

Secondly, these individuals would demand that issuers pay them higher compensation or take out insurance to help them bear the additional risk without additional personal costs. Increased pay, to account for the additional workload in monitoring disclosures, would appear to be a price worth paying for shareholders, but insurance is more problematic.

Since directors' and officers' insurance cannot cover wilful misconduct, such insurance could cover negligent but not fraudulent misstatements.[292] By placing liability on the individual insider, the intention is to deter misstatements by subjecting the individual to the risk of a pecuniary loss. If the issuer provides an insurance policy against such a loss, the intended negative pecuniary effect on the individual is removed, and the individual's incentive to monitor corporate disclosures is removed to the same extent. The problem, then, is that the insurance company will not necessarily take on the monitoring role vacated

[290] See note 263 and accompanying text.

[291] Supervision of Accounts and Reports (Prescribed Body) and Companies (Defective Accounts and Directors' Reports) (Authorised Person) Order, SI 2012/1439.

[292] See generally, Stuart Hill, 'Directors' Liabilities: Provision of Insurance' in Simon Mortimore (ed) *Company Directors: Duties, Liabilities, and Remedies* (3rd edn, OUP 2017) 529-550.

by the insider. The insurance company will want to reduce its risk in the case of the individual policy paying out, but the main ways for doing this are (i) pre-contractual investigations to select which firms to accept as customers and the price at which to take on the risk, and (ii) diversification of the risk of the individual policy to diffuse its effect in case of payout.

As for (i), the result of an insurance company's investigations may affect the cost of the D&O insurance which, if disclosed to investors, could allow them to ascertain which companies insurers deem more risky. This information is, however, not currently required to be disclosed, which means that they do not benefit from the investigative work that insurers do as part of their underwriting.

As for (ii), diversification can either be internal (i.e., the aggregation in one insurance company of a large portfolio of policies insuring the same type of risk, to increase the confidence level of expected claims and to reduce the effect of an individual claim) or external (sell parts of the policies in the reinsurance market). It is not unreasonable to expect that insurance companies after underwriting a policy would be actively involved, for example in overseeing corporate disclosure practices or establishling guidelines on corporate practices to be followed. However, the available evidence shows that insurance companies do not monitor.[293] Baker and Griffith attribute this to an agency problem: corporate insiders purchase insurance with (effectively) shareholders' funds to the fullest extent possible, with a preference to pay a

[293] Tom Baker and Sean J. Griffith, *Ensuring Corporate Misconduct* (Univ Chicago Press 2011).

higher premium to avoid interference in the company's operations. Through the use of insurance, the intended deterrent effect of disclosure liability has thus been converted to a compensation mechanism which no longer serves the purpose of deterrence. Deterrence devolves into compensation.

Fox has alluded to problems of D&O insurance in arguing that it should "probably be prohibited".[294] His main reason was probably based on his advocating a regime where damages are paid to the firm rather than to investors, and from this perspective it would not make much sense for the firm to pay for the insulation of directors and officers from actually paying such compensation. Instead, Fox preferred a regime where directors' and officers' liability should be capped with reference either to the individual's compensation received from the firm or total wealth, and raising their compensation so that they would accept such risk.[295] The important thing to remember here is that the aim is not compensation, but deterrence: clearly the directors and officers will not be able to pay the full costs of the misstatement, but that is not the point. The aim is instead to construct a regime where a misstatement would hurt insiders so significantly that they are deterred from engaging in misstatements.

There may, however, be other mechanisms that are more efficient deterrents than personal pecuniary liability. When we start with the perspective of tort law theory, we tend to assume that if the performance of an activity is not

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[294] Fox (n 214) 288 (labelling D&O insurance "highly problematic").

[295] Fox (n 214) 288-89.

associated with any liability rule, people will not take care in performing that act. But such a conclusion is of course only true to the extent that the relevant actor does not risk incurring any other costs in the performance of the act. In the case of corporate disclosure misstatements, it is reasonable to expect that the directors and officers responsible will incur significant reputational costs. The effects on their reputation of a misstatement, especially if serious, may be near-immediate and last for the duration of their careers. If a corporate director or officer is found to have been a driving force behind a misstatement or an ineffective overseer, investors may not want their continued involvement in the company, or for that matter in any company. Casual empiricism suggests that reputational effects are already playing a significant role in the UK enforcement of disclosure misstatements. In Tesco, for example, eight of its ten directors as of the misstatement had left the company by the time of the next AGM, long before the resolution of either the FCA's or the SFO's investigations.[296] Empirical studies of US data corroborate the idea that involvement in a disclosure misstatement can significantly harm an individual's reputation. A study which examined the fates of the approximately 2,200 managers identified by the US SEC as responsible for financial misrepresentation found that 93% of them lost their jobs.[297] Another study found that outside directors of firms facing fraud class action lawsuits lost

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[296] See section 8.2.

[297] Jonathan M. Karpoff, D. Scott Lee and Gerald S. Martin, 'The consequences to managers for financial misrepresentation' (2008) 88 Journal of Financial Economics 193.

other directorships and that this effect was particularly strong when the fraud allegation was more severe or the director had more responsibility to monitor.[298]

A reputational penalty does not hurt individuals' *current* wealth as much as Fox's proposal, but instead reduces their *future* earnings power. The deterrence that the reputational effect can achieve is thus higher when directors and officers are at an earlier stage of their careers (and still have most of their future earnings power ahead of them) than when they are nearing retirement. To deter directors and officers from engaging in disclosure misstatements, we can thus not solely rely on reputation.

In conclusion, there are difficult tradeoffs involved also in designing a deterrence regime for directors and officers, but placing liability on them should contribute significantly to increased deterrence, even though it cannot

[298] See Eliezer M. Fich & Anil Shivdasani, Financial fraud, director reputation, and shareholder wealth, 86 J Fin Econ 306 (2007). See also Maria Correia & Michael Klausner, Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis (working paper 2012) (finding that CEOs and CFOs and other officers of public firms face increased risk of turnover after a class action lawsuit for securities fraud and decrease their chances of finding a comparable position in another public firm). In a recent paper, Gow et al. found that directors strategically withheld from their public biographies information about prior directorships of companies that had experienced adverse events during the director's tenure. See Ian D. Gow, Aida Sijamic Wahid and Gwen Yu, 'Managing reputation: Evidence from biographies of corporate directors' (2018) 66 Journal of Accounting and Economics 448.

be expected to deter misstatements on its own.[299] For this reason commentators have considered imposing liability also on other parties, which will be explored in the next subsection.

4.6. Third-party ("gatekeeper") liability

The difficulties in creating deterrence through issuer or D&O liability have led commentators to offer alternative regime designs where outside actors (sometimes called 'gatekeepers') take on liability, with the underlying idea that they will then be incentivized to monitor companies which will increase deterrence of wrongdoing. Several commentators have presented proposals to amend US disclosure regulation along such lines.

Coffee has advocated the creation of a "disclosure counsel" role, where outside experts review all of a public firm's disclosures and certifies their accuracy. Such counsel could be an outside law firm, which could be disciplined or suspended by the SEC if found negligent, but not liable to investors in private 10b-5 actions on that basis.[300] This, argues Coffee, would enhance deterrence without threatening the law firm with insolvency.

Fox has also proposed that the US adopt a third-party liability regime for corporate disclosure. In his model, a new corporate organ called the "external certifier" is tasked with the role of reviewing and certifying the accuracy of

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[299] See, e.g., Kraakman (n 146) 108 (referencing the judgment proof problem and the inequality between the potential gains from misstatements and the limited downside).

[300] John C. Coffee Jr., *Gatekeepers – The Professions and Corporate Governance* (2006) 351-352.

both the annual report and all the firm's SEC filings during the past year.[301] Fox's overall model would entail a significant reshaping of the US regime for continuous disclosure liability, with no liability to investors at all, but strict liability to the issuer from directors, officers and the external certifier, subject to a due diligence defense.[302]

Fox's proposed regime would likely be costly to introduce, as it would require new laws and regulations to govern the new corporate organ of the external certifier as well as ongoing issuer costs in paying for the services of the external certifier and SEC oversight. Fox's solution to the difficulties of creating deterrence through D&O liability would involve allowing for damage caps relating to their compensation or overall wealth, but not insurance.[303] For the external certifier, he would however allow insurance.

It is, of course, difficult to assess whether Fox's construction would effectively deter disclosure misstatements and this would depend significantly on its exact implementation. I would submit that the regime as presented by Fox would not address the important problem (discussed in the previous subsection) that a liability regime introduced for purposes of deterrence will devolve into a compensation regime unless it is designed to explicitly combat this issue.

My point is this. We introduce liability on a particular person in order to ensure that this person takes adequate care in producing or monitoring corporate

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301 Fox (n 214) 277.

302 Fox (n 214) 284.

303 Fox (n 214) 288-89.

disclosures. If they do not take such care, they are liable to compensate. If the liable person is allowed to diffuse its liability risk, deterrence reduces as risk diffusion increases. This risk diffusion can be internal (as when an 'external certifier' has 1,000 clients) or external (as when an external certifier insures against the risk of paying out, thereby moving the risk to an insurance company). The insurance company is then supposed to take on the role of monitoring to deter misstatements, but can, again, diffuse the risk internally (by insuring 1,000 policies of external certifiers) or externally (by selling 99.9% of an individual policy in the reinsurance market). In these cases, the risk ends up in a diversified pool, which will reduce incentives to monitor and thereby convert the role of liability from deterrence to compensation. They could, of course, monitor, but this is incredibly expensive and difficult, as evidenced by the many failings we observe already today from directors and auditors. Diversification may often be cheaper than monitoring, but this process converts a deterrence scheme to a compensation scheme.

If we are seeking real deterrence, risk needs to be concentrated in one or a few parties who should not be allowed to diffuse it. If we introduce a third party gatekeeper, they must therefore be required to hold on to some portion of the risk if they are to be an effective monitor.[304]

From the perspective of shareholders, regimes that convert deterrence into compensation are inefficient since they could bear the loss from misstatements themselves by diversifying their portfolios instead of having the firm pay to

[304] The same could be said for other third-party gatekeepers, such as auditors and credit rating agencies.

shift that risk to a third party. The "external certifier", if allowed to diffuse its risk, becomes an insurance company. As already discussed in the context of issuer liability, the expected cost to a diversified investor of leaving losses in the firms in which they occur, then, is lower than the expected cost of shifting them, since risk shifting necessitates the incurrence of transaction costs, both for insurance and for litigation to establish liability. A diversified equity investor would thus share in higher corporate profits without such a regime.

In order to make a liability regime focused on deterrence function well, it needs to prohibit insurance and/or diversification (as the case may be), or target parties that are unable to insure or diversify. I would submit that we, rather than creating new organs for third-party monitoring, should start by asking if there may already be undiversified stakeholders who could be mobilized to monitor. The next section will discuss this.

4.7. Finding and mobilizing undiversified stakeholders

I have so far argued that the main problem of attempting to create deterrence through liability is that no-one wants to actually be left holding significant, concentrated risk when it is complex and costly to monitor those who may cause your liability to be activated. Therefore, institutions tasked with liability diversify when they can: auditors take on many clients to diffuse the risk of any single client misstating its financial statements in ways which are difficult to detect, and take out insurance as well. Directors require issuer-paid insurance before accepting directorships. Rather than creating further institutions with similar incentives, it is submitted that a more efficient, and cost-effective, solution would be to find existing stakeholders that are undiversified and mobilize them.

Coffee has noted that the stakeholders that we should feel the most sorry for are the company's own employees.[305] Employees are undiversified since much of their human capital is tied up in the firm, and human capital cannot be diversified in the way that financial capital can. The future careers of employees that have invested several years working for one firm will depend on the success of their current firm. Put differently, if a finance manager in Company A failed to notice (or alert the board of directors to) the CFO fraudulently misrepresenting the company's financial position, he may find it difficult to find new employment. Already today, in cases where senior managers take significant risks which may risk the viability of the firm, employees would therefore be motivated to blow the whistle.

Since employees are already present inside companies, it would seem a good idea to enlist them as monitors. Employees at the level below senior management will often have significant insight into what is happening at the firm, but lack the highly charged incentives of the managers at the top. Because of this discrepancy, employees may rationally act to expose disclosure misstatements quickly –in order to save their jobs or, if the regime so provided, to collect a bounty.

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[305] See text accompanying note 222. Langevoort has recently also made the point that employees are the stakeholders that are worst off from large corporate frauds. *See also* Langevoort (n 217) 51.

The evidence suggests that employees can be a useful group of stakeholders to incentivise. Employees have been found to be the main source of successful fraud prosecutions in the US, followed by industry regulators and the media.[306] Firms subject to whistleblowing allegations have also been found to exhibit significant decreases in financial misreporting and tax aggressiveness compared with control firms.[307]

The aim of this chapter is not to design a complete employee whistleblower regime, but such a regime could be outlined. Companies could be required to nominate an independent director on the audit committee to which employees could report concerns in relation to suspected misstatements. That director should have a budget and the required authority to investigate such concerns. If the director deemed an employee's report valuable, they should have discretion to provide the employee with a monetary reward corresponding to a suitable percentage of the company's benefit from the report. Within a stipulated time frame of receiving the report, the audit committee member should be required to submit it to the regulator (in the UK, the Financial Conduct Authority would likely be most suitable) together with an explanation of what actions have been taken. If the director declined to take action, the FCA should nonetheless have the authority to reward the employee out of the

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306 See Alexander Dyck, Adair Morse & Luigi Zingales, Who Blows the Whistle on Corporate Fraud?, 65 J. Fin. 2213 (2010).

307 Jaron H. Wilde, ' The Deterrent Effect of Employee Whistleblowing on Firms' Financial Misreporting and Tax Aggressiveness' (2017) 92 Accounting Review 247.

company's funds to the same extent as the director, if it thought it was suitable. A system along these lines would create a powerful deterrent effect on senior managers considering whether to engage in misstatements, since the knowledge that their subordinates could report their potential transgressions for significant financial rewards (in relation to their salaries) would mobilize them as internal monitors. Such internal monitors would be more cost-efficient than external monitors such as auditors or external certifiers, because the employees will acquire knowledge of potential transgressions as part of their job. Further, it would be difficult for a senior manager to restrict employees' access to information internally without raising the alarm, while it is much easier to restrict information access from people external to the firm.

A study of the role of sell-side financial analysts in connection with disclosure misstatements concluded that they did not discover disclosure misstatements in companies whereas short sellers, insiders and institutional investors were able to do so.[308] A study by Karpoff and Lou also found that short sellers contributed to detecting financial misrepresentations, with short interest increasing in the 19 months before the public revelation of the misstatement.[309] Short-selling was associated with a faster discovery of misstatements and

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308 Paul A. Griffin, 'A League of Their Own? Financial Analysts' Responses to Restatements and Corrective Disclosures' (2003) 18 Journal of Accounting, Auditing and Finance 479. See also Brown et al (n 235).

309 Jonathan M. Karpoff and Xiaoxia Lou, 'Short sellers and financial misconduct' (2010) 65 Journal of Finance 1879.

dampened the share price inflation of the misstatement. Short-sellers thus play an important role by keeping share prices closer to fundamental values.

4.8. Preliminary conclusions

It is interesting to juxtapose the claim of Chapter 3 – that EU capital markets law supports information traders as a positive matter and *should* do so as a normative matter – with Coffee's claim that it is "ironic" that short-term investors such as hedge funds may be the only winners from a regime of issuer liability. I argue that such an outcome could be justified with reference to the important role information traders have in the capital markets.

This chapter has failed to find a convincing justification for issuer liability based on deterrence. If pressed, one could attempt to justify issuer liability by arguing that it protects information traders from unanticipated events. Such an attempt would ultimately fail to convince, however, on the basis that undiversified active investors engaging in information trading arrange their own protection by engaging in significant pre-investment due diligence. By not providing for issuer liability, they would be further encouraged to perform such due diligence for the benefit of all investors. The "flipside" of that coin is that active investors need to be offered an opportunity to profit by performing such due diligence, and we will see in chapter 7 how this is done in practice (but not in theory).

It seems likely that some liability placed directly on directors and officers will be more useful for deterrence purposes than issuer liability, even if limited to the compensation they have received from the company or some multiple thereof. It appears more cost-effective to provide company employees with incentives to monitor in the form of whistle-blowing incentives, rather than to create new external third-party monitors and regulatory oversight thereof.

5. Incentives for insider monitoring

5.1. Introduction

This chapter will analyse the current 90A regime to see what incentives it is likely to create inside companies. The particular issue to be considered is the effects on disclosure *liability* of delegation within companies of disclosure *responsibility*.

5.2. The effects of delegation in the 90A regime

5.2.1. The issue

Under the 90A regime, the issuer is liable in respect of an *untrue or misleading statement* only if a person discharging managerial responsibilities (a 'PDMR') knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading.[310] Similarly, the 90A regime provides issuer liability for *omissions* of matters required to be included in published information only if a PDMR knew the omission to be a dishonest concealment of a material fact.[311]

To understand what incentives this gives rise to, the first task is to establish who, exactly, will be considered a PDMR under the 90A regime. A PDMR is defined as "any director of the issuer (or person occupying the position of

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[310] Section 3(2), Schedule 10A FSMA.

[311] Section 3(3), Schedule 10A FSMA. Dishonesty is further defined in s. 6 Sch. 10A.

director, by whatever name called)".[312] This is different from the regular definition of PDMR in MAR for market abuse and disclosure purposes, which includes not only directors but senior executives with regular access to inside information and the power to make managerial decisions affecting the future development and business prospects of the issuer.[313] This definition of PDMR was introduced already through the first ("stop-gap") version of the 90A regime, but there is no explanation for its choice of drafting in the statute's preparatory documents.

In any event, this PDMR definition means that only a director's (and not a senior manager's) knowledge or recklessness will automatically be attributed to the company. The inclusion of "person[s] occupying the position of director, by whatever name called" is in all likelihood meant to include de facto directors or shadow directors, rather than the board's delegates. The PDMR definition, further, means that a claimant only needs to show that *one* director possesses the required mental state, not the board as a whole. It is not clear, however, what the liability situation would be where directors delegate the act of disclosure in the company's name to another person who intentionally or

[312] Section 8(5)(a), Schedule 10A FSMA. Section 8(5)(b) also provides that, if the company is managed by its members, any member will be considered a PDMR and that, if the company does not have any PDMRs under (a) or (b), any senior executive fulfilling disclosure duties will be considered a PDMR. Since these are unusual and clearly delineated situations, they will not be considered further.

[313] MAR article 3(1)(25). This definition was for UK purposes previously (from the introduction of MAD in 2005 until MAR came into effect in July 2016) found in section 96B FSMA.

recklessly misstates those disclosures, or if directors rely on information from subordinates who later are found to have been fraudulent or reckless in providing them such information.

Davies noted in his 2007 discussion paper that:

> [A] company can only know things if the knowledge of human beings is attributed to it, and the section treats those 'discharging managerial responsibilities' as the relevant persons. Normally, this will be the directors.[314]

It is open to question what Davies meant with the term "normally" in the quoted sentence, but since there was no apparent analysis involved before he reached the conclusion above it seems unlikely that the sentence intended to suggest that executives below board level could be considered PDMRs. Davies's statement is instead likely to be a generalizing description of the contents of the provision for purposes of not subjecting to further analysis the special cases of issuers without directors.[315] In more recent work on the subject, Davies noted that the PDMR definition in the 90A regime is based on a concept from EU law (which would suggest that executives could be included, as they would in the EU law concept), but then argued that the UK definition "incentivizes those at board level to arrange information flows

[314] Davies Review Discussion Paper 25 (para 53).

[315] The PDMR definition in the "stop-gap regime" of section 90A that was in effect at his time of writing looked the same as the current section 90A.

within the company so that knowledge of adverse facts does not reach the board" (thus clearly concluding that they cannot).[316]

Such a strict, textual interpretation of FSMA appears undesirable as it could easily be strategically avoided. Boards of directors typically delegate significant authority to effectuate the necessary disclosures in the company's name to a manager within the company (who may or may not be a director). That person may in turn be supported by "investor relations" or "corporate communications" personnel. Boards of listed companies would therefore not be expected to review and approve every item to be disclosed, but instead establish a framework of principles or guidelines for how its delegate(s) shall proceed. That framework may stipulate that the board shall approve annual and quarterly financial reports and other episodic disclosures of material information before they are released for public dissemination, but that the delegate may disclose other items, including those required by law, without pre-approval.[317] Further, even when directors *do* review disclosures prior to dissemination, they would still have needed to rely on others within the company to provide correct input information (such as accounting data). In the case of a misstatement, directors may therefore not have actual knowledge that the disclosure was untrue or misleading.

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[316] Davies (n 289) 334.

[317] Common disclosures include managers' transaction reports under MAR.

The interesting question is then whether, when directors delegate the act of disclosure to a non-director, the law will necessarily, as Davies appears to have concluded,[318] find that *liability* remains with the directors even though the *authority* has been delegated to subordinates. By decoupling the act of disclosure from the mental state required for liability under the 90A regime, liability could then easily be avoided.

5.2.2. Guidance from case law

To understand what approach the courts may take in a case such as the Tesco misstatement, where the FCA did not find any wrongdoing at the level of the directors, this section will examine the case law from the perspective that, if the courts have allowed corporate liability for certain acts to follow directors' delegation of that act, they may consider doing so in the 90A context as well. Below I will first present the main cases identified as relevant to the question, after which I will consider what this body of case law may mean for attribution in the 90A regime.

In *Lennard's Carrying v Asiatic Petroleum*, the House of Lords needed to determine whether, and if so how, a ship-owning company could avail itself of a no-fault defence to liability under the Merchant Shipping Act 1894. Their lordships held that a company could have the actions or knowledge of a natural person attributed to it if that person was 'the directing mind and will' of

[318] Davies (n 289) 334.

the company for purposes of the act.[319] The phrase 'directing mind and will' subsequently developed into a term of art, with the House of Lords' judgment in *Tesco Supermarkets v Nattrass* generally interpreted as precluding corporate liability for actions below senior decision-makers within the company.[320] Such a limitation of the doctrine of corporate liability was however halted (at least in the case of civil and administrative liability) by the leading modern case on attribution – the decision of the Privy Council in *Meridian Global Funds Management Asia Ltd v Securities Commission.*[321] The question in this case was when a company should be deemed to know that it was a substantial shareholder, since this required immediate disclosure under sections 20(3)-(4) of the New Zealand Securities Amendment Act 1988, which was worded as follows:[322]

> (3) Every person who, after the commencement of this section, becomes a substantial security holder in a public issuer shall give notice that the person is a substantial security holder in the public issuer to
>
> (a) The public issuer; and

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[319] *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd*, [1915] AC 705 (Viscount Haldane LC, with whom the other judges concurred).

[320] Tesco Supermarkets Ltd v Nattrass, [1972] AC 153.

[321] *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 BCLC 116, [1995] 2 AC 500.

[322] As per [1995] 2 BCLC 116, at 119.

(b) Any stock exchange on which the securities of the public issuer are listed.

(4) Every notice under subsection (3) of this section shall-

(a) Be in the prescribed form; and

(b) Contain the prescribed information; and

(c) Be accompanied by, or have annexed, such documents, certificates, and statements as may be prescribed; and

(d) Be given in the prescribed manner; and

(e) Be given as soon as the person knows, or ought to know, that the person is a substantial security holder in the public issuer.

The question for the Privy Council was whether the knowledge of the employee who conducted certain securities trades could be counted as the corporate person's knowledge under section 20(4)(e), even if the directors were unaware.

In giving the judgment of the Board, Lord Hoffmann provided a classification of corporate attribution rules. In his taxonomy, *primary rules of attribution* (a company's articles of association and company law) combine with *general rules of attribution* (the law of agency) to form the fundamental legal framework that governs how a natural person is able to bind a company in contract and subject it to obligations such as vicarious liablity in tort. While that fundamental framework will be sufficient to answer most questions regarding whether a natural person has acted on behalf of a company, Lord Hoffmann acknowledged that there will be some exceptional cases where courts need to go further: "This will be the case when a rule of law, either expressly or by implication, excludes attribution on the basis of the general principles of agency or vicarious liability", as when criminal laws "impose liability only for the actus reus and mens rea of the defendant himself".[323] In these cases, a court may need to fashion *a special rule of attribution* based on an interpretation of the substantive rule in question:

> "This is always a matter of interpretation: given that it was intended to apply to a company, how was it intended to apply? Whose act (or knowledge, or state of mind) was for this purpose intended to count as the act etc of the company? One finds the answer to this question by applying the usual canons of interpretation, taking into account the language of the rule (if it is a statute) and its content and policy."[324]

Since it deals with the subject-matter of disclosure, it is particularly instructive to study how the Privy Council in *Meridian* thereafter proceeded to construct a special rule of attribution to determine whose knowledge should count as that of the company under the New Zealand statute:

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323 [1995] 2 BCLC 116, at 121-22.

324 [1995] 2 BCLC 116, at 122.

"The policy of s 20 of the 1988 Act is to compel, in fast-moving markets, the immediate disclosure of the identity of persons who become substantial security holders in public issuers. Notice must be given as soon as that person knows that he has become a substantial security holder. In the case of a corporate security holder, what rule should be implied as to the person whose knowledge for this purpose is to count as the knowledge of the company? Surely the person who, with the authority of the company, acquired the relevant interest. Otherwise the policy of the Act would be defeated. Companies would be able to allow employees to acquire interests on their behalf which made them substantial security holders but would not have to report them until the board or someone else in senior management got to know about it. **This would put a premium on the board paying as little attention as possible to what its investment managers were doing.** Their Lordships would therefore hold that upon the true construction of s 20(4)(e), **the company knows that it has become a substantial security holder when that is known to the person who had authority to do the deal**. It is then obliged to give notice under s 20(3). The fact that [the employee] did the deal for a corrupt purpose and did not give such notice because he did not want his employers to find out cannot in their Lordships'

> view affect the attribution of knowledge and the consequent duty to notify."[325]

In *Meridian*, the court thus stepped back from the 'directing mind and will' theory of attribution in favour of focusing on the purpose of the provision:

> "It was […] not necessary in this case to inquire into whether [the employee] could have been described in some more general sense as the 'directing mind and will' of the company. But their Lordships would wish to guard themselves against being understood to mean that whenever a servant of a company has authority to do an act on its behalf, knowledge of that act will for all purposes be attributed to the company. **It is a question of construction in each case as to whether the particular rule requires that the knowledge that an act has been done, or the state of mind with which it was done, should be attributed to the company**."[326]

Corporate liability in *Meridian* followed the board's delegation of the actual act and the court emphasised that another outcome would have incentivised boards to engage in delegation without oversight for purposes of 'strategic deniability'.

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[325] [1995] 2 BCLC 116, at 126 (emphasis added).

[326] [1995] 2 BCLC 116, at 126 (emphasis added).

In *Morris v Bank of India*, a strong Court of Appeal (Mummery, Neuberger LJJ and Munby J) laid down further helpful guidance for future cases where corporate attribution issues arise in relation to fraud.[327] In this case S., the general manager of BOI's London branch, had been found to have had actual knowledge of, or exhibited reckless indifference to, the fraudulent nature of BOI's transactions with BCCI. BCCI entered insolvency and its liquidators sued BOI under s. 213 of the Insolvency Act 1986 for contributions to the company's assets. This statute provides as follows:

> "**213. Fraudulent trading.**
>
> (1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.
>
> (2) The court, on the application of the liquidator may declare that **any persons who were knowingly parties** to the carrying on of the business in the manner above-mentioned **are to be liable to make such contributions** (if any) to the company's assets as the court thinks proper."[328]

BOI's directors did not have knowledge of the fraudulent nature of the relevant transactions, so the question was whether the branch manager's

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[327] Morris v Bank of India [2005] EWCA Civ 693, [2005] 2 BCLC 328.

[328] s. 213 Insolvency Act 1986 (emphasis added).

mental state could be attributed to BOI. The CA established that the statute's purpose was to compensate those who suffered loss as a result of fraudulent trading, and that a special rule of attribution was required in order to make that policy effective.[329]

> "The crucial question is whose knowledge in the company counts, for the purposes of s 213, as corporate knowledge of the outsider company. In most companies of any size there will be a chain of command and delegation of authority and it is likely that the transactions with the fraudulent company will be dealt with at a level in the company below that of the board. **It would in practice defeat the effectiveness of the section if liability were limited to those cases in which the board of directors was actually a direct privy to the fraud of the company with whom the transactions were entered into.**"

While there was no dishonesty on the part of any of BOI's directors, policy concerns nonetheless required the attribution of the branch manager's "blind eye knowledge"[330] to BOI lest the court would "ignore reality, and risk emasculating the effect of the provision".[331]

The CA also noted that there are "circumstances in which an individual's knowledge of fraud cannot and should not be attributed to a company", such

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329 Morris v Bank of India [2005] 2 BCLC 328, 356 at [111], [120].

330 Roy Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, 4th student edn 2011) 661.

331 Morris v Bank of India [2005] 2 BCLC 328, 360 at [129].

as when the company itself is the target of the dishonesty.[332] The court also cautioned against interpreting its findings in this case to mean that the knowledge of any agent should be attributed to the company under this statute, and offered the following general guidelines:

> "We are of the view that [the answer to the question of whether a particular agent's knowledge should be attributed to the company] must typically depend on factors such as these. The agent's importance or seniority in the hierarchy of the company: the more senior he is, the easier it is to attribute. His significance and freedom to act in the context of the particular transaction: the more it is 'his' transaction, and the more he is effectively left to get on with it by the board, the easier it is to attribute. The degree to which the board is informed, and the extent to which it can be said that it was, in the broadest sense, put on inquiry: the greater the grounds for suspicion or even concern or questioning, the easier it is to attribute, if questions were not raised or answers were too easily accepted by the board."[333]

Morris v Bank of India is therefore an example where the statute required intent or recklessness and this mental state was only present below the level of the

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[332] Morris v Bank of India [2005] 2 BCLC 328, 357 at [114].

[333] *Morris v Bank of India* [2005] 2 BCLC 328, 361 at [130].

board of directors but still imputed to the company. This case thus offers helpful guidance for potential 90A claimants.

In *Bilta (UK) Ltd (in liq) v Nazir*[334] Lords Toulson and Hodge of the Supreme Court explained that, for third party claims against a company, the general rules of agency will generally serve to attribute both the acts and the state of mind of directors or employees to the company.[335] If agency rules do not achieve that result but a court nonetheless construes a statute to require such attribution, it may use "special rules of attribution" to make it so.

In *FCA v Da Vinci Invest*,[336] Snowden J. was faced with the question of how to establish whether a corporate person had committed market abuse. The facts were as follows. Three individual traders had contracts with Da Vinci Invest ("DVI") allowing them to use DVI's "direct market access" arrangements to trade directly on the London Stock Exchange. The FCA accused the three traders of having committed market abuse, and the question for Snowden J. was whether DVI could also be liable under the civil framework in s. 118 FSMA (now found in MAR). Since Snowden J. found that there was no mental element required in order to commit the market abuse offences referencing "behaviour", the only question he needed to answer was whether the traders' actions could be attributed to DVI. Referencing the sections of *Meridian* and *Bilta* quoted above, Snowden J. held that this question could be answered by

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[334] *Bilta v Nazir* [2015] UKSC 23, [2016] AC 1, [2015] 2 All ER 1083.

[335] *Bilta v Nazir* [2015] 2 All ER 1083, 1149 [205] (Lord Hodge and Lord Toulson).

[336] *FCA v Da Vinci Invest Ltd* [2015] EWHC 2401 (Ch), [2016] 1 BCLC 554.

referencing the law of agency, without resorting to special rules of attribution such as the 'directing mind and will'.[337] With notable similarities to the courts' reasoning in both *Meridian* as well as *Morris v Bank of India*, Snowden J. explained how the policy of the market abuse regime required that DVI was held liable:

> "It would be contrary to the policy of the market abuse regime under FSMA were the companies involved to be able to escape liability for the actions of their employees by contending that the senior directors or executives who might, for other purposes, be said to constitute their 'governing mind and will' did not actually direct the trading in question and had no detailed knowledge of what was being done on the electronic trading platforms by those employees (or even by computer programs designed or operated by those employees). Quite apart from the obvious difficulties of proving such direction or knowledge, such an approach would put a premium on the management of a company paying as little attention as possible to what its traders or automated trading systems were doing."[338]

The cases identified above demonstrate a considerable willingness by courts to allow liability to follow companies' internal delegation of authority to make

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[337] *FCA v Da Vinci Invest Ltd* [2016] 1 BCLC 554, 586-87 at [112].

[338] FCA v Da Vinci Invest Ltd [2016] 1 BCLC 554, 587 at [113].

them liable for actions by non-director employees. There are obvious and strong policy reasons for doing so – as seen in quotes above, courts consider the effects of decoupling liability from authority (as could be the case were the 'directing mind and will' theory instead applied) highly undesirable. If a case based on the 90A regime hinged on the attribution of the behaviour of non-directors to the company, plaintiffs would presumably cite the reasoning of the courts in *Meridian*, *Morris v Bank of India*, and *FCA v Da Vinci Invest* as the basis for such claims.

However, the 90A statute contains a particular 'quirk' in relation to all of those cases in that it stipulates the persons (directors) whose knowledge or recklessness is to count as that of the company. May courts still interpret this broadly and hold the company liable for misstatements that originate in the behaviour of employees?

It is difficult to formulate a convincing argument for why companies should be able to avoid 90A liability by removing their directors from the disclosure process and delegating disclosure tasks to non-directors. If that were the case, the 90A regime would produce a very poor set of incentives. It is also difficult to see why, from the perspective of an investor, there should be any difference between a *director* intentionally falsifying the company's disclosures and a *senior manager* (but non-director) doing the same thing under delegation from the board.

Indeed, if the aim of disclosure liability is to deter misstatements – as chapter 4 has advocated it *should* be – then regulation should be structured so as to encourage companies to put in place strong internal control systems, rather than to reward poor internal oversight procedures with a lack of liability. While I have expressed in chapter 4 severe doubts as to whether issuer liability is capable of deterring disclosure misstatements, the 90A regime is based on this idea, and its underlying policy reasons would be undermined if courts did not consider intentional or reckless behaviour below the level of the board of directors.

It was held in *Meridian* that courts are not limited by the restrictive wording of a statute in deciding matters of attribution. Lord Hoffmann explained that courts may need to fashion special rules of attribution "when a rule of law, either expressly or by implication, excludes attribution on the basis of the general principles of agency or vicarious liability".[339] Therefore – notwithstanding either the formulation of the 90A regime or the conclusion of Professor Davies as to its current limitation – I would submit that courts may start any determination of 90A liability from the position that both authority and liability for corporate disclosures rest with the board of directors, but that delegation within the company of the *authority* to disclose may mean that the *mens rea* assessment also moves to the directors' delegate(s). Both *Meridian* and *FCA v Da Vinci* were decided in such a way in similar regulatory contexts (disclosure and maket abuse, respectively). For courts seeking guidance as to when and how to allow liability to follow authority down the corporate

[339] *See* text accompanying note 323.

delegation chain, the examples in *Morris v Bank of India* quoted above will be helpful.[340]

From a forward-looking policy perspective for countries that wish to offer issuer liability regimes based on fraud, it appears most appropriate that such liability be activated regardless of the role of the individual within the company that commited the fraud. Such a regime would produce incentives for directors to put in place strong oversight routines. It could also tie in to directors' liability for misstatements, by making them contribute to any compensation to investors as outlined in section 4.5.

This solution would be similar to vicarious liability, but it would actually be a special rule of attribution. For vicarious liability to be activated, the employee would need to have fulfilled the required elements of the particular tort in close connection to his employment., and the company may then be held "responsible for the act of the other without itself being deemed a wrongdoer and without the employee's state of mind being attributed to it."[341] The 90A regime, however, is very clear that only the issuer can be liable to third parties for misstatements that fall under the statute's coverage, although there are limited exemptions in s. 7(3)(a) Sch. 10A FSMA, such as when the individual has assumed responsibility to a particular person for the accuracy of the information.[342] The existing civil law framework of vicarious liability was used

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340 *See* text accompanying note 333.

341 *Bilta v Nazir* [2015] 2 All ER 1083, 1149 [205] (Lord Hodge and Lord Toulson).

342 The scope of this exemption is the subject of chapter 6.

by way of analogy in the Davies Review to justify the imposition of issuer liability, and as part of this argument Davies even noted that the doctrine included the actions of non-director employees.[343] It is not clear why Davies referenced non-director employees in drawing support from the doctrine of vicarious liability for an issuer liability regime, since the PDMR definition existing at his time of writing (to which he did not propose changes) was the same as today, that is, including only directors.

Another issue to briefly consider is what sort of behaviour will amount to "recklessness" in reality. Since the 90A regime's liability provision is modelled on the tort of deceit, courts would be expected to interpret the recklessness element in this light. In actions for deceit, it is for the claimant to prove that the statement maker either did not honestly believe the statement to be true or was reckless as to the truth.[344] As to the difference between recklessness and negligence, the Davies Review noted:

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343 *See* Davies Review Final Report (n 4) 8.

344 *Derry v Peek* (1889) 14 App. Cas. 337.

> "Recklessness in particular is a potentially slippery concept. It would be important that it should be clear that a genuine belief in the truth of the statement made did not amount to recklessness. In other words, and contrary to developments in the United States, the proposed regime would make a firm distinction between recklessness (potentially leading to liability in damages) and gross negligence (which would not); and the dividing line between them would be the presence or absence of a genuine belief in the truth of what was said."[345]

Courts' determination of the mental state of defendants will necessarily involve an assessment of the likelihood (on a civil rather than criminal standard) that they were simply over-optimistic with poor business skills, rather than intentionally dishonest. In *Contex Drouzhba v Wiseman*, the question for the High Court was whether a director who ordered goods requiring payment within 30 days was guilty of deceit in circumstances when it appeared he would have had to know the company was unable to pay. Offering an example which appears to have significant similarities with Arlen & Carney's description of the "last-period problem" of a typical fraud case,[346] Irwin J. in the High Court explained:

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[345] Davies Review Final Report (n 4) 17.

[346] *See* section 4.3.3 above.

> "In my view, there is no necessary contradiction between a foolish optimism that something will turn up and dishonesty. Specifically, it is perfectly possible for a businessman to practice deceit in order to keep his business alive, in the unreasonable hope that things will come right in the end."[347]

The defendant was found guilty of deceit. Further guidance for the determination of recklessness in the company law setting is scarce – it is not a common standard against which English law evaluates directors' actions.[348]

5.3. Preliminary conclusions

Courts should be free to interpret the 90A regime's mental state requirement to apply it to not only directors but also their delegates where appropriate, in order to fulfil the policy goals behind the statute. *Morris v Bank of India* offers helpful guidance here and, if followed in the 90A context, would mean that recklessness by a director, specifically, is not necessarily required to impose liability.

The requirement in the 90A regime of a mental state meeting the fraud standard does not mean that companies will not face consequences for negligent misstatements. The next chapter will examine whether the tort of

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[347] *Contex Drouzhba v Wiseman* [2006] EWHC 2708 (QB) [57].

[348] Perhaps English courts can find guidance in the application of Delaware's duty of care standard which directors breach if they exhibit a "reckless indifference to or a deliberate disregard of" shareholders' interests. *Allaun v Consolidated Oil Co, 16 Del. Ch. 318, 147 A. 257 (1929).*

negligent misstatement could apply to continuing corporate disclosures. As pointed out in the Davies Review, the FCA also has the ability to impose administrative penalties or restitution schemes should an issuer not take reasonable care in disclosures.[349] FCA restitution schemes will be analysed in the context of the Tesco misstatement in chapter 8. A third possibility is for shareholders to bring derivative actions against a company where directors have breached their duty of care in making disclosures.

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[349] Davies Review Final Report (n 4) 11, referencing DTR 1A.3.2 which requires an issuer to take all reasonable care to ensure that any information it notifies to a RIS is not misleading, false or deceptive and does not omit anything likely to affect the import of the information.

6. Incentives for investor monitoring

6.1. Introduction

This chapter aims to analyse what incentives the current liability regime for continuous disclosures give an informed trader (in the form of an active shareholder) to buy a stake in a company. The situation that will be considered is that the investor bases its investment decision on the company's public disclosures, which later turn out to have been misstated, and seeks compensation under the 90A regime and the tort of negligent misstatement (that is, the *Caparo* line of cases).

The first question to be examined, then, is the extent to which the 90A regime preserves the tort of negligent misstatement. As we have seen, the concern that *Caparo* could be applied to continuous disclosures (and liability extended to TD disclosures) was a major reason for the introduction of the 90A regime, but chapter 2 noted that *Caparo* liability, confusingly, appears to have been preserved. The availability of this head of liability is an important threshold question, as we may expect aggrieved investors to prefer to sue under *Caparo* (requiring negligence) than the 90A regime (requiring fraud or recklessness) should it be available. Investors may also be able to bring more misstatement cases should a suit in negligence be available.

The second question is what types of losses shareholders may get compensated for in light of the "no reflective loss" principle. The distinction between reflective and non-reflective losses is important since it determines the amount of compensation available and thereby the overall attractiveness of private investor suits.

When these questions have been answered, the chapter will conclude by discussing the incentives resulting from the 90A regime from the perspective of the claim in chapter 3 that disclosure regulation should have the role of supporting information traders.

6.2. Did *Caparo* survive?

The first question to consider is whether *Caparo* survived the introduction of the 90A regime. At the time of implementation of the TD in the UK, commentators generally advocated a new regime to replace the uncertain negligence regime based on *Caparo* and limiting the potential impact of *Caparo* was, as we have seen, the main reason for the 90A regime's introduction..[350]

Based on the Davies Review, the Government prepared legislation for consultation in 2008.[351] In order to maintain the applicability of the *Caparo* decision to corporate governance-focused disclosures, while guarding against a broader interpretation that would allow stock market investors to claim for negligent misstatements in continuing disclosures, the Government proposed to carve out from the new regime "the rights of a holder of securities in his capacity as such".[352] Following the consultation, however, the Government decided to broaden the proposed carve-out for the tort of negligent misstatement and remove the "capacity as such" phrasing:

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[350] See, e.g., Burn (n 63) 48.

[351] HM Treasury, 'Extension of the Statutory Regime for Issuer Liability' (July 2008).

[352] Id.

> "The Government does not believe it is practicable to draft an exception in relation to undefined hypothetical rights that the courts might or might not subsequently recognise. A general exception referring to rights of a shareholder in his capacity as such or similar wording is not capable of being clearly defined without creating doubt as to the scope and effect of the statutory regime. It would be likely to result in significant tangential litigation seeking to define exactly how the exception should be applied."[353]

The end result is that Schedule 10A FSMA does not intend to affect "civil liability […] arising from a person's having assumed responsibility, to a particular person for a particular purpose, for the accuracy or completeness of the information concerned".[354] The Government's intention with this exclusion was "to ensure that an issuer will remain liable for negligent misstatements where such liability would exist under the rule in *Caparo v Dickman*, as subsequently developed by the courts."[355] If there was any doubt as to whether the Government thereby intended *Caparo* and its progeny to remain law, it also stated:

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[353] HM Treasury, 'Extension of the Statutory Regime for Issuer Liability: A Response to Consultation' (March 2010) para 6.35.

[354] FSMA Schedule 10A, para 7(3)(a)(v).

[355] HM Treasury (n 351) 21.

> "Under the test confirmed in Caparo and subsequent cases, liability arises in relation to negligent advice, where advice is given to a known recipient for a specific purpose of which the adviser is aware, and the recipient has relied on the advice, acting on it to his detriment. Expressed in other words, **the defendant will be liable for negligent misstatements causing economic loss where the defendant has assumed responsibility** to the claimant for the accuracy of the information given to the defendant, who acted on that information and suffered loss as a result. **The revised provision** in paragraph 7(3)(a)(iv) of the Schedule to the Regulations **preserves this test**."[356]

The Government proceeded:

> "The new test excludes the possibility of shareholders asserting that companies have a wider duty of care for misstatements in relation to governance rights that might cause economic loss (except of course where there is an assumption of responsibility falling within the scope of our provision). No such duty has been established in case law. The Government is not aware of any material circumstances in which such a duty would be appropriate, nor were any examples provided during consultation."[357]

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[356] Id, para 6.33 (emphasis added).

[357] Id., para 6.34.

The first sentence of the quote above is confusing for serveral reasons. It is not clear why the "assumption of responsibility" requirement is labelled a "new test", but presumably this is because it is new compared to the Government's consultation proposal (the *Caparo* test is, of course, not new). The sentence also appears to find it important to limit the duty of care for *governance* disclosures, even though that is exactly what *Caparo* had already achieved. Presumably the idea is to note that the incorporation of the *Caparo* test into the "assumption of responsibility" exception in the 90A regime will mean that *Caparo*'s limitation of the duty of care in the case of governance-focused disclosures will be preserved.

However, after this discussion of *governance*-focused disclosures, the Government does not mention *investor*-focused disclosures. To only discuss the former type of disclosure and not the latter suggests that the Government may have misunderstood the main reason for the 90A regime's introduction. The aim was to limit the risk that investors would be able to argue that TD disclosures (such as interim reports) were not *governance*-focused but *investor*-focused with the purpose of informing their trading (rather than shareholder voting) and thereby creating a broad duty of care from issuers to investors which could form the basis for private actions. By codifying *Caparo*, this risk remains the same as before the TD. This is surprising since it means that the original motivation for the legislation has not been fulfilled.

From the perspective of a teleological statutory interpretation, the text accompanying note 356 above would strongly suggest that *Caparo* is preserved in the 90A regime but left open to further interpretation by the courts. This conclusion is, however, not universally accepted. Professor Alcock has instead interpreted the negligence exemption from rhe 90A regime as follows:

> "The negligent misstatement exception makes no reference to the *Caparo* proximity test (nor actually to negligence) and only allows liability where a person has "assumed responsibility to a particular person for a particular purpose". The emphasis on a particular person does seem to eliminate any general liability of a company, its directors and advisers to shareholders for disclosure failures as in *Hall* [*v Cable & Wireless*] or over-optimistic defence documents. The need to have "assumed responsibility" may even call into doubt any liability to a bidder who raises his bid in response to such documents as in *Morgan Crucible*. On the other hand, the specific use of the accounts in *Galoo* and the possible private undertakings in *Partco* should still give rise to liability."[358]

In *Morgan Crucible*, a case decided shortly after *Caparo*, the Court of Appeal held that the directors of a target company of a take-over bid could owe a duty of care for public representations about the company aimed at influencing the conduct of a known bidder.[359] In *Galoo*, the Court of Appeal similarly held that auditors submitting company accounts to investors for the purpose of

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358 Alastair Alcock, 'Liability for Misinforming the Market' (2011) Journal of Business Law 243, 259.

359 *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] 1 All ER 148.

informing and aiding their purchase of shares in the company could owe them a duty of care.[360] In *Partco*, the Court of Appeal found it arguable that personal statements made by two executive directors of Partco to a purchaser of the company could create a duty of care.[361] Finally, in *Hall* the High Court found that Cable and Wireless plc could owe two investors who simply bought shares through the stock market a duty of care based on the company's failure to publish full and accurate information about a material contract.[362] Alcock thus argues that the prior cases which indicated a general reliance on corporate disclosures with less personal interactions were at particular risk.

In reaching his conclusion, Alcock appears to opt for a literal, textual interpretation of the statute and the *prima facie* meaning of the phrase "assumed responsibility" in favour of reading it as the reference to the developed common law which the Government clearly intended. Alcock, further, does not mention (let alone analyse) the Government's statements, instead apparently offering his interpretation after studying only the wording of the provision itself. It is submitted that the better approach is to consider the provision's articulated purpose and to read the "assumption of responsibility" requirement not as a phrase to be given meaning through an isolated review of the statute's wording but as the recognised tort law concept that it is.

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360 *Galoo Ltd v Bright Grahame Murray* [1995] 1 All ER 16.

361 *Partco Group v Wragg* [2002] EWCA Civ 594, [2002] 2 BCLC 323.

362 *Hall v Cable and Wireless plc* [2009] EWHC 1793 (Comm), [2010] 1 BCLC 95.

The "assumption of responsibility" test as established in case law clearly aims for an objective assessment by the court of whether responsibility has been assumed, rather than to ask whether the person subjectively assumed responsibility. The determination of whether there has been an assumption of responsibility is therefore to be made by the court.[363] It is, further, not convincing when Alcock claims that there is no reference to the *Caparo* proximity test in the new carve-out, since in *Caparo* the assumption of responsibility (which is mentioned in the statute) *is* the measure of proximity.[364] In conclusion, Alcock's argument fails to persuade and the better interpretation is to acknowledge the Government's intended reference to the common law.[365] Caparo survived.

6.3. Can *Caparo* apply?

It may appear self-evident that if *Caparo* survived the introduction of the 90A regime, it could apply to corporate disclosures – it would otherwise be strange

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[363] See Cartwright (n 37) 186, 204-05; Christian Witting, Liability for negligent misstatements (OUP 2004) 175 para 9.22 (noting that all but one of the Lords in Hedley Byrne referred to an objective assessment).

[364] Christian Witting, *Street on Torts* (OUP, 14th edn. 2015) 51 "*Ipso facto* it makes sense to view 'assumption of responsibility' as a type of proximity […] Where an 'assumption of responsibility' is apparent, there is no need to look for any further indication of proximity between the parties." (citing to *Customs and Excise Commissioners v. Barclays Bank plc* [2007] AC 181) (noting further, and citing p. 87 of that case, that "By contrast, where there is no assumption of responsibility, the court will apply a more general test of proximity.")

[365] Davies & Worthington (n 19) 961 appear to arrive at the same conclusion.

that UK commentators so forcefully argued in favour of redrafting the TD, seeking assurances from the Commission, and, finally, introducing legislation to limit its effect. The arguments of why *Caparo* would apply were, however, never laid out in any significant detail, so it is fruitful to do so here to gain an understanding of both whether *Caparo* can apply, and to have a basis for the analysis in the subsequent sections.

This section will thus consider how the three elements of Lord Oliver's detailed requirements for finding a duty of care may apply to continuing capital markets disclosures.[366] I will examine each of those three requirements in turn under the relevant headings:

- The statement is required for a purpose
- Awareness that the recipient will receive the statement
- The recipient acts on the statement in accordance with its purpose

While a claimant would also need to establish that the statement maker then breached that duty and that he suffered loss as a result, this will not be covered herein.[367]

6.3.1. The statement is required for a purpose

The first requirement is that the statement is required for a purpose, and that the statement maker is aware of this purpose. In determining the purpose of a

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[366] Thus disregarding the fourth factor, as per note 49.

[367] For a helpful overview of these issues, see Cartwright (n 37) 235-237, 244-253.

certain piece of disclosure, judges will make an objective assessment. This is perhaps most clear from the speech of Lord Jauncey in *Caparo v Dickman*:

“My Lords, Pt VII of the Companies Act 1985 provides that the accounts of a company for each financial year shall be laid before the company's general meeting, that is to say before the members in general meeting. Copies of the accounts must be sent to the members at least 21 days in advance, and it is obvious that the reason for this is to enable the members to prepare themselves for attendance at and participation in the meeting. The annual general meeting provides the opportunity for members to question the stewardship of the company during the preceding year, to vote for or against election or re-election of directors, to approve or disapprove the appointment or reappointment of auditors and co take other decisions affecting the company as a whole or themselves as members of a particular class of shareholders. There is nothing in Pt VII which suggests that the accounts are prepared and sent to members for any purpose other than to enable them to exercise class rights in general meeting. I therefore conclude that the purpose of annual accounts, so far as members are concerned, is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the

> company is no part of the statutory purpose of the preparation and distribution of the accounts."[368]

In *Caparo*, their lordships interpreted the law to establish a purpose of an auditor's report which was not actually articulated in the relevant law itself: auditors' reports are for "shareholders *qua* shareholders", not "shareholders *qua* investors" or "shareholders *qua* potential investors". The House of Lords thus *did* recognize a duty of care, but running only from the auditors to the shareholders *qua* shareholders.[369] Further, as Davies has also noted, the House of Lords' interpretation in *Caparo* of the purpose of the circulation of accounts and reports to shareholders will mean that the issuer and its directors similarly do not have a duty of care to investors at large for such statements, since the purpose of those statements established in *Caparo* precludes such liability as well.[370]

In *Possfund Custodian Trustee Ltd v Diamond*,[371] a strike-out action, Lightman J considered a claim in the tort of negligence to the effect that the purpose of a prospectus included informing not only those investors who purchased shares

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368 *Caparo Industries plc v Dickman*, [1990] 1 All E R 568, H L (Lord Jauncey at p 607). Lord Bridge's speech contains a similar line of deductive reasoning on 580, and Lord Oliver's at 583.

369 The principle of "no reflective loss" will also be relevant in determining whether the shareholders actually are able to seek damages from the auditors in a situation such as this. This principle, which means that shareholders are unable to seek damages for losses in the value of their shares that are consequential of a loss to the company, will be analysed further in section 6.3.5.

370 Paul Davies, 'Liability for misstatements to the market' (2010) 5 Capital Markets Law Journal 443, 450.

371 [1996] 2 All ER 774 (Ch D).

in the primary market (from the issuer) but also in the secondary market (on the stock exchange). Lightman J ordered the plaintiff to substantiate their claim by filing expert testimony on the issue of the purpose of prospectuses. The plaintiff provided an affidavit by a director of an investment bank which stated that market participants considered a prospectus as intended to support both primary and secondary market transactions and that this was the intention of those issuers and advisers who prepared them.[372] Lightman J considered that evidence satisfactory enough to allow the claim to proceed to trial:

> "The plaintiffs claim that there has developed and been generally recognised an additional purpose, an additional perceived intention on the part of the issuer and other parties to a prospectus, namely to inform and encourage after-market purchasers, and that this is the basis for the pleaded purpose attributed by the plaintiffs to the prospectus. If this is established, then it does seem to me to be at least arguable that a duty of care is assumed and owed to those investors who (as intended) rely on the contents of the prospectus in making such purchases."[373]

Lightman J also considered that the issue of proximity, the stumbling block in *Caparo v Dickman*, was possible to overcome:

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372 *Possfund Custodian Trustee Ltd v Diamond* - [1996] 2 BCLC 665, 678.

373 *Possfund Custodian Trustee Ltd v Diamond* - [1996] 2 BCLC 665, 680.

> "As it seems to me, it is at least well arguable that the necessary proximity in such a case is established if the reliance by the members of public for the purpose in question is intended by the representor. Intention, if not sufficient to establish the necessary proximity, is at the least a very important factor."[374]

Here, the judge also made reference to *Morgan Crucible v Hill Samuel*, a strike-out action in which the Court of Appeal found it arguable that the directors of a target company had a duty of care towards a known bidder in preparing their defence documents.[375] In giving the Court's opinion, Slade LJ noted that this may especially be so when they intended for the bidder to rely on that document.[376] It is thus clear that the purpose of a statement does not have to be articulated in the relevant legislation in order for a court to examine its underlying purpose in context and conclude that the maker of such a statement will owe a duty of care. If a purpose were articulated in such a way, however, it may be difficult for a defendant to argue that it should be disregarded.

It should also be recognised that the purpose of statements or documents may evolve over time. Thus, while Mervyn Davies J. in *Al-Nakib* held that a prospectus had the purpose of inviting primary market subscribers and not secondary market purchasers, a plausible case could today be made that the purpose of a prospectus has changed to also be aimed at the secondary market.

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374 *Possfund Custodian Trustee Ltd v Diamond* - [1996] 2 BCLC 665, 679.

375 *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] BCLC 178.

376 *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] BCLC 178, 191.

An investor who purchased in the after-market in reliance on statements in a prospectus may be able to argue that the purpose of that document includes her transaction as it contributes to an efficient after-market in the issuer's shares. Evidence could (for example) include the FCA's discussion paper on the availability of information in the UK equity IPO process, which lists three functions of the prospectus: providing information to the IPO investors themselves to value the shares; creating confidence for potential investors by subjecting the statements in the prospectus to liability; and 'creating a document of record that can be valuable to prospective new investors and other stakeholders in the early stages of the company's post-flotation existence'.[377] The explicit acknowledgement by the regulator that the purpose of the document includes the creation of an efficient after-market could be a persuasive piece of evidence in seeking to establish a duty of care.[378]

6.3.2. Awareness that the recipient will receive the statement

The second requirement is that the statement maker knows that the advice will be communicated to the recipient. While the statement maker does not need to know the exact identity of the recipient, the latter should be a member of an "ascertainable class". This could be a potential stumbling block in financial markets, where disclosures may be directed to investors in general, and the question becomes if such a large group could count as an ascertainable class.

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377 FCA, Discussion Paper 16/3: Availability of Information in the UK Equity IPO Process, 18, para 3.3 (April 2016).

378 *See* PR Recital 7 for the suggestion that this regulation appears to do the same.

As Neill LJ explained on behalf of the court in *James McNaughton Papers Group Ltd v Hicks Anderson & Co*:

> "Where there is a single advisee or he is a member of only a small class it may sometimes be simple to infer that a duty of care was owed to him. Membership of a large class, however, may make such an inference more difficult, particularly where the statement was made in the first instance for someone outside the class."[379]

While the Court of Appeal did not further explain why it may be harder to find a duty of care when the class is large, this may have been a reference to prior authoritative statements that the law of negligent misstatement ought to be expanded incrementally rather than through sudden leaps.[380] As regards the last part of the quote above, it may be noted that, in the case of many corporate disclosures, the main intended group of recipients are actually investors in the market.

As for the issue that the size of the class may be large if it is deemed to include all investors who trade in the market, there is no authoritative statement from an English court considering this requirement in light of continuing disclosures and plausible arguments could be made in either direction. On the one hand, there is case law to the effect that statement makers do not need to know the

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[379] *James McNaughton Papers Group Ltd v Hicks Anderson & Co* [1991] BCLC 163, at 173-174.

[380] *Sutherland Shire Council v Heyman* [1985] 60 ALR I at 43-44 (Brennan J, High Court of Australia), approved by *Caparo Industries plc v Dickman*, [1990] 1 All E R 568, H L (Lord Bridge at 574, Lord Roskill at 582, and Lord Oliver at 586).

identity of the claimant. In *Hedley Byrne* itself, for example, the defendant only knew that the information was required by a customer of another bank for the purposes of extending credit, and in *Aiken v Stewart Wrightson Agency* sufficient proximity for a duty of care was found to run to unknown members of a syndicate even though its membership could alter between years.[381]

6.3.3. The recipient acts on the statement in accordance with its purpose

The third requirement is that the advice is acted upon by the recipient for the purpose for which it is supplied and without independent inquiry. The requirement that the recipient acts without independent inquiry may be particularly relevant where the statement maker possesses superior insight, and it is obvious that the issuer of a security will be the most knowledgeable about it.[382] Further, it would be prohibitively expensive for an investor to independently establish the correctness of such information, which means that an efficient market for these products depends on the statement maker's provision of reliable information. For buyers and sellers in the stock market, we would not expect this requirement to be a notable hurdle.

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[381] The issue has been considered in other cases that indicate potentially large groups of claimants; see, e.g., *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145 (UKHL) 181. The case of *Aiken v Stewart Wrightson Agency* [1995] 1 WLR 1281 similarly deals with unknown members of syndicates.

[382] This superior knowledge is indeed one reason why it makes sense to impose disclosure obligations on companies in the first place.

6.3.4. Policy considerations

It follows from the analysis of the three elements of Lord Oliver's *Caparo* requirements above that it is possible that negligently misstated disclosures aimed at investors could give rise to a duty of care. That does not mean, of course, that judges would simply proceed to impose a duty of care on companies in such situations. It may be particularly difficult to impose duties of care on individual directors, since they would need to assume personal responsibility for statements.[383] The statement by Lord Bridge quoted earlier includes the additional requirement that courts should consider whether the imposition of a duty of care would be "fair, just and reasonable", and such considerations will also, of course, be important to courts.[384]

In future cases, courts will presumably assess the purpose of a statement (as in *Caparo*) to decide whether or not its maker has a duty to take care for the benefit of the recipient. Much of the case law, including *Caparo*, concerns parties that are further removed from each other than the typical investment disclosure situation. In *Caparo*, the main question was whether a firm's auditors owed stock market investors a duty of care; investors who were third parties to the contract between the firm and its auditors. In the TD disclosure rules reviewed herein, investors are however the intended recipients of the information and this is explicitly stated in the relevant regulations.

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[383] *Williams v Natural Life Health Foods* [1998] 2 All ER 577.

[384] *See* text accompanying note 45.

The annual accounts, which must be circulated to every member of the company and presented in general meeting,[385] will thus likely be considered part of "governance" disclosures which, without more, would be for "shareholders *qua* shareholders" to help them exercise their governance function in the company. The same would be expected to apply to the directors' remuneration report, which must be voted upon by shareholders,[386] circulars to approve related party transactions,[387] circulars to approve significant transactions,[388] and materials sent to shareholders in takeover situations.[389] These disclosures would not be expected to generate a duty of care from the issuer to investors in the market, unless there was some further communication or interaction through which the issuer assumed responsibility for the statements for the benefit of such other persons. As opposed to the annual report, the half-yearly reports under the TD are not tied to shareholder voting and would likely be considered investor-focused disclosures. The MAR requirement to immediately disclose inside information could be seen both as

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385 Companies Act 2006, sections 423 and 437.

386 Companies Act 2006, section 439.

387 FCA's Listing Rule 11.1.7R.

388 FCA's Listing Rule 10.5.1R requires a circular to be sent to shareholders so that they may vote whether to approve a significant "Class I" transaction.

389 Davies and Worthington (n 19) 1086 have noted that *Caparo* should apply to both bidder and target documentation in the takeover context

having a governance-focused purpose (in that they deprive insiders of information) and an investor-focused purpose.[390]

In establishing a duty of care, the fact that a particular purpose is stated in a regulation will not automatically trigger liability in negligence, but it will increase the foreseeability to the statement maker that it will be relied upon for that purpose. There will, however, be no liability in negligence for such misstatements until courts choose to so extend this head of liability. Claimants seeking compensation in negligence would either need to argue that their claims fall into a category that has already been accepted by the courts or that the court should expand liability to their new category of claim. In the latter case, judges have expressed a preference for an incremental, gradual expansion to new categories.[391]

Judges are also likely to be reluctant to create new duties of care where the economic implications would be highly significant.[392] The fact that the 90A regime already offers a statutory tort for aggrieved investors may also cause judges to defer to the statute rather than to potentially open the "floodgates" of negligence liability to investors, which would be a major economic event

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[390] Professors Gullifer and Payne discuss in some detail whether various disclosures may be deemed governance-focused or investor-focused, and it is in all honesty difficult to attempt to add much to their review so I will instead refer you to it. *See* Gullifer and Payne (n 59) 558-562.

[391] *Caparo Industries plc v Dickman* [1990] 2 AC 605, 618 (Lord Bridge), 633-34 (Lord Oliver); *Customs & Excise Commissioners v Barclays Bank plc* [2006] UKHL 28, [2006] 4 All ER 256, 260-61 [4] (Lord Bingham).

[392] *Morgan Crucible Co plc v Hill Samuel Bank Ltd* [1991] BCLC 178, 192.

and reshape the UK investor litigation landscape. One may suspect that courts would prefer to leave such a substantial change to Parliament. Courts can also dismiss negligence actions for disclosure misstatements with reference to the policy reasons presented in chapter 4 herein.

6.3.5. Excursus: Can issuers disclaim *Caparo* liability?

Courts have allowed statement makers to prevent a duty of care from arising in the first place when they have explicitly disclaimed responsibility.

The question is thus whether an issuer can successfully preclude a duty of care to investors from arising by including a disclaimer in its disclosures. This is a question of more than academic value, as disclaimers arguably could limit significant amounts of liability in practice. As an example, the Tesco misstatement in 2014 did not contain any disclaimer of liability and subsequent statements from Tesco – despite the focus that lawsuits and several regulatory inquiries would have brought – did not contain any disclaimers either. It is somewhat surprising that a large listed company would not attempt to disclaim a duty of care from arising, since *Caparo* was considered a concern before the TD's introduction and remains available to the same extent today. I am not aware of prior work on the issue of disclaimers in corporate disclosures, so I will start by establishing the framework.

In *Hedley Byrne v Heller*, where the House of Lords first established tort liability for negligent misstatements, the statement maker had included a liability disclaimer which the court considered operational. This was thus the first case not only to hold that there may be liability for negligent misstatements, but also that disclaimers may exclude such liability.

In *Caparo v Dickman*, Lord Bridge reviewed the case law on negligent misstatements and drew the following principles.

> "The salient feature of all these cases is that the defendant giving advice or information was fully aware of the nature of the transaction which the plaintiff had in contemplation, knew that the advice or information would be communicated to him directly or indirectly and knew that it was very likely that the plaintiff would rely on that advice or information in deciding whether or not to engage in the transaction in contemplation. In these circumstances the defendant could clearly be expected, **subject always to the effect of any disclaimer of responsibility**, specifically to anticipate that the plaintiff would rely on the advice or information given by the defendant for the very purpose for which he did in the event rely on it. So also the plaintiff, **subject again to the effect of any disclaimer**, would in that situation reasonably suppose that he was entitled to rely on the advice or information communicated to him for the very purpose for which he required it."[393]

In *Smith v Eric S Bush*, the House of Lords considered whether a surveyor hired by a mortgagee owed a duty of care for its valuation to a mortgagor house

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393 *Caparo Industries plc v Dickman*, [1990] 1 All E R 568, 576 (Lord Bridge).

purchaser, and the permissiblity of the surveyor's liability disclaimers.[394] It held that the surveyor owed the house purchaser a duty of care since it knew that the purchaser would rely on it, but that the surveyor's liability disclaimer was invalid under the reasonableness test of the Unfair Contract Terms Act 1977 ("UCTA"). UCTA allows for persons to restrict their liability for negligence – including negligence stemming from the common law duty to take care – to the extent it meets a reasonableness test.[395] UCTA Schedule 2 offers a list of issues that should be considered for purposes of the reasonableness test, the following being the most relevant for current purposes:

> "the strength of the bargaining positions of the parties relative to each other, taking into account (among other things) alternative means by which the customer's requirements could have been met."

In this context we may note that, were a listed company to disclaim liability in negligence to investors, the 90A regime would still remain available and the FCA could still take action against negligent disclosures as well. It thus seems that there are alternative means available.

Since the UCTA applies to contracts, it may be argued a simple "notice" may not be included under its coverage. A notice by the British Waterways Board excluding liability for negligence was held to be invalid when a barge worker

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[394] *Smith v Eric S Bush* [1989] 2 All ER 614.

[395] Unfair Contract Terms Act 1977, s. 1(1)(b) and 2(2).

did not – expressly or impliedly – agree to it, since he had no choice but to engage in the activity which caused him damage.[396] However, if agreement to a disclaimer notice is a critical determinative factor, then public companies ought to be able to disclaim liability for negligent statements, since investors who read statements including disclaimers are free to choose whether or not to trade.

The Court of Appeal recently considered the effect of liability disclaimers in a corporate disclosure situation. Roskilde, a Danish bank, had produced an investor presentation which later turned out to contain a significant misstatement of the amount of its non-performing loans – the presentation gave an amount corresponding to approximately £7 million (which would have been a modest 0.14% of the bank's total loan book) when the actual figure was approximately 60 times higher.[397] The presentation also included a slide headed "Disclaimer" which stated, among other things, that the preentation was "solely for use by investors met during the non-deal road show made in connection with the bank's Q3 2007 figures" and that "no liability whatsoever is accepted as to any errors, omissions or misstatements contained herein". The presentation was used in connection with a road show and Roskilde also placed it on its website. Taberna, a secondary market purchaser of Roskilde's securities, had found the presentation on Roskilde's

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[396] Burnett v British Waterways Board [1973] 2 All ER 631.

[397] *Taberna Europe CDO II plc v Selskabet af 1 September 2008 A/S (formerly Roskilde Bank A/S)* [2016] EWCA Civ 1262, [2017] 3 All ER 1046.

website and claimed to have relied on it in its securities purchases. Roskilde went bankrupt. Taberna sued for misrepresentation. Moore-Bick LJ for the court started by determining whether there had been any representation from Roskilde to Taberna:

> 'In an age when most commercial documents exist primarily in electronic form and can be made available to a wide audience at the touch of a button it is important not to allow inroads to be made too easily into the principles enunciated in cases such as *Peek v Gurney* and *Caparo v Dickman*. However, if a company actively invites potential investors to make use of information originally produced for a different purpose, it can hardly complain if they do so. Most company accounts are public documents and many are no doubt placed on the company's website, but I do not think that that alone can be sufficient to create the degree of proximity required to give rise to a duty of care. To hold otherwise would be inconsistent with the decision in *Caparo v Dickman*. In order for a representation in a document to be actionable at the suit of the recipient there has to be a connection between the maker and the recipient of a kind that enables the court to be satisfied that the maker was intending the recipient to rely on the document in a particular way.'[398]

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[398] *Taberna* 1052.

Since Roskilde had directed Taberna to the investor presentation, it was found to have intended for Taberna to rely on it. Moore-Bick LJ next examined the disclaimer, finding in favour of Roskilde:

> 'Since it is common ground that there was no contract between Roskilde and Taberna which incorporated the disclaimer, it must be effective, if it is to be effective at all, simply as a notice to the reader of the document that Roskilde is unwilling to accept liability for its contents.'[399]

> 'I can see no reason in principle why a person should not be able to publish information of the kind contained in the Investor Presentation on the basis that he is not willing to take responsibility for it, at least where it is reasonable for him to do so (as the judge found it was in this case), provided, of course, that he makes the position clear. So in principle I agree with the judge that, subject to any rules of construction which cut down the scope of such clauses, Roskilde is entitled to rely on them.'[400]

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[399] *Taberna* 1053.

[400] *Taberna* 1055.

> 'In my view Roskilde was entitled to include in the Investor Presentation a disclaimer of liability for the statements contained in it. The disclaimer may, of course, be overridden by the dealings between the parties, but the judge's findings do not go far enough for that to assist Taberna in this case. Taberna was in my view in no better position than the investors to whom the document was originally addressed and Roskilde is therefore entitled to rely on the disclaimer as an answer to its claim.'[401]

Following *Taberna*, it seems that disclaimers are operational in the corporate disclosure context. This also makes sense from a normative perspective, since informed traders are able to negotiate their own protection with issuers, and since chapter 4 does not see value in blanket issuer liability to investors.

6.4. The rule against reflective loss

In *Caparo v Dickman*, Lord Bridge remarked *obiter dicta* that company law contains principles that the company's claims take preference to shareholder claims for the same loss:

[401] *Taberna* 1057.

> 'The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders, eg by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditor in the name of the company, not by individual shareholders.' [402]

The principle underlying Lord Bridge's conclusion above was established in *Foss v Harbottle*: the company, rather than any shareholder individually, is the proper plaintiff in actions for wrongs done to the company.[403] This 'proper plaintiff' rule has been supplemented with the 'rule against reflective loss': a shareholder cannot sue a third party to recover a loss it has suffered if that loss is merely a loss in the value of its shares, since the shareholder's loss is then merely a reflection of the company's loss. The 'rule against reflective loss' was

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[402] *Caparo Industries plc v Dickman*, [1990] 1 All E R 568, H L (Lord Bridge at p 580).

[403] *Foss v Harbottle*, 67 E.R. 189; (1843) 2 Hare 46

first articulated by the Court of Appeal in *Prudential Assurance v Newman*,[404] and confirmed by the House of Lords in *Johnson v Gore Wood*.[405] To analyse if and how this principle will apply to shareholders' claims for losses due to disclosure misstatements, it is necessary to review the factual circumstances of these two cases.

In *Prudential Assurance*, two directors of Newman Industries Ltd who were also directors of TPG – a company they proposed Newman acquire – had knowingly provided false information inflating the value of TPG's assets to the other Newman directors and subsequently to its shareholders as part of a circular to approve the transaction. A plaintiff shareholder brought an action seeking damages from the two directors in three ways: as a derivative claim, as a direct personal claim for the shareholder only, and as a direct claim on behalf of all Newman shareholders. The Court of Appeal (Cumming-Bruce, Templeman and Brightman LJJ) stated:

[404] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354, [1982] Ch 204, CA.

[405] *Johnson v Gore, Wood & Co* [2002] 2 A.C. 1 HL.

> "[It is an] elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and therefore the person in whom the cause of action is vested. This is sometimes referred to as the rule in *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189 when applied to corporations, but it has a wider scope and is fundamental to any rational system of jurisprudence."[406]

Having thus confirmed that the company, as a legal person separate from its incorporators, was the proper claimant, the court held that:

[406] Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 All ER 354, at 357.

"the personal claim is misconceived. It is of course correct […] that [the two directors], in advising the shareholders to support the resolution approving the agreement, owed the shareholders a duty to give such advice in good faith and not fraudulently. It is also correct that, if directors convene a meeting on the basis of a fraudulent circular, a shareholder will have a right of action to recover any loss which he has been personally caused in consequence of the fraudulent circular; this might include the expense of attending the meeting. But what he cannot do is to recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a 'loss' is merely a reflection of the loss suffered by the company. The shareholder does not suffer any personal loss. His only 'loss' is through the company, in the diminution in the value of the net assets of the company, in which he has (say) a 3% shareholding. The plaintiff's shares are merely a right of participation in the company on the terms of a the articles of association. The shares themselves, his right of participation, are not directly affected by the wrongdoing."[407]

[407] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354, at 366-367.

The sentence which says that 'the shareholder does not suffer any personal loss' has been criticized, but its intention is clear: the loss was suffered by the company and the shareholders loss was only derivative, or reflective, of the company's loss.

In *Johnson v Gore Wood*, the claimant had, through his company, hired a firm of solicitors who allegedly caused losses through negligence. The solicitors settled a claim made by the company on terms not precluding the claimant from subsequently bringing certain personal claims as well. The claimant then brought personal claims to recover, among other things, the value reduction of his shares and the loss in the corporate pension the company had been unable to pay into as a result of the solicitors causing the company losses. The solicitors argued that the claimants' losses were reflective of the company's losses and should not be eligible for reimbursement.

Lord Bingham articulated three propositions derived from prior case law:

> "(1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss.

> (2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding.
>
> (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other." [408]

In their lordships' speeches, the only one of the claimant's losses which was subject to some disagreement and discussion was the company's inability to pay into his pension fund and the claimant's loss in subsequent value appreciation on that fund. In the end, although Lord Cooke was unsure and deferred to the analysis of the others, their lordships agreed that the portion of the claimant's loss that consisted of the *contribution* into the pension fund was merely reflective of the corporate loss and therefore not allowed, but the *enhancement* in value of that contribution was his own, personal loss, and could be brought as a personal claim.

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[408] *Johnson v Gore, Wood & Co* [2002] 2 A.C. 1 HL, [2001] 1 All ER 481, at 503 (citations to other cases omitted).

6.4.1. Is the rule applicable?

We know from Lord Bridge's speech in *Caparo v Dickman* (quoted in text accompanying note 402 above) that the rule against reflective loss applies to negligence actions. In *Gardner v Parker*, the Court of Appeal (Neuberger LJ, Mance LJ and Bodey J) offered a complete description of the applicability of the 'no reflective loss' rule:

> "It is clear […] that the rule against reflective loss is not concerned with barring causes of action as such, but with barring recovery of certain types of loss. On that basis, there is obviously a powerful argument for concluding […] that, whether the cause of action lies in common law or equity, and whether the remedy lies in damages or restitution, should make no difference as to the applicability of the rule against reflective loss."[409]

Further guidance to the specific FSMA context may be found in a judgment of the High Court. In *Sivagnanam v Barclays Bank*,[410] the claimant was the sole shareholder of a company which had already settled a mis-selling claim with Barclays, but now sued in a personal capacity alleging that Barclays separately owed him a duty for which he had a private right of action under section 138D FSMA. Cooke J dismissed the claim since the rule against reflective loss barred double recovery.

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[409] *Gardner v Parker* [2004] EWCA Civ 781, [2004] 2 BCLC 554, at 567.

[410] *Sivagnanam v Barclays Bank Plc* [2015] EWHC 3985 (Comm) (4 December 2015).

Since the rule against reflective loss is concerned with barring the recovery of certain types of losses, it would be difficult to articulate an argument that it should *not* be available for issuers defending 90A actions. The applicability of the rule to such actions is further supported by the fact that the rule has been applied in the context of FSMA and that the 90A regime does not stipulate how losses should be calculated. The rule should thus be generally available to issuers defending shareholder disclosure actions, whether based on the tort of negligence or the 90A regime. It should also be available for FCA restitution actions under s. 384 FSMA.

6.4.2. Rationales for the rule

Each of the four law lords who justified the "no reflective loss" principle in *Johnson v Gore Wood* did so on the bases of creditor protection and preventing double recovery.[411] Lord Millett stated that:

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[411] *Johnson v Gore, Wood & Co* [2001] 1 All ER 481, at 503 (Lord Bingham), 512 (Lord Cooke), 521 (Lord Hutton), and 528 (Lord Millett). Lord Goff did not mention rationales for the rule in his speech.

> "If the shareholder is allowed to recover in respect of such [corporate] loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors *and other shareholders*. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder."[412]

In *Johnson v Gore Wood*, Lord Millett and Lord Hutton considered the effects both on creditors and other shareholders.[413] To see the problem, we can build on an example provided by Ferran:

> '[T]ake a company with a net present value of £1 million and four shareholders, A, B, C and D; £2 million has been extracted from the company by wrongdoers in breach of duties owed to the company and to its shareholders personally. All four shareholders would be fully and equally compensated if the company sued successfully to recover the lost £2 million: the shareholders' loss is *reflective* of the company's loss.'[414]

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[412] *Johnson v Gore, Wood & Co* [2001] 1 All ER 481, at 528 (emphasis added).

[413] *Johnson v Gore, Wood & Co* [2001] 1 All ER 481, at 521-522.

[414] Eilis Ferran, 'Litigation by shareholders and reflective loss' (2001) Cambridge Law Journal 245-247.

In this example, if A sues the third party to recover his £500,000, the company can only sue for the remaining £1,500,000. But if the company is successful in that suit, it will be distributed equally among all four shareholders, so that A will get 25% of the corporate recovery and be overcompensated in relation to B, C and D who will all be undercompensated. If the system allows A to sue, it thus forces B, C, and D to also sue outside of the corporate context. Allowing the suit to be pursued outside of the corporate context would also allow the shareholders to get compensated ahead of the company's creditors. The policy behind the reflective loss rule thus protects both creditors and the shareholders as a collective. By focusing on making the corporate whole, it preserves the priorities of distribution and allows the board of directors to consider the interests of the various stakeholders as appropriate.

While their lordships did not articulate it this way, I would submit that there are, in addition to the creditor protection and double recovery arguments they articulated, two strong, shareholder-focused efficiency reasons for the "no reflective loss" principle.

The first is that it solves a collective action problem: if shareholders in the example above were able to individually claim for losses that are also those of the company, it could create a "run" scenario which would be troublesome where the defendant is of doubtful solvency.[415] The concern is that, if we allowed shareholders to claim individually for corporate losses, they would *have*

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[415] *Compare* Armour et al (n 157) 320-21.

to claim individually even if they would recognise that they would all be better off if only the company claimed. The rule against reflective loss preempts the "run" problem by coordinating action through the company.

The second reason is that it is more efficient to have the company pursue the claim – both because the company will have more information about the underlying facts and can easier formulate its claim, but also because it saves shareholders the costs of pursuing their claims individually, which doubtlessly would total a higher sum than when the company in effect represents all shareholders. The inefficiencies of allowing shareholders to claim for corporate losses are well illustrated by the following passage in *Prudential v Newman*:

> "The obscurities and confusion of the pleadings, the mass of documentary evidence, the fact that the Prudential, not being the proper plaintiffs, had no knowledge of what had gone on inside Newman and the assumed need to prove conspiracy led to the Prudential submitting that every […] document and every act or omission by [the defendant directors] was a badge of fraud, and to submit that [the auditor's] valuation was only explicable by cunning on the part of [one of the defendant directors] and incompetence on the part of [the auditor], and that the directors of Newman were bemused and the advisers of Newman blinded."[416]

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[416] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354, 368-369.

Another aspect of this second efficiency-related argument may be deduced from Lord Millett's speech and can be labelled a 'corporate autonomy' argument. The shareholders typically let a board of directors manage the affairs of the company and represent it towards third parties. If the board of directors (or a liquidator if it is insolvent) in Ferran's example above choose to settle a claim against a third party on the company's behalf, it would be highly inefficient if the shareholders were able to then sue the third party for the difference between the nominal and settled-for amounts of the claim by arguing that the remainder were at that point a crystallised shareholder loss. The argument against shareholder compensation for losses of this sort is sometimes labelled a 'causation' issue: the shareholder's loss is not caused by the third party directly, but by the board of directors when they choose to settle the company's claim for less than the full amount.[417] The 'corporate autonomy' aspect is perhaps of even more fundamental importance: if shareholders were allowed to claim against a third party after the company had settled, they would inevitably have to be part of all negotiations or third parties would never engage in settlement discussions at all. It is therefore fundamental to the management of the company's affairs that shareholders should not be able to claim for losses that are merely reflective of their companies' losses.

[417] See, e.g., *Garcia v Marex* [2018] EWCA Civ 1468 [32].

6.4.3. Which losses are reflective?

The distinction between corporate losses and personal losses seems relatively clear in theory, and a few cases elucidate how courts have approached the issue. Neuberger LJ has formulated the principle as follows:

> '[A] loss claimed by a shareholder which is merely reflective of a loss suffered by the company – ie a loss which would be made good if the company had enforced in full its rights against the defendant wrongdoer – is not recoverable by the shareholder [save in a case where, by reason of the wrong done to it, the company is unable to pursue its claim against the wrongdoer]'[418]

Courts will therefore need to examine the nature of losses in cases where the wrongdoer breached duties both to the company and to a shareholder to determine which losses lie at the corporate level and which lie at the shareholder level.

In *Heron International Ltd v Lord Grade*,[419] the board of directors of a company subject to two takeover bids preferred the lower bidder and was able to take action to enforce this choice. If the takeover were completed by the lower bidder, the broadcasting regulator would require the company to transfer control of one of its subsidiaries to an institutional trustee and not interfere in its operations. The Court of Appeal (Lawton, Templeman and Brightman LJJ)

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[418] *Gardner v Parker* [2004] EWCA Civ 781, [2004] 2 BCLC 554, 562.

[419] *Heron International Ltd v Lord Grade* [1983] BCLC 244, 261-263.

distinguished between corporate and shareholder losses, holding that the loss in the value of the subsidiary would be a corporate loss which shareholders could not sue to recover. The shareholders would, however, suffer a loss as they were deprived of the opportunity to accept the higher offer, which the court held was admissible.

In a case such as Tesco,[420] where the misstatement caused outside investors to believe that the company was performing better than it actually was and the share price therefore was inflated compared to a situation with no misstatement, the loss would appear to be non-reflective. This is because the situation in Tesco was always the same, only the *disclosure* of the situation changed, and for that reason the overstatement of profits could not have caused an actual loss to Tesco. However, while this is the main story it cannot be the full story, because we saw in section 4.2.1 that an efficient market will price in all the costs of a misstatement at the time the misstatement is announced. That section also argued that that the market reaction will include four different types of costs:

1. The correction in firm value as investors reprice the stock on the basis of the correct information.
2. Damages or restitution payments to investors and penalties payable to public authorities or regulators.
3. A reputational cost to the firm.

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[420] The Tesco misstatement is the subject of chapter 8, where it is discussed in more detail.

4. The expected cost of new remedial (and precautionary) measures by the firm aimed at avoiding future misstatements.

While "category 1" above is not a corporate loss and therefore should be allowed as 'non-reflective', the other three categories are costs that the company will incur as a result of the misstatement. Let us consider the "category 2" loss. This loss includes amounts paid out as compensation to investors. That is, if investors expect the announcement of a misstatement to mean that the company will incur costs of compensating investors for the misstatement, then the t_1 share price reaction in an efficient market will include the present value of that investor compensation scheme. The market will estimate the expected compensation payment to investors and reduce the company's value with this amount already at t_1. This payout to t_1 shareholders is of course a corporate loss, because it is actually a future payment from the company to the shareholders, which means that shareholders should not get compensated for it. In a situation where t_1 shareholders get compensated for the full t_1 loss in share price, they would also get compensated for the company's cost of compensating them. Tugendhat J confronted this issue in *Collins Stewart v Financial Times*:

> ‘If the market price is assumed to be so rational as to afford a reliable measure of damage, then it is inconsistent to assume that there is not also factored into the market price of [the] shares a figure which represents the market's assessment of the value for the present claim. It is not reasonable to postulate a market which is both rational enough to provide a sound measure of damages, but which does not also take into account the prospects of the claimant recovering compensation for the damage in legal proceedings of which the market is aware.’[421]

Tugendhat J concluded that ‘assessment [of the damage] by the value of the shares involves circularity, and is impossible’.[422]

6.5. Investor compensation and incentives

The 90A regime is silent on how to measure losses and the lack of case law means that it is an open question. There are two main alternatives: either the tortious measure used for deceit or negligent misstatement claims (which allows for compensation of the claimant’s full loss) or the contractual measure (which also protects expectation interest). Since the 90A regime is modelled on the tort of deceit, it is likely that the tortious measure will apply.[423] Tests of remoteness then have to be considered, where the negligence test would allow compensation of losses with reference to the scope of the duty breached and

[421] *Collins Stewart Ltd v Financial Times Ltd* [2004] EWHC 2337 (QB) [79].

[422] Ibid [78].

[423] Gullifer and Payne (n 59) 565.

the deceit test would allow compensation of all losses flowing from the misstatement. Again, given the base in deceit, courts would likely utilise this for the 90A regime, meaning that investors eligible under 90A may be able to claim higher compensation, but always subject to the principle that reflective losses cannot be compensated.[424]

Section 3(4) Sch. 10A FSMA notes that a loss will only be eligible for compensation to the extent that "the person sufffering it acquired, continued to hold or disposed of the relevant securities" in reliance on the information in question at a time when such reliance was reasonable. This is a slightly relaxed reliance requirement compared to the tort of deceit, which requires that the statement maker should intend for the recipient to rely on the information.[425] Importantly, however, the 90A regime has not adopted a general presumption of reliance based on the "fraud-on-the-market" theory. Professor Ferran has argued that this theory could still be of relevance in the UK, based on the efficient capital market hypothesis.[426] That is, an investor would argue that the

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424 The United States applies a legal framework similar to the "no reflective loss" principle in what they label the "loss causation" doctrine. This requires plaintiffs to show that their losses were connected to the substance of the misrepresentation. This thesis is focused on English law issues and will therefore not examine issues of comparative law here, but for further details on the US framework *see* Martin Gelter, Global Securities Litigation and Enforcement, in Pierre-Henri Conac and Martin Gelter, 'Global Securities Litigation and Enforcement' (CUP 2019) 3, 73-74, *and* Merritt B. Fox, 'Why Civil Liability for Disclosure Violations when Issuers Do Not Trade?', 2009 Wisconsin Law Review 297, 322-323 (also containing references to case law).

425 Smith v Chadwick (1884) 9 App Cas 187.

426 Ferran (n 253) 317.

market price was relevant to their trading and show that the market price was informed by the information in question, meaning that reliance on the price would infer reliance on the information.[427]

From a normative perspective, Professor Davies has suggested, however, that it may be undesirable to allow a general inference of reliance on the market price.[428] If *actual* reliance were required, issuer liability would serve the purpose of compensating only those information traders who are able to demonstrate that they actually relied on the statement, and not those 'passive investors' who rely on the market price. Liability would then have the more targeted objective of compensating only those investors that actually used the information for securities pricing. A neat effect of requiring actual reliance, rather than allowing for the inferred fraud-on-the-market variety of reliance, would then be that all types of investors who are not information traders effectively compensate information traders for their work in such instances.

Actual reliance would, however, reduce the number of investors eligible to claim in any misstatement action, and thereby also the amount of compensation payable. This would not change our earlier conclusions in relation to the deterrence effect of issuer liability. The Davies Review did not consider the *amount* of compensation to be the critical part in creating

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427 For an in-depth analysis of how the fraud-on-the-market type of reliance connects to the efficient capital market hypothesis, *see* Jonathan R. Macey & Geoffrey P. Miller, Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory, 42 Stanford Law Review 1059 (1990).

428 Davies (n 316) 336.

deterrence through issuer liability, as it focused on the negative impact such a lawsuit would have on the responsible insiders' reputations.[429] From this perspective, it is not the amount at stake in the litigation that creates deterrence and the choice between different forms of reliance should not therefore impact our conclusions in chapter 4. Requiring actual reliance, rather than inferred reliance of the fraud-on-the-market type, would therefore appear preferable from a normative perspective, but the absence of case law on the 90A regime means that we will need to wait and see how the courts weigh the arguments.

6.6. Preliminary conclusions

Caparo survived the introduction of the 90A regime unscathed, which raises questions of why the regime was added in the first place. While one may suspect that the ability to bring suits in negligence under *Caparo* would be attractive to investors, the appeal is significantly tempered by the reflective loss doctrine, which applies to 90A actions as well as *Caparo* actions. Finally, if issuer liability is preserved on compensatory grounds, direct reliance appears preferable to inferred reliance, since the aim of liability then would be to compensate only that subset of traders working to trade information into share prices.

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[429] See section 4.3.3.

7. Insider and investor monitoring in practice

This chapter considers agency costs of corporate disclosure, on the basis that valuable firm-specific information can be considered a resource that develops within the company and is controlled by its managers.[430] Since the managers are able to exercise discretion over how information is used, they may prefer to use it in ways that maximise their personal utility rather than firm value. The design and effects of the rules that aim to restrict such strategic behaviour are the topic of this chapter.

7.1. The EU regulation of how information may reach the stock market

There is regulation prohibiting managers from exercising complete discretion over information, such as the well-known MAR obligation requiring issuers to immediately disclose information that is material enough to be labelled "inside information". However, much information does not rise to the level of materiality required to become "inside information". Such information may, however, still be of interest to information traders since they may be able to combine it with their own expert knowledge to trade profitably in the firm's shares.[431] The topic of such "sub-material information" has not been subject to much legal analysis. For example, one recent review stated that the

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[430] By "managers", this chapter considers those directors or senior officers within the firm that have access to inside information and exercise discretion over disclosure decisions, similar to "persons discharging managerial responsibility" in MAR Art 3(1)(25).

[431] The focus of this chapter (and indeed the thesis) is on shares, even though much of the regulatory framework referenced in here applies to financial instruments generally.

prohibitions on selective disclosure in the US and the EU mean that issuers "are forced to choose between full confidentiality and speaking to the public at large", a statement which means that the authors consider only non-public information ("NPI") that rises to the level of inside information.[432] However, sub-material information has been recognised as a concept in the literature and is of central importance where managerial opportunism is analysed.[433] The concept is perhaps best described in Professor Clark's corporate law textbook:

> "[I]nsiders occasionally have insight into their companies' futures that is better than the market's because of continual exposure to numerous bits and pieces of information and opinion that come their way by virtue of their being in their official positions and that have value as a totality. This total picture is based in part on numerous small items that, individually considered, are not important enough to be labelled material […]"[434]

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432 *See* Enriques & Gilotta (n 149).

433 *See* Jesse M. Fried, 'Insider Trading via the Corporation' (2014) 162 University of Pennsylvania Law Review 801, 809 (arguing that "insiders can profit legally by trading on many types of valuable, 'sub-material' information"); Reinier Kraakman, 'The Legal Theory of Insider Trading Regulation in the United States' in Klaus J. Hopt & Eddy Wymeersch (ed.) *European Insider Dealing—Law and Practice* (1991) 39, 48 (describing how insiders can lawfully conduct profitable trading); Donald Langevoort, 'Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation' (1999) 99 Columbia Law Review 1319, 1335 ("Materiality is a fluid concept: [i]nsiders at almost all times have the advantage of superior insight and a sense of which way things are going even if they do not possess a fact that a court would call material").

434 Robert C. Clark, *Corporate Law* (1986) 507–08.

In practice, while the EU prohibits selective disclosure of NPI that is material enough to be labelled "inside information", managers may selectively disclose NPI that does not reach this threshold in the interest of the firm, guided by their fiduciary duties. For such information, managers retain considerable freedom in choosing not only whether to disclose it, but also the means, the timing and the recipients. If this appears inconsequential, that this is not the case – investors in the UK spend approximately £500 million per year on private access to corporate managers to acquire such information.[435]

It is therefore informative to review the different ways information may be used from the perspective of a manager in control of it. It is submitted that there are four methods available to corporate managers to deploy information to the stock market:[436]

- public disclosure of the information;
- personal trading by the manager in the issuer's shares;
- trading by the issuer in its own shares; and
- selective disclosure to an outsider who trades the issuer's shares.

The EU and UK regulation of these different deployment methods will be analysed next. The aim is to compare the regulation of these methods from the

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[435] See note 536 and accompanying text.

[436] The closest precedent found in the literature for this functional approach considers three alternatives for use of information, but not selective disclosure. *See* Andrea M. Buffa & Giovanna Nicodano, 'Should Insider Trading Be Prohibited when Share Repurchases Are Allowed?' (2008) 12 Review of Finance 735 (2008).

perspective that they form part of the same system and may be functional substitutes. The EU system will thereafter be compared to US securities regulation, due to the significance of the US market and its prominence in the literature.

7.1.1. Public disclosure

Of the four deployment methods identified, public disclosure is fundamentally different to the other three since it does not give rise to agency concerns in the way that the other deployment methods do. Indeed, the MAR employs an episodic disclosure obligation (requiring public disclosure of inside information as soon as possible) for the exact purpose of divesting insiders of the opportunity to take advantage of it.[437]

7.1.2. Trading by insiders

From the moment a company lists its shares on a trading venue, new information about its business is valuable since it can be monetised by trading in the stock market. Since company insiders have the best access to such information, they could – in the absence of regulation – use it for profitable trading. However, there is no absence of regulation. The EU views insider dealing as a fundamental obstacle to well-functioning markets; so fundamental, in fact, that it employs (in addition to the episodic disclosure obligation described above) three different types of rules to prevent it. First, managers are prohibited from trading under both the MAR and the CSMAD when they

[437] MAR Art 17(1), Recital 49.

possess inside information.[438] This is an episodic ban as it is activated intermittently, if and when managers possess inside information. Secondly, regardless of whether or not they possess inside information, managers may not trade their firms' securities in so-called "closed periods" during the 30 days preceding periodic financial reports.[439] This is a periodic ban as it arises at regular, predictable intervals. Thirdly, managers are subject to obligations to publicly disclose their trades within three business days for purposes of deterrence and detection of insider trading.[440] The periodic disclosure obligations that issuers are subject to (semi-annual reports) are not considered part of the insider dealing toolkit as evidenced by their placement in the Transparency Directive.[441]

7.1.3. Trading by issuers

Public firms may purchase their own shares in the market, hold them in treasury, and resell them back into the market.[442] Such market transactions require authorisation by the shareholders in general meeting,[443] but the

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438 MAR, Art 14 and MAD, Art 3.

439 MAR Art 19(11).

440 MAR Arts 19(1), 19(3), Recitals 58-59.

441 TD, Art 5.

442 For UK purposes, the main rules governing share repurchases are found in Part 18 of the Companies Act 2006 and FCA Listing Rule 12.

443 Companies Act 2006 c. 6, s. 701 governs on-market purchases. Sales of treasury shares are permitted under CA 2006 s. 727, but since a sale into the stock market would entail a deviation from

directors decide on the timing of these transactions and could therefore take advantage of their superior information to have firms transact in their own shares at an opportune time. For example, if the directors know that the firm will sign a significant contract in the near future but have not yet effectuated any public disclosure, it would be profitable for the firm to buy back its own stock with a view to re-sell it into the market at a higher share price after the announcement. The reverse situation is also possible: the firm would first issue new shares into the market, then release negative information, and repurchase the shares. [444] To what extent is this type of insider trading, then – by issuers themselves – prohibited?

The episodic trading ban applies to issuers' trading,[445] but MAR offers an exemption for trading within buy-back programmes conducted for certain purposes, such as to satisfy share option programmes, provided that requirements including price and volume limits are adhered to.[446] However,

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shareholders' pre-emption rights, they would need to waive their pre-emption rights in advance in accordance with s. 573.

444 Such "placings" of up to 10% of the existing shares can be executed quickly and structured to avoid publishing a prospectus. See Paul L. Davies & Sarah Worthington, *Gower's Principles of Modern Company Law* (10th ed., 2016) 843. The Pre-Emption Group will not support a general authority to disapply pre-emption rights for new share issues that exceed 5% of current share capital; see Pre-Emption Group, *Disapplying Pre-Emption Rights: A Statement of Principles* (2015).

445 MAR Art 3(1)(13) stipulates that both natural and legal persons are covered by the regulation.

446 MAR Art 5 and Commission Delegated Regulation (EU) 2016/1052 of 8 March 2016 supplementing Regulation (EU) No 596/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the conditions applicable to buy-back programmes and

this does not mean that issuers can use this safe harbour to trade on inside information, since that would also imply a breach of the episodic disclosure obligation.

Issuers are not generally subject to periodic trading bans under EU law, although they can only avail themselves of the safe harbour for share buy-backs if they refrain from trading during closed periods. Before the MAR was introduced, the UK applied both a general periodic trading ban and a specific ban on buy-backs by issuers with a premium listing, but these prohibitions were removed when the MAR came into effect to avoid contradicting the new EU framework.[447] Furthermore, the EU does not employ trade reporting obligations to deter or detect issuers' insider trading via the company. The FCA, however, requires prompt and detailed disclosure of repurchase transactions.[448]

7.1.4. Selective disclosure

In the absence of a prohibition on selective disclosure, an opportunistic manager could easily circumvent the episodic and periodic insider trading bans by colluding with a person outside of the firm who trades and shares the profits with the insider or the firm. To prevent this, there is a similar episodic

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stabilisation measures [2016], OJ L173/34, Arts 2 and 3 (this is targeted at market manipulation, not insider trading).

447 Financial Conduct Authority, Implementation of the Market Abuse Regulation (2014/596/EU), Policy Statement 16/13 (April 2016) (removing Listing Rules 9.2.7R, 12.2.1R, and 12.6.1R).

448 LR 12.4.6R.

"tipping" ban: selective disclosure constitutes "unlawful disclosure" regardless of whether or not the recipient trades,[449] and a conspiring information recipient is as proscribed from trading as the insider who tipped her.[450]

Contrary to the ban on trading, however, the episodic ban on selective disclosure is not absolute. MAR permits selective disclosure when made "in the normal exercise of an employment, a profession or duties".[451] The European Court of Justice has interpreted an earlier (but identically worded) incarnation of this exemption to only permit selective disclosure that has "a close link" with, and is "strictly necessary" for, the exercise of employment, profession or duties.[452] This underlying rationale for the exemption remains in MAR, which uses it to permit market soundings but does not describe other forms of permitted selective disclosure.[453] The FCA allows selective disclosure to government departments or regulatory bodies such as the Takeover Panel under this exemption,[454] and would assess the lawfulness of any particular instance of selective disclosure by taking into account whether the recipient was subject to confidentiality obligations and the commercial purpose for the

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449 MAR, Arts 10, 14. CSMAD also labels selective disclosure a criminal offense in Art 4.

450 MAR, Arts 8, 14.

451 MAR, Art 10(1).

452 Case C-384/02 *Grøngaard & Bang* [2005] ECR I-9939.

453 MAR, Art 11(4) (market soundings).

454 FCA, Market Conduct Guidance 1.4.3G.

disclosure.[455] Among behaviours that the FCA considers indicative of unlawful disclosure are selective briefings of financial analysts by directors or managers.[456]

Managers can, of course, make mistakes and selectively disclose information which they did not realise was material. Art 17(8) MAR stipulates that such mistakes must be rectified by promptly disclosing the relevant information unless the recipient is under a duty of confidentiality. Furthermore, the recipient would be subject to the episodic trading ban.[457] The MAR provision requiring cleansing of non-intentional selecive disclosure by prompt public disclosure of the information is almost a carbon copy of the pre-existing US equivalent, Regulation Fair Disclosure. Similar to the US regulation, the MAR framework does not require the issuer to acknowledge at the point of public disclosure that a disclosure mistake has occurred.

In contrast to the episodic ban, there is no periodic ban on selective disclosure in the EU or UK frameworks. In the US, it is common for issuers to prevent their insiders from speaking to investors (so-called "quiet periods", to compliment "close periods") on a voluntary basis, but this appears less

455 FCA, Market Conduct Guidance 1.4.5G. Further examples are provided in FCA, Disclosure Guidance and Transparency Rules (DTR) 2.5.7G.

456 FCA, Market Conduct Guidance 1.4.2G. This example should presumably be read to include a reference to inside information being disclosed in this way, as it would seem that the FCA is well aware of the practice of selective analyst briefings. See further below, sections 7.2.3 and 7.4.1.

457 Unless the recipient was not in a position where they ought to have known that the information was inside information; see Art 8(4) MAR.

common in Europe.[458] Further, selective disclosure does not activate any reporting obligations when the tipping occurs or when the recipient trades, unless the recipient is subject to the regime for notification of major holdings.[459]

7.1.5. Concluding and comparative remarks on information deployment

To summarise the findings above, we can compare the different ways EU regulation seeks to deter and detect the use of corporate information for trading purposes in a matrix as follows.

[458] A survey of US public firms has reported that that 99% of firms used a "blackout" period (i.e. a period trading ban), only 85% of the same firms used a "quiet period" (a periodic tipping ban) and only half of those latter firms had codified the quiet period as a formal company policy. See National Investor Relations Institute, *Trading Blackouts and Quiet Periods Survey* (2015).

[459] TD, Art 9. This regime includes certain family members.

Table 2: EU regulation of information deployment methods

Deployment method	**Episodic ban**	**Periodic ban**	**Reporting obligation**	**Immediate disclosure obligation**
Personal trading by insider	Yes	Yes	Yes	Applies generally
Firm trading	Yes	No	No (UK: Yes)	Applies generally
Selective disclosure and outsider trading	Yes (for both disclosure and trading)	No	No	Applies generally

This comparison highlights potential regulatory gaps. While the episodic ban applies to all three forms of private information use, neither the periodic ban nor the reporting obligation apply to trading by the firm or selective disclosure. Firm trading does however, as noted, require prompt reporting in the UK, but selective disclosure does not. Selective disclosure is consequently the least regulated method for information deployment. In light of the Commission's view that "transparency is a prerequisite for the prevention of market abuse,"[460] the lack of EU-level transparency for both trading by issuers in their own shares and for selective disclosure raises questions as to why the EU has opted only to regulate the most obvious private information deployment method.

The regulatory framework outlined in the matrix above appears fairly strict when compared to the securities regulation of the United States. The US and the EU employ similar rules for only two of the four methods for information deployment above. Similarly to the EU, US securities regulation makes use of an episodic ban on insider trading.[461] It also requires insiders to report changes in their ownership of issuer shares within two business days,[462] a slightly shorter period than the EU.

As regards the other two methods, however, there are clear differences. When a US firm trades its own shares, the episodic ban applies, there are no periodic bans, and trades typically only have to be disclosed in the next quarterly report.[463] While US securities regulation prohibits selective disclosure of material information under Regulation Fair Disclosure, this is a disclosure-based regulation only applicable to issuers. This has the effect that recipients of

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460 Commission Delegated Regulation 2016/1052 (n 446), Recital 3.

461 Under 17 C.F.R. § 240.10b-5.

462 17 C.F.R. §240.16a-3(g)(1).

463 See Fried (n 433) 814-15, 823-24; James D. Small III, W. Clayton Johnson & Leslie N. Silverman, 'The Resurgence of United States at-the-market Equity Offerings to Raise Capital in Volatile Equity Markets' (2009) 4 Capital Markets Law Journal 290, 302.

selective disclosure may lawfully trade on material information they receive from insiders, as long as they do not activate the insider trading framework by providing a personal benefit to the insider.[464] This is in stark contrast to the EU framework, which has a strong focus on market egalitarianism and prohibits anyone in possession of inside information from trading. US information traders may consequently be more aggressive in seeking out valuable information for trading their EU counterparts.

Furthermore, US securities regulation does not contain a general episodic disclosure obligation such as the EU's requirement that information must be disclosed as soon as it meets the "inside information" definition. The mere fact that material information arises within a US public firm does not trigger any duty to disclose the information, unless it is information of a type listed in the Securities and Exchange Commission's Form 8-K, such as entering into a material agreement outside the issuer's ordinary course of business.[465] Even then, Form 8-K only requires disclosure within four business days compared to the requirement in MAR to disclose as soon as possible. This does not mean that managers can disclose material information freely, however, since Regulation Fair Disclosure mandates that intentional disclosure of material information may not be made selectively.

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[464] Dirks v. SEC, 463 US 646 (1983).

[465] 17 C.F.R. § 249.308.

Finally, it should be noted that US securities regulation makes use of another tool not seen in the MAR to combat insider trading – automatic forfeiture of all profits insiders make on transactions completed within a six-month period (so called "short-swing" profits).[466]

7.2. The role of selective disclosure

7.2.1. The practices of private investor meetings

Since Table 2 has shown that selective disclosure is the least regulated information deployment method, it will now be analysed further to attempt to determine whether there is any real risk of managerial opportunism. The practices of private investor meetings do not appear to have been analysed in the legal literature,[467] so – in order to elucidate the role of selective disclosure among a manager's other information deployment options – it is worth describing the general attributes of such meetings. I will do so by drawing on academic research in disciplines such as accounting and finance, and present details of meeting and disclosure practices as described in investor relations publications and the financial press.

Private meetings or discussions between senior corporate managers and investors or analysts are generally referred to as an "investor relations" activity.

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[466] Section 16(b) of the Securities Exchange Act 1934.

[467] The topic has generally not been analysed much in the literature, likely because "informal contact between institutional investors and firms is by its nature private and difficult to quantify." Lucian A. Bebchuk & Michael S. Weisbach, 'The State of Corporate Governance Research' (2010) 23 Review of Financial Studies 939, 942.

The National Investor Relations Institute ("NIRI")[468] defines investor relations as "a strategic management responsibility that integrates finance, communication, marketing and securities law compliance to enable the most effective two-way communication between a company, the financial community, and other constituencies, which ultimately contributes to a company's securities achieving fair valuation." [469] More simply, investor relations is described by industry literature as a corporate function for marketing the firm's stock.[470]

Analysts and active investors consistently rank private conversations with management as their preferred channel for sourcing information. In 1977, securities analysts regarded personal conversations with managers as the most

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468 Founded in 1969, NIRI characterizes itself as "the professional association of corporate officers and investor relations consultants responsible for communication among corporate management, shareholders, securities analysts and other financial community constituents." It presents itself as "[t]he largest professional investor relations association in the world, . . . [with] more than 3,300 members represent[ing] over 1,600 publicly held companies and $9 trillion in stock market capitalization." *See About NIRI*, National Investor Relations Institute, http://www.niri.org/FunctionalMenu/About.aspx.

469 National Investor Relations Institute, 2014 Annual Report 1 (2014), http://www.niri.org/about-niri/annual-report [hereinafter NIRI 2014 Annual Report].

470 Bruce W. Marcus, *Competing for Capital – Investor Relations in a Dynamic World* (2005) 12 (arguing that the role of investor relations is to convince investors that the firm's stock will be a better investment than other alternatives). *See* Anne Guimard, *Investor Relations – Principles and International Best Practices in Financial Communications* (2d ed. 2013) 190 for a description of investor relations as a marketing function. Guimard was a NIRI board member as of its latest annual report. *See* NIRI 2014 Annual Report (n 469).

valuable source of information.[471] This was also true in 1998,[472] and still appears to be the case today.[473]

Firms equally regard private meetings as the most important communication channel with investors.[474] According to company managers, the most

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471 *See* Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission (1977) 67–68.

472 In 1998, UK analysts and fund managers rated direct contacts with issuers as their most important source of information; see Richard G. Barker, 'The market for information – evidence from finance directors, analysts and fund managers' (1998), 29 Accounting and Business Research 3. Barker et al noted the "central importance" of private meetings to all active investors they interviewed; see Richard Barker, John Hendry, John Roberts and Paul Sanderson, 'Can company-fund manager meetings convey informational benefits? Exploring the rationalisation of equity investment decision making by UK fund managers' (2012), 37 Accounting, Organization and Society 207, 211.

473 Lawrence D. Brown et al., 'Inside the "Black Box" of Sell-Side Financial Analysts' (2015) 53 Journal of Accounting Research 1, 10–13 (finding that sell-side analysts find communication with management more useful than their own research or firms' public reporting); Lawrence D. Brown, Andrew C. Call, Michael B. Clement & Nathan Y. Sharp, 'The Activities of Buy-Side Analysts and the Determinants of Their Stock Recommendations' (2016) 62 Journal of Accounting & Economics 139, 147 (finding that buy-side analysts find sell-side analysts' provision of access to management more useful than their written reports, earnings forecasts or stock recommendations); *see also* Guimard (n 470) 161 (arguing that one-on-one meetings are the preferred way of investor communication for both issuers and investors and labelling the practice "irreplaceable").

474 Guimard, (n 470) 161; National Investor Relations Institute, *Analyst Sponsored Investor Conferences Survey: 2013 Report* (Jan. 10, 2014) 14 (finding that "one-on-ones were the most valuable element of an analyst sponsored investor conference"). In surveys of the largest public companies in the UK in 1991 and 2002, one-to-one meetings were regarded as the most important communication channel with analysts and investors, followed by telephone calls; see Claire Marston, 'Investor Relations

important discussion topics in private meetings with investors and analysts are company strategy in the short term, explanation of recent results, and explanation of major new projects and developments.[475] Private investor meetings are now so common that many professional investors require a meeting with the CEO before initiating a new investment,[476] and some investors decline to take part in meetings with firms unless they are on a "one-on-one" basis with senior management.[477]

Fund managers have been found to focus on downside risks in private meetings, while sell-side financial analysts were equally interested in upside and downside risks which could trigger buy or sell recommendations.[478] Active investors also commonly use private meetings to verify the assumptions of their valuation models with management.[479] Another documented function of

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Meetings: Evidence from the Top 500 UK Companies' (2008) 38 Accounting and Business Research 21, 40.

475 Marston (n 474) 37-38.

476 Leslie Kwoh, 'Investors Demand CEO Face Time', Wall Street Journal, Nov. 28, 2012. One investor has stated that he would typically have two or three such meetings before "even contemplat[ing] an investment." For further examples, see Alex Jolliffe, *Corporate Access: The Investor View*, IR Magazine, Supplement: Corporate Access: Opportunity Knocks (June 2012) 12, and Serena Ng & Anton Troianovski, 'Investors Prize Face Time with Bosses', Wall Street Journal (Sept. 28, 2015).

477 Guimard (n 470) 160.

478 John Holland, *A Model of Corporate Financial Communications* (Institute of Chartered Accountants of Scotland 2006) 132 (interviewing managers of 25 UK-listed issuers, 22 of which were FTSE100 companies).

479 Barker et al (n 471) 213.

these meetings is to assess the quality of the CEO and CFO by observing how they function together and to provoke them to see how they react.[480] One interview-based study of large investors found that they considered themselves to be information traders rather than owners and that the main function of one-on-one meetings was to probe the firm's public reporting in order to find information which could be used for trading.[481] Another study, which interviewed managers of 25 of the largest UK companies, found that they were well aware that fund managers and analysts were participating in private meetings in order to gain information advantages and that the meetings would be pointless otherwise.[482]

The frequency of private meetings between investors and managers appears to have increased over time. In the late 1980s, one commentator noted that American analyst practices of arranging management meetings started to

480 Barker et al (n 471) 215; Holland (n 478) 22; Bill McInnes, Vivien Beattie and Jacky Pierpoint, 'Communication between Management and Stakeholders: A Case Study' (Institute of Chartered Accountants in England and Wales, 2007) 40, 58 (interviewing managers and various stakeholders of a large UK-listed company).

481 John Hendry, Paul Sanderson, Richard Barker and John Roberts 'Owners or traders? Conceptualizations of institutional investors and their relationships with corporate managers' (2006), 59 Human Relations 1101, 1110, 1121 (conducting in-depth interviews with senior managers from 11 of the 20 largest UK-based institutional investors, finding that the core function of the meetings for the investors was to refine the information which they used to trade, with investors stating clearly that the aim was to uncover information for trading).

482 Holland (n 478) 20.

become more widespread in Europe.[483] Surveyed UK public firms participated in 25 meetings on average in 1991, a figure which increased to 77 meetings in 2002.[484] More recent data suggests that 35% of UK companies now hold more than 250 such meetings per year.[485] While "investor relations" as a discipline originated in the United States,[486] recent studies suggest that the average European issuer now conducts more investor meetings than the average US issuer.[487] The data presented here only covers physical meetings, however, so the figures would be higher if telephone calls, which may be similar in content and purpose, were included.[488]

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483 Klaus J. Hopt, 'The European Insider Dealing Directive' in Klaus J. Hopt and Eddy Wymeersch (eds), *European Insider Dealing – Law and Practice* (Butterworths 1991) 135.

484 Marston (n 474) 40.

485 Steve Kelly, 'Are Companies Asleep in Investor Relations?' *Financial Times* (17 March 2013).

486 *See* UK Investor Relations Society, *A Brief History of Investor Relations*, available at http://www.irs.org.uk/news/a-brief-history-of-investor-relations.

487 Lloyd Bevan, 'Corporate access by the numbers', IR Magazine (12 August 2014) available at http://www.irmagazine.com/articles/corporate-access/20327/corporate-access-numbers/ (noting that the average European issuer surveyed takes part in an average of 226 one-on-one investor meetings per year compared to 165 such meetings for the average North American issuer); Ipreo, *Global Corporate Access Study* (2013) 2 (noting that non-US issuers have more one-on-one meetings than US issuers regardless of size (large-caps having 222 such meetings per year, mid-caps 177 and small-caps 83).

488 It is very difficult to establish the amount of private interactions firms have with analysts and investors. Soltes reviewed records of all interactions between one large-cap NYSE-traded firm and sell-side analysts over a year, and found that only 21% of interactions were publicly observable, for example, where the firm's participation in investor conferences was disclosed. *See* Eugene Soltes,

7.2.2. The function of private investor meetings

7.2.2.1. From the perspective of firms

NIRI describes the importance of private investor meetings as follows, which emphasises that the focus of such meetings is to provide investors with information they cannot otherwise obtain:

> One-on-one meetings with individuals or groups are a common and indispensable way to disseminate information about a company and to answer legitimate requests for a discussion of long-term strategies, as well as to provide detailed information. One-on-one meetings help to increase transparency, build goodwill, and make a company more approachable in the eyes of the investment community.[489]

This description succinctly illustrates that firms may use selective disclosure of new information to bond with investors. Other benefits of private meetings presented in the investor relations literature similarly allude to the use of NPI as a corporate resource. For example, private meetings may be used to

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'Private Interaction Between Firm Management and Sell-Side Analysts', 52 Journal of Accounting Research (2014) 245, 247.

[489] National Investor Relations Institute, Standards of Practice for Investor Relations – Disclosure 53 (2014).

convince investors to buy the firm's stock.[490] This was the situation in a recent US insider trading case:

> "[The Head of Investor Relations at Dell] selectively disclosed confidential quarterly financial information [...] to establish relationships with financial firms who might be in a position to buy Dell's stock."[491]

Private meetings may also help build shareholder loyalty to increase the likelihood of participation in future securities offerings, assistance if the firm encounters a crisis, or support for potential future strategic shifts or large acquisitions.[492] Such meetings also allow for investor feedback and may provide an informal venue for managers to test ideas.[493] Reasons for conducting private meetings particularly with hedge funds may include generating greater

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490 Guimard (n 470) 97 (explaining that it is important to have investors willing to buy stock when existing shareholders sell); *id.* at 165 (suggesting that "[d]ecisions about whether to send the CEO or IRO to meet with a portfolio manager should be based . . . on the likelihood that the meeting will lead to the purchase of stock in the company"; *see also* Marcus (n 470) 91 (arguing that the purpose of private meetings is to increase investors' understanding of the firm and convince them to buy the firm's stock).

491 United States v. Newman, 773 F.3d 438, 455 (2d Cir. 2014).

492 Guimard (n 470) 162 (stating the importance of regular meetings with investors), 181 (stating that "[f]aithful shareholders are more likely to participate in a capital increase . . . or to help withstand a crisis"); Marcus (n 470) 107 (noting that some investors are willing to "provide some support in difficult times"); Kwoh (n 476) (quoting a CEO describing the purpose of private meetings as "selling the management team" and showing accountability).

493 Marcus (n 470) 107.

liquidity,[494] increasing volatility, and decreasing uncertainty associated with market rumours.[495] In general, firm benefits of private meetings appear to be provided in the form of intangible value that is difficult to quantify.

7.2.2.2. From the perspective of participating investors

A main function of private meetings with senior management is, of course, to enable investors and analysts to find value-relevant NPI that can be used for profitable trading. Perceived advantages to investors of private meetings compared to other disclosure methods include the opportunity to ask more searching questions and receive more detailed answers than would otherwise be possible, as well as the opportunity to challenge managers more than would be appropriate in a public forum.[496] Analysts use meetings to verify facts, find new information, and familiarise themselves with corporate managers.[497] Topics of discussion are often forward-looking and include industry

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494 One representative of a hedge fund argued that issuers should participate in private meetings with hedge funds since they provide liquidity. *See* Matt Brusch, *What Investors Want from IROs*, IR Update (Oct. 2010) 18.

495 Guimard (n 470) 102 (suggesting "[h]igher volatility" and "remov[ing] uncertainty in the stock conveyed by market rumors" as reasons for meeting with hedge funds, but not explaining why increased volatility would be beneficial or why private meetings may be a preferable method for managing rumors).

496 *See* Guimard (n 470) 162 (suggesting that corporate managers meeting with hedge fund managers may have an experience similar to "being held in custody in an interrogation room"); Marcus (n 470) 107–08 (noting that professional portfolio managers have an urgent and intensive demand for substantial information and ask highly technical questions); Kwoh, (n 476) (quoting a CEO of a public firm who notes that "investors probe him for confidential information . . . 'all the time'").

497 Marcus (n 470) 96.

competition and the managers' strategy.[498] Analysts also attempt to confirm their earnings projections, for example by gaining management's feedback on whether their forecasts are "*in the ball park*."[499]

Functionally, investors can engage in three conceptually distinct types of activities to reduce uncertainty about the pricing of a security: they can seek to acquire new information, verify already available information, or analyse available information.[500] Investors use private meetings with management to reduce uncertainty about securities pricing by asking questions both to acquire new information and to verify existing information. Acquisition of new information could consist of asking for more details on items that already have been subject to some disclosure[501] or, as was the case in the well-known US insider trading case of *US v. Newman*, attempting to learn of information in advance of its imminent public disclosure.[502] Verification of information could involve asking management to confirm whether previous forward-looking

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498 Id.

499 *Id.* at 106. For a real-world example, see *United States v. Newman*, 773 F.3d 438, 454–55 (2d Cir. 2014), where investor relations personnel provided testimony that analysts regularly received information from firms "in order to check assumptions in their models in advance of earnings announcements" and the investor relations departments in question "routinely 'leaked' earnings data in advance of quarterly earnings."

500 Gilson & Kraakman (n 170) 564–65.

501 For example, in Soltes (n 488) 257, 43% of all analyst interactions occurred within 72 hours of public news releases by the firm.

502 *Newman*, 773 F.3d at 454–55.

statements are still valid, since such information would be more reliable if confirmed by a person with the ability to influence it.

The costs associated with undertaking each of these activities will determine the availability of the information resulting from them.[503] Information costs of private investor meetings would include compensation of intermediaries who arrange conferences as well as salaries for professional analysts who know the most valuable questions to ask corporate managers and have the skill to translate their answers into profitable stock market trading strategies. These costs are consequently relatively high, meaning that comparatively few investors will take part in such meetings and have access to such information. Verification of information relating to a firm without its cooperation is expensive, however, so procuring a private meeting with management may still be the most cost-effective method of doing so.[504] Furthermore, acquiring new information directly from senior managers may remove the need for further verification as they are often the best possible source.

Not all investors are interested in acquiring NPI. Liquidity traders buy or sell stocks depending on whether they have a surplus or shortage of liquid funds for consumption without conducting any research, and passive investors may invest in funds that simply track an index and charge minimal management fees. Investors who demand NPI are sometimes referred to as "information

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[503] Gilson & Kraakman (n 500) 594-95 (describing the different types of information costs).

[504] This could involve paying an intermediary for arranging a meeting via "corporate access." *See* sections 7.2.3 and 7.4.1.

traders"[505] or "active investors," a group which includes mutual funds and hedge funds.[506] These investors believe they can outperform a passive index investment by investing based on their own information collection and analysis, and that the returns from their superior skill will outweigh the costs of this activity. They attend private meetings to unearth information, to refine their estimated intrinsic value of a security, and trade when their estimation varies from the market price. The investment performance of active investors is typically evaluated against a benchmark. Active investors demand NPI—and therefore, private meetings with corporate managers—as it provides them with unique NPI to help them outperform such benchmarks.[507]

To deduce the appropriate price of a security an active investor must estimate many variables. For example, the discounted cash flow model commonly used for equity valuation forecasts a firm's future cash flows by applying growth and profitability estimates to its historical accounting figures. Factors relating to the firm, its industry, and the economy all need to be considered to forecast

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505 *See, e.g.*, Fischer Black, 'Noise' (1986) 41 Journal of Finance 529 (contrasting different types of traders).

506 "Buy-side" institutions such as mutual funds and hedge funds employ their own financial analysts. They may also receive information from "sell-side" financial analysts employed by brokers. "Active investors" is an umbrella term and only a subset of such investors seek to acquire NPI in private investor meetings—it is that subset which this chapter references with the term.

507 In Barker's interviews with fund managers, they all shared the primary objective of maximisation return compared to their benchmarks; *see* Barker (n 472), 12. In a study of 11 investment managers, eight of them regularly participated in private meetings with issuers whereas the others were quantitative or index investors; *see* Barker et al (n 472) 211. *See also* Hendry et al. (n 481) 1112, where one fund manager emphasised that the goal was to "make some relative money".

revenue growth for the firm's products or divisions, and costs need to be estimated to determine how future revenue will translate into profitability. The financing structure must also be projected to estimate the residual cash flows available to shareholders.

All forward-looking data points in a valuation model are estimates and therefore subject to uncertainty. Given this uncertainty, we can portray an active investor's expectation of the price of an individual share that will prevail at some date in the future (and, thereby, the potential return on investment) as a probability distribution. The dispersion around the mean expected share price will reflect the risk the investor attributes to the expected return on the firm's shares as a result of the uncertainties in the valuation inputs.[508] We can further think of value-relevant information as data that has the ability to change the return distribution.[509] Production, purchase, or discovery of new information can consequently change an investor's share price probability distribution.

By reducing uncertainty about valuation estimates, investors can refine their assessments of the risk-return profile of a security. If an investor acquires information that reduces the probability of a positive deviation from the mean, the expected value becomes lower and the investor may be more inclined to

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508 Risk is used in this context as a measure not only of downside deviations from the expected mean, but also upside deviations. Zvi Bodie, Alex Kane & Alan J. Marcus, *Investments* (10th ed. 2014) 129.

509 This depiction of information is inspired by Jack Hirshleifer, 'Where Are We in the Theory of Information?' (1973) 63 American Economic Review 31. *See also* Gilson & Kraakman (n 500) 561.

sell the security. If the acquired information instead reduces downside risk, the expected value increases and the investor may be more inclined to buy the security. If risk is reduced symmetrically (equally on the downside and the upside, with the same mean after the information acquisition), the investment offers more return per unit of risk, which will make it more attractive.[510] Thus, any change in the risk profile of a security can have value to active investors, and new information about a security will have value if it changes the risk profile.

7.2.2.3. From the perspective of non-participating investors

Investors who do not participate in private meetings may still benefit from them. If they are shareholders, they can share in the benefits accruing to the firm which are set out in Section 7.2.2.1. There are two further potential benefits that may lie more on the shareholder level than on the firm level: increased market efficiency and improved monitoring of management.[511]

7.2.2.4 i) Market efficiency benefits?

[510] Eugene F. Fama & Arthur B. Laffer, 'Information and Capital Markets' (1971) 44 Journal of Business 289, 290. Of course, for an optimally diversified investor a reduction in the idiosyncratic risk of one security which they already hold may not be of value, but for an active investor attending a private meeting with management in order to decide whether to take or change a position in a security, such a reduction of risk could be of interest.

[511] These benefits were not noted in the investor relations literature in Section 7.2.2.1, so they do not appear to be the focus of firms themselves.

A security is typically described as trading in an efficient capital market if the price of the security always reflects all available information.[512] Efficiency is usually considered in relation to three different types of information. Developed equity markets are generally considered to be efficient in relation to two such types: historical price information (weak form efficiency) and other publicly available information (semi-strong efficiency). As these types of information will be instantly incorporated into prices, they do not offer opportunities for profitable trading.[513] Markets do, however, typically not impound information available only to a small number of people into prices (that is to say, markets do not exhibit strong form efficiency), meaning that such information may offer profitable trading opportunities.[514] The absence of strong form efficiency thus provides an initial explanation for professional investors' demand for NPI.

In considering the market efficiency requirement that prices fully reflect "available" information, Gilson and Kraakman noted how the three levels of market efficiency relate to different information sets that become reflected in the price following distinct processes.[515] Arranging the three levels on a continuum from weak to strong market efficiency, they argued that market

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512 Eugene F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 Journal of Finance 383.

513 *Id.*; Eugene F. Fama, 'Efficient Capital Markets: II' (1991) 46 Journal of Finance 1575, 1607.

514 Fama (n 512) 409-13.

515 Gilson & Kraakman (n 500) 558–60.

efficiency should be viewed as a relative concept, with relative efficiency as a measure of how quickly prices reflect new information.[516] Relative efficiency then increases as the group of initial recipients of information becomes broader.[517] If information is initially distributed broadly, it will be expected to be reflected in price quickly and the market will exhibit high relative efficiency with regards to that information. Conversely, if information is initially distributed to only a few recipients, it will be expected to take longer to become reflected in price and the market would therefore be described as having lower relative efficiency in respect of such information. While this applies to all relevant information about a security, the focus here is on disclosures by firms themselves.

Non-mandated disclosures take many different forms. Examples of methods in which firms disclose information to investors include one-on-one meetings and private telephone conversations, small-group meetings with investors, non-public roadshow presentations, analyst and investor days, and press releases.[518] If we apply the concept of relative efficiency to illustrative corporate disclosure methods, we may represent it along the lines of Figure 5.

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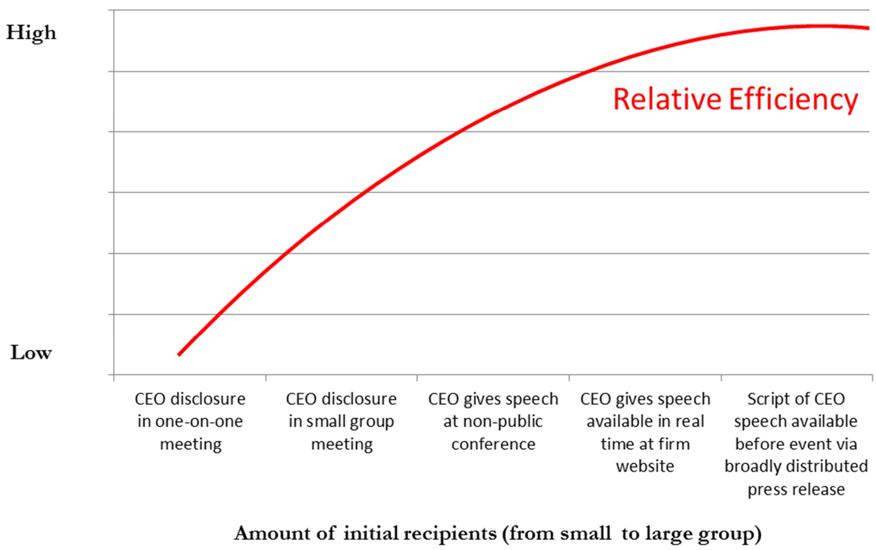
516 Id., 560.

517 While such a continuum of information distribution makes intuitive sense, a "market may be efficient [with regards to a piece of information] if 'sufficient numbers' of investors have ready access" to it. *See* Fama (n 512) 388; Gilson & Kraakman (n 500) 569.

518 A useful overview of how firms interact with investors via these (and other) methods from the perspective of an investor relations professional is presented in Guimard (n 470) 143–87.

Figure 5. Relative efficiency of different corporate disclosure methods



While Figure 5 should not be viewed as a *quantitative* representation of how prices adapt to new information disclosed via different methods, the *qualitative* intuition should be broadly correct. Information selectively disclosed to one investor will take longer to become reflected in price than broadly disseminated information since investors with private information seek to maximise their personal gain. Knowing that other traders are able to observe their trading activity, traders with selectively disclosed information will attempt to make decoding as difficult as possible by trading slowly in order to conceal their informational advantage and disguise themselves as liquidity traders.[519] The more successfully such information recipients convince other traders that

[519] Xavier Vives, *Information and Learning in Markets* (2008) 339–47.

they are uninformed, the larger their potential profit will be and the less information will be impounded into the price of the security.[520]

Without cooperation from the selective disclosure recipient, other investors must resort to the less efficient processes of "price decoding" or "trade decoding" to attempt to decipher the value of the recipient's NPI.[521] However, neither type of decoding informs the outsider as to whether the observed trading is based on new information (such as NPI from the issuer), mistaken belief, or for liquidity reasons. It is therefore unlikely that decoding would offer many, if any, opportunities for market participants to learn of information disclosed to an investor in a private meeting.[522] Research confirms that when information traders are able to choose when and how to trade, they can prevent decoding.[523]

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520 Fox et al also discuss how traders that have discovered fundamental value pricing discrepancies may trade cautiously over long periods of time. *See* Merritt B. Fox, Lawrence R. Glosten, & Gabriel V. Rauterberg, 'Informed Trading and Its Regulation' (2018) 42 Journal of Corporation Law 817, 835-845.

521 Gilson & Kraakman (n 500) 573. "Trade decoding occurs whenever uninformed traders glean trading information by directly observing the transactions of informed traders," for instance, by studying transactions subject to reporting requirements. *Id.* Price decoding occurs when an outsider observes a price change and concludes that another trader in the market possesses new information.

522 For early statements to this effect, see id. pp. 572–79, 629–34 and Donald C. Langevoort, 'Investment Analysts and the Law of Insider Trading' (1990) 76 Virginia Law Review 1023, 1038.

523 *See, e.g.*, Pierre Collin-Dufresne & Vyacheslav Fos, 'Do Prices Reveal the Presence of Informed Trading?' (2015) 70 Journal of Finance 1555 (finding that "when informed traders can select when and how to trade, standard measures of adverse selection may fail to capture the presence of

The difficulty in decoding does not mean that informed trading will never have any impact on share prices. Factors affecting the incorporation of information into prices may be sketched out by considering an individual investor's preferences in a practical case. Consider a stylised version of *Newman*,[524] where one or more investors receive advance information about the contents of a firm's quarterly report.[525] From the perspective of an investor, we can outline four factors that will influence how they choose to trade and consequently the extent to which prices will reflect the information.

First, as already determined, the size of the group of initial recipients will matter. If several traders have the same information (for instance, by attending the same conference presentation), the information may be impounded into prices more quickly than if only one investor receives it. This results because the recipients may not be able to coordinate and instead have to compete to capture the gains.[526] Second, the amount of time before the quarterly report becomes public is important. If the recipient has a week to trade, they can trade more slowly, whereas if the information will become public in a few hours, they may opt for a more aggressive strategy that results in more

informed trading"); *see also* Lauren Cohen, Christopher Malloy & Lukasz Pomorski, 'Decoding Inside Information' (2012) 67 Journal of Finance 1009 (insider trades not decoded until publicised).

524 *See generally* United States v. Newman, 773 F.3d 438 (2d Cir. 2014).

525 "[I]llegal trading usually concerns 'bombshell' information that companies are forced to disclose publicly in the near term." William T. Allen, Reinier Kraakman & Guhan Subramanian, *Commentaries and Cases on the Law of Business Organization* (4th ed. 2012) 681.

526 Vives (n 519) 339–47.

information leakage.[527] Third, the recipient's investment constraints will be relevant. The recipient may have limits for the percentage of a firm's shares they can hold, be subject to constraints on short-selling or borrowing, or may have limited funds available to invest. Fourth, the amount of other trading in the market will impact the trading strategy and information revelation. The more liquid the market for the stock in question, the easier it will be for an informed investor to trade without revealing their advantage.[528]

If the recipient is unable to trade, e.g., due to investment constraints, they may, of course, decide to share the information with another investor who is so able. It may indeed be useful for an information trader to establish informal reciprocal relationships with like-minded investors in order to benefit when other investors are similarly unable to trade. Such secondary selective disclosure could have some positive impact on market efficiency, depending on how the secondary information recipients view the four factors outlined above.

The picture that emerges from this analysis is one where a selective disclosure recipient may rationally trade in a way that leaves information less than fully

527 *Compare* Robert J. Jackson, Jr., Wei Jiang & Joshua Mitts, 'How Quickly Do Markets Learn? Private Information Dissemination in a Natural Experiment' 27 (Colum. Bus. Sch., Research Paper No. 15-6, 2015), http://ssrn.com/abstract=2544128 (finding evidence suggesting that traders with private information trade strategically, depending on the expected length of their trading advantage).

528 *See* Collin-Dufresne & Fos (n 523) (finding that information traders increase trading with a rise in stock liquidity); Allen et al. (n 525) (noting that informed trading may "fail entirely to move prices if the level of background 'noise trading' is sufficiently high").

incorporated into prices. Indeed, in certain configurations of the four factors sketched out above, the information will never affect the stock price at all.

When information is distributed to only one investor, this recipient receives a valuable trading advantage. On the other side of the spectrum where information is disclosed broadly, relative market efficiency is high and recipients do not on average receive any trading advantages. In-between these end-points, the two effects will exhibit some progressive development. We can then illustrate the corporate manager's choice between disclosure methods as a trade-off between improving market efficiency and conferring value on recipients, as in Figure 6.

Figure 6: Trading value to recipients of different disclosure methods

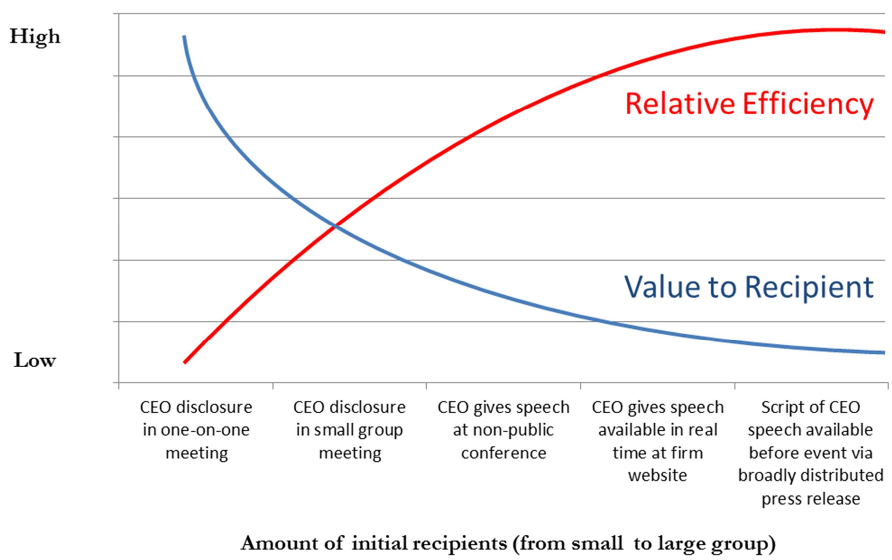

Figure 6 shows that a public firm can either have secrecy or increased market efficiency with regards to a particular item of NPI, but not meaningful degrees of both at the same time. In conclusion, there appears to be little expected market efficiency benefit to investors as a group of the practice of selective disclosure, unless the firm selectively discloses the information to larger groups.

7.2.2.5 ii) Monitoring Benefits?

If it is doubtful that private meetings with investors produce notable market efficiency benefits, such meetings may instead be beneficial to investors at large by providing a forum where professional investors can engage in monitoring and verification by questioning the public reporting presented by management and verified, in part, by the auditors. The social benefit of private investor meetings may then arise from their function of ensuring that managers' disclosure decisions are unbiased—with an *ex ante* disciplining effect, as managers will be aware that they will need to justify their disclosure decisions to investment experts, and with an *ex post* effect of verifying the actual disclosures made.

However, the investors who take part in private meetings will not be inclined to share their findings broadly, as we have just seen that they profit more from private information. Additionally, the extent to which managers opt to subject themselves to such monitoring is entirely voluntary and unknown to shareholders. This may lead to a situation where honest managers subject themselves to monitoring by more skillful or diligent investors, whereas less honest managers choose not to subject themselves to investor monitoring or only meet with investors who are less skillful monitors.[529]

An argument that selective disclosure practices are beneficial may proceed by claiming that by leaving some value-relevant information on the table, active investors may be more attracted to meet with managers to monitor them for the benefit of all investors.[530] Whether this would work in practice would depend on the managers' skill and interest in choosing to meet participants who have the motivation to conduct monitoring and verification instead of those only looking to acquire the NPI.

7.2.3. Corporate access as a medium for investor meetings

As information about listed securities is more valuable the more privately it is received, the demand for selectively disclosed information and the willingness to pay for it is obvious. Active investors will prefer to receive NPI as privately as possible in order to have a larger window of exclusivity in which to profit from it. Several factors may affect the amount an investor would be willing to pay for information, such as the materiality threshold, the quality and usefulness of management's disclosures in previous meetings, the amount of

529 While one reason for managers choosing not to participate in investor meetings may be an unwillingness to be monitored in this way, another reason is to ensure that information reaches all investors simultaneously. There is consequently nothing inherently honest or dishonest about a firm's choice not to participate in investor meetings.

530 *Compare* Ronald J. Gilson & Jeffrey N. Gordon, 'Controlling Shareholders' (2003) 152 University of Pennsylvania Law Review 785 (discussing costs and benefits of the presence of controlling shareholders).

uncertainty surrounding the firm's future (the more uncertainty, the more valuable the information may be), and perhaps also the perceived skill, knowledge or frankness of management. While, on the one hand, it is rational for investors to economize on information costs (for example, by pooling together in the employment of securities analysts and other experts to study and issue reports on firms to reduce verification costs),[531] information is on the other hand not valuable for trading purposes if everyone has access to it, which is why investors rationally demand NPI directly from managers.[532]

A recently introduced offering that caters to investors' demand for private information is "corporate access", an investor meeting arranging service now provided by all major investment banks.[533] As part of their corporate access offerings, investment banks provide issuers assistance with practicalities in arranging roadshows and investor meetings. In return, they aim to get compensated in trading commissions from the investors who take part in these private meetings if and when they decide to trade the issuer's securities. Another type of corporate access service provided by investment banks are private conferences where investors are able to meet with senior managers of public firms in return for paying attendance fees to the arranging banks or

531 Gilson & Kraakman (n 500) 600.

532 Investors may, of course, find it economical to pool their resources in an investment fund that acquires NPI; the point here is that such a fund will need to trade against an uninformed trader in order to profit from its NPI.

533 John Brinkley, 'Managing Face Time: What IROs Need to Know About Working with Corporate Access Providers' (Nov 2012) *IR Update* 14-15.

routing their trading through such banks' brokerage departments.[534] The public firms themselves do not typically pay to participate in corporate access events. The head of corporate access at one large investment bank has described an ideal corporate access event as follows:

> "Yahoo! says to me, 'UBS, we'd like you to host us on a road show. We're looking to find new shareholders. What do you think? 'And I say, 'Okay, I know there are some people who are interested in your stock in Chicago, so why don't we go to Chicago?'
>
> Yahoo! representatives come with us, they do a day of meetings, they do a group lunch in Chicago. They tell their story, they tell everyone why this new CEO is going to change things and why it's a great investment from here on out.
>
> A bunch of those investors say, 'You know, I think it is time to buy Yahoo! stock.' They will call up their UBS sales trader and say, 'You know what, we're thinking of buying Yahoo! Give us 10 million shares.'
>
> So we get a commission on that trade. Yahoo! is happy because it got a new shareholder, we're happy because we got some

534 See, e.g., FCA Policy Statement 14/7, 'Changes to the use of dealing commission rules: feedback to CP13/17 and final rules (May 2014) para 2.11; T. Clifton Green, Russell Jame, Stanimir Markov and Musa Subasi, 'Broker-hosted investor conferences' (2014) 58 Journal of Accounting and Economics 142.

> commissions off the back of it, and the investors are happy because they got to meet with management."[535]

There is no doubt that professional investors view meetings with management as a valuable source of information about listed securities. Some asset managers, including hedge funds, reportedly pay brokers up to £13,000 for a one-hour meeting with a CEO and £10,000 for a CFO.[536] The FCA has estimated that up to £500 million of dealing commissions were used to facilitate corporate access in the UK in 2012.[537] While most public firms would meet with investors with some frequency, only meetings arranged by brokerage firms typically require payment from investors, with fees paid to the brokers.[538] Investment banks' corporate access departments can thus assist investors who are unable to procure meetings with management by themselves (for example, if they are too small to be of interest to management) by lending them their reputation to procure a meeting with managers.[539] Corporate access will be

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535 Brinkley (n 533) (also comparing corporate access to a free five-star concierge service); *see also* Guimard (n 470) 163–64 (proposing criteria for evaluating corporate access services, mentioning that such services are "the least-costly solution for the issuer"); Brusch (n 494) (noting that intermediaries are "typically paid by commission").

536 Steve Johnson, 'Fears rise over cash for access' *Financial Times* (3 March 2013).

537 FCA Consultation Paper CP13/17, 'Consultation on the use of dealing commission rules' (November 2013) para 2.29.

538 Andrew Hampton, 'No more fudging corporate access' (*FT Adviser*, 12 December 2013).

539 For example, one investor recently stated that an investment management business needed to be of a certain size to be able to procure the meetings with company executives that he considered

used as an example in Section 7.3.1 below and the practice will also be considered further in Section 7.4.1.

7.3. An agency perspective on deployment of corporate information

7.3.1. The regulation of sub-material, value-relevant information

So far, this chapter has not covered the question of when, exactly, information is material enough to become "inside information" and activate the episodic bans on trading and selective disclosure. The EU regulation of insider dealing and corporate disclosure share the same concept of materiality, which is incorporated into the requirements for information to become "inside information". This means that, when information is material enough to be "inside information", not only is trading based on the information prohibited, but the information must also be disclosed as soon as possible.[540]

The practice of corporate access, where investors pay large sums of money to meet with senior managers of public companies, could arguably be described as investors paying for expected profitable trading opportunities. It is difficult to see why a manager of a mutual fund or hedge fund would spend money and time procuring private access to corporate insiders if they do not gain non-public insights that enable profitable trading to cover their corporate access

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necessary to establish a viable business, see Steve Johnson, 'Richard Pease follows the lead of Neil Woodford' *Financial Times* (19 October 2014).

[540] MAR Art 14 (prohibition on insider dealing) and Art 17 (immediate disclosure of inside information).

costs. And if investors do receive valuable non-public information, it is hard to understand why it does not constitute market abuse.

The key to pinpointing how (or, perhaps, *whether*) corporate access meetings comply with the market abuse framework is to examine when information disclosed by corporate insiders does not reach the threshold to constitute "inside information" which is unlawful to disclose and trade on. I will occasionally refer to the regulatory area in which such valuable, but sub-material, information may exist as a "twilight zone" – a zone (if it exists) where information is valuable enough for investors to seek it out and even pay for it but without that information being inside information. The size and perimeter of this twilight zone are, naturally, subject to considerable uncertainty, and the zone's existence is often not acknowledged by cartographers of EU disclosure regulation.[541]

To assess the perimeter of the "twilight zone" more closely, we need to analyse the elements of the definition of inside information. The MAR establishes four requirements that a piece of information must fulfil in order to constitute "inside information": it must be precise, not public, relate to an issuer, and be likely to have a significant effect on the price of the issuer's shares if it were made public.[542] The first and last of these four requirements – precision and significant effect – are less self-explanatory than the others and, since they are

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541 *See* note 432 and accompanying text.

542 MAR, Art 7(1).

crucial in establishing the perimeter of permitted selective disclosures, worthy of further elaboration.[543]

The precision requirement can be broken down into a two-pronged test. For the first prong, information must be such that "indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur".[544] This first prong thus has both a historic and a forward-looking dimension. For the historic dimension, rumours and speculation should be distinguished from objective evidence.[545] In the case of selective disclosure from the issuer itself, rumours are unlikely to arise as discussions with corporate managers should provide a high degree of certainty. As for circumstances or events that may occur (the forward-looking dimension), only the information available at the relevant time should be considered.[546] Further, the requirement that the event may reasonably be expected to occur does not mean that it needs to be highly probable, but there needs to be a realistic prospect that it will occur.[547] This

543 These two elements are also singled out in MAR Recital 18 as requiring a "closer definition" in order to enhance "legal certainty for market participants".

544 MAR Art 7(2).

545 Committee of European Securities Regulators, Market Abuse Directive: Level 3 – second set of CESR guidance and information on the common operation of the Directive to the market, July 2007 ("CESR Guidance"), para 1.5. CESR has now been replaced by ESMA through Regulation (EU) 1095/2010, OJ L331/84, but this guidance is still valid.

546 Ibid.

547 *Markus Geltl v Daimler AG*, Case C-19/11 (Judgment of the Court, Second Chamber, 28 June 2012), para 48 (noting that such an interpretation would have undesirable effects when inside information

requirement may therefore not pick up on "softer" elements that may be involved in selective disclosure situations, such as a manager's body language or nuances in phrasing.[548]

The second prong of the precision requirement is that the information must be specific enough to enable a conclusion to be drawn as to its possible price effect; a requirement which may be deemed fulfilled even if it is not possible to infer the direction of that price effect.[549]

The requirement that the information must be "likely to have a significant effect" may at first appear to offer a clear and helpful materiality test, but this impression is neutralized when one sees that this phrase is itself defined as "information a reasonable investor would be likely to use as part of the basis of his or her investment decisions".[550] This definition has been interpreted in two different ways, with notably different results.[551] The first interpretation is that

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is used to determine whether disclosure is required). This has since been codified in MAR Recital 16.

548 *See, e.g.,* Ng & Troianovski, note 476 (describing how a manager's unwillingness to elaborate in private on the firm's need to raise capital was correctly interpreted as a negative sign by meeting attendants, causing the share price to decline 15% before the firm announced an equity offering).

549 Case C-628/13, *Jean-Bernard Lafonta v Autorité des marchés financiers*, (Judgment of the Court, 11 March 2015), OJ C-146/5 (overruling, for UK purposes, David Massey v FSA [2011] UKUT 49 (TCC) para 39).

550 MAR Art 7(4).

551 This was highlighted by the UK regulators' joint response to the Commission's 2010 consultation on MAD, in which was stated that it was unclear how the two definitions interacted and that "one interpretation could result in a very broad requirement on issuers to disclose information"; *see* FSA and HMT, "Joint response to the call for evidence, Review of Directive 2003/6/EC on insider

the definition replaces the price significance test with an open-ended reasonable investor test, rendering the price significance test a hollow phrase. The second interpretation is that the definition complements the price significance test by clarifying how to determine on an *ex ante* basis which information would be likely to meet the price significance test by stating that it shall be viewed from the perspective of a reasonable investor. There are strong indications that this second interpretation was favoured by both CESR[552] and the Commission itself.[553] It also appears to be the better interpretation in light of the efficient capital market hypothesis, which implies that all available information is impounded into the price of securities and therefore implicitly forming part of an investment decision.

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dealing and market manipulation" (July 2010), available at <http://ec.europa.eu/internal_market/consultations/2010/mad_en.htm>.

552 CESR endorsed this interpretation by (i) stating that the reasonable investor test "assists" in determining the type of information that should be considered under the significant price effect test and (ii) by pointing out that implementing measures (such as the Commission Directive, a Level 2 measure, which first implemented the reasonable investor test) cannot extend the scope of a Level 1 directive; *see* CESR Guidance (n 545) para 1.11.

553 The Commission stated that it had "further clarified" the MAD concepts in its Level 2 measures, which suggests that it did not consider itself to have expanded the scope of the MAD. It also endorsed CESR's statements on the issue by declaring that "CESR has developed useful guidance seeking convergence in application of these concepts among its members, by providing instructive examples and indicators on how these concepts could be understood and applied." See European Commission, Call for Evidence – Review of Directive 2003/6/EC on insider dealing and market manipulation (20 April 2009) 7-8, available at <http://ec.europa.eu/internal_market/consultations/2009/market_abuse_en.htm>.

If the first interpretation was instead chosen, much information would become inside information. If we assume that investors taking part in a private meeting would ask questions that assist them in making an investment decision, any information disclosed to them could be viewed as satisfying the reasonable investor test on the assumption that the investors are objectively reasonable. This would be a problematic outcome because, without the requirement that there independently be a significant price effect, any information that would have some relevance to price (no matter how small) would then fulfil the price significance test so that the information could be "inside information". This would be unworkable since the same definition is used for disclosure purposes: any non-public information that a reasonable investor would like to know would then constitute "inside information" and would be required to be disclosed. The second interpretation is therefore preferable, on the basis that the first interpretation would be absurd.

The analysis above argues that the price significance test and reasonable investor test should be considered complementary, and that information thus must be such that could have a significant price effect in order to be classified as inside information. In *David Massey v. the FSA*,[554] the Upper Tribunal instead opted for the interpretation that the significant price effect test had a "specially extended meaning", which meant that it was not relevant whether the information would have a significant effect on price. The Tribunal did not

[554] David Massey v FSA [2011] UKUT 49 (TCC), para 39.

consider the effect such an interpretation would have on the disclosure obligation which uses the same definition.

The FCA itself appears ambivalent about the relationship between the price significance test and the reasonable investor test. Its *Woolworths* decision, for example, included a reference to an expert witness of the FCA who had stated that a significant share price movement would be 10% (testimony which would not appear to be necessary if the reasonable investor test was the only required test),[555] but the regulator has taken the view that the reasonable investor test replaces the price significance test in motivating its decisions since 2010, such as *Shah*, *Hannam*, *Greenlight*, and *Osborne* (relating to market abuse),[556] and *Lamprell*, *JJB Sports*, and *Photo-Me* (relating to disclosure rules).[557] Older decisions sometimes suggested that the tests were complementary and sometimes that the significant price effect test dominated.[558] At the same time, the FCA has admitted that it considers the interpretation it employs for market abuse purposes impracticable for disclosure purposes.[559]

555 FSA, Final Notice to Woolworths Group (2008).

556 FSA, Final Notices to Rahul Shah (2013), Ian Hannam (2012), Greenlight Capital Inc. (2012) and Andrew Osborne (2012).

557 FSA, Final Notices to Lamprell plc (2013), JJB Sports plc (2011), and Photo-Me International plc (2010).

558 For the complementarity view, see, *e.g.*, the FSA's notices to Filip Boyen (2008) and Darwin Clifton (2009). For the view that the significant price effect test dominates, see, *e.g.*, the FSA's notices to Alexei Krilov Harrison (2009) and William Coppin (2010).

559 Joint FSA/HMT Response (n. 551).

As part of the query to understand more about the non-material world, it is fruitful to examine where and how the MAR itself offers hints about what is not considered inside information. Such hints can be found in a few places. For example, Recital 58 states that the obligation for insiders to publicly report their trades in their firms' shares is not only meant to prevent insider dealing but also has an independent rationale as it can be a "highly valuable source of information to investors". This seems to acknowledge that managers can lawfully conduct trades based on information that is available to them, but unavailable to investors at large, and that their trades can act as valuable signals of managers' assessment of such private information. Another example is Recital 19, which contains a statement (not present in prior European market abuse regulation) that MAR does not prohibit "discussions of a general nature regarding the business and market developments between shareholders and management concerning an issuer" as they are "essential for the efficient functioning of markets". This recital implies that there can be value for investors in having discussions with managers, even when the information they receive is not material enough to activate the episodic trading or selective disclosure bans in MAR.

It is useful, to give further examples of information that may be valuable and for the further analysis of private investor meetings that will follow, to briefly explore why Recital 19 was introduced into the new MAR. The reason appears to lie in the evolution of the MAR since the Commission's first draft in 2011.[560] This first draft included a fairly revolutionary idea to bifurcate the definition of inside information for disclosure and trading purposes.[561] In the first draft proposal for a presidency compromise, MAR's Recital 19 had been inserted just after another draft recital which the Commission had worded as follows:[562]

> "Inside information can be abused before an issuer is under the obligation to disclose it. The state of contract negotiations, terms provisionally agreed in contract negotiations, the possibility of the placement of financial instruments, conditions under which

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560 Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), COM(2011) 651 final.

561 The Commission based the bifurcation proposal on a submission from the UK expressing a "firm view . . . that information can be abused by traders at a point before it [is precise enough to become inside information]". See HM Treasury and the Financial Services Authority, "Joint response to the call for evidence, Review of Directive 2003/6/EC on insider dealing and market manipulation" (July 2010). The idea was to introduce a class of sub-material, but value-relevant, information which in the UK had been used to "gold-plate" the prior market abuse regime. This class of information was referred to by the acronym of RINGA ("relevant information not generally available"). As the UK were ultimately unable to convince the EU to include the RINGA concept in the MAR, it was subsequently phased out of the UK regime as well. The European Securities Market Expert Group shared the UK's views; for a discussion *see* Carmine Di Noia and Matteo Gargantini, 'The Market Abuse directive disclosure regime in practice: some margins for future actions' (2009) "Rivista delle società" 4/2009.

562 Council of the European Union, Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) - Presidency compromise, Doc No 9435/12 (2 May 2012).

> financial instruments will be marketed, or provisional terms for the placement of financial instruments may be relevant information for investors. Therefore, such information should qualify as inside information. However, such information may not be sufficiently precise for the issuer to be under an obligation to disclose it. In such cases, the prohibition against insider dealing should apply, but the obligation on the issuer to disclose the information should not."[563]

Based on its placement, it thus seems reasonable to interpret the "investor meetings recital" as a clarification that the new, stricter, insider trading prohibition would still permit investor meetings. The "investor meetings recital" then remained in MAR even after the preceding recital was removed.[564]

In conclusion, the MAR appears to recognise that not all valuable information is material. Judging from the actions of market participants, there is certainly information that is valuable for them to receive directly from public firms, but which they do not believe qualifies as inside information. This, however,

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[563] Ibid, proposed Recital (14) on p. 16.

[564] Technically, there is still a preceding recital, but it instead codifies Case C-19/11 *Markus Geltl v Daimler AG* [2012] OJ C258/5, and has done so since a draft dated 30 Nov 2012. See Council of the European Union, Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) - Presidency compromise proposal for a general approach, Doc No 16416/1/12 REV 1 (30 November 2012). (This was only an intermediate version in the drafting process and the numbering of the recitals were subsequently changed.)

appears to sit uncomfortably alongside a strong emphasis from the European Court of Justice in recent years on market egalitarianism.[565] The ECJ's focus on egalitarianism is demonstrated in cases such as *Lafonta v AMF*, where the court held that information will be deemed to meet the requirement of being "precise" as long as it is not "vague or general";[566] a definition which does not restrict much information from falling under the definition of inside information. As the Court considered the precision requirement in *Lafonta,* it also explained that:

> "[I]f it were accepted that information is to be regarded as precise only if it makes it possible to anticipate the direction of a change in the prices of the instruments concerned, it would follow that the holder of that information could use an uncertainty in that regard as a pretext for refraining from making certain information public and thus profit from that information to the detriment of the other actors on the market."[567]

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565 See *Spector Photo Group and Van Raemdonck*, C-45/08, OJ C-51/6, paragraphs 47 and 62; *IMC Securities v Stichting Autoriteit Financiële Markten*, C-445/09, ECR 2011 I-05917, paragraph 27; *Geltl v Daimler AG*, C-19/11 (Judgment of the Court, Second Chamber, 28 June 2012), OJ C-258/5, paragraph 33; *Jean-Bernard Lafonta v Autorité des marchés financiers*, (Judgment of the Court, 11 March 2015), C-628/13, OJ C-146/5, paragraph 21.

566 *Jean-Bernard Lafonta v Autorité des marchés financiers*, (Judgment of the Court, 11 March 2015), C-628/13, OJ C-146/5, paragraph 31.

567 Ibid, paragraph 36.

This quote is a clear demonstration of how the ECJ's focus on egalitarianism has made the Court reluctant to define the "inside information" requirements in a way that excludes much information at all, out of a fear that it would enable some traders to take advantage of others. Unfortunately, both this determination by the ECJ as to "precision" and the UK Upper Tribunal's determination of what constitutes a "significant effect" have watered down the inside information definition to a point where it is difficult for investors to determine with certainty whether or not a piece of information would constitute "inside information". The trade-off with any materiality threshold is that, if the threshold is high (so that not much information meets the hurdle to become inside information) we would expect more managerial agency costs, but if it is low (so that much information is "inside information" such as, in my view, provided for by the courts just referenced), we may instead get many *de facto* breaches of the prohibition on selective disclosures. Since the threshold is low, it may be suspected that many breaches are not actually enforced. I will comment on this further in section 7.4.1.

7.3.2. The risk and evidence of managerial opportunism

Due to the separation of ownership and control in public firms, managers will have an incentive to divert value to themselves instead of distributing it to shareholders.[568] Value-relevant NPI is a highly suitable asset for appropriation

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[568] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior,* Agency Costs and Ownership Structure (1976) 3 Journal of Financial Economics 305, 308.

by managers for several reasons. First, managers acquire NPI about their firms by virtue of their position, typically without personal cost.[569] Second, NPI is not recorded on the firm's balance sheet or otherwise, so it is impossible to monitor its use. This also means that the firm is not visibly affected, or harmed, by the selective disclosure. Third, it is impossible for firms to create a system to monitor managers to determine whether they selectively disclose valuable NPI in private discussions. Fourth, other market participants and shareholders are not necessarily aware that private disclosure has taken place and certainly not aware of what particular information has been shared. Fifth, private meetings where NPI is disclosed appear legitimate even when they are not, since they are assumed to be in the interest of the firm.[570] Sixth, neither the manager nor the recipient has anything to gain from publicizing the fact that a transfer of valuable NPI has occurred. Seventh, and finally, the recipient monetizes the NPI by anonymous trading in the stock market which typically cannot be decoded.[571] In sum, it is currently very difficult to discern to what extent a manager may have selectively disclosed NPI.

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569 To the extent any outlay is necessary to acquire particular information, corporate funds can likely be spent. *See, e.g.,* Clark (n 434) 507–08; Hirshleifer (n 509) 35.

570 *See* Guimard (n 470) 97–103 (noting selective activities to attract shareholders); 168-70 (noting selective events to educate analysts).

571 *See* Section 7.2.2.4.

Not even the disclosing manager will know the exact value of the benefit conferred on the selective disclosure recipient.[572] Since information does not have an assigned value within the firm, and since its value is realized on the shareholder level with no visible impact on the firm level, attention may be deflected away from the size of the value transfers that occur. In absolute terms, managers may reallocate highly significant sums of money among investors when they opt for selective disclosure over alternative uses of information.

Managers may act in two ways to increase the value of the information property that they control. First, they can delay public disclosure for as long as possible in order to have more time to utilize the information. Second, managers may prefer public disclosure to be convoluted and fragmented so that they can maintain control over as much information as possible, making investors dependent on them to be able to fully interpret the public disclosure.[573] This creates a risk that the public disclosure becomes formalistic in order to achieve superficial compliance with reporting requirements but still leaves out valuable details necessary to fully understand it. The EU regulation responds to the risk of delay, both by requiring that episodic disclosure is

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572 From another perspective, the fact that NPI does not have a value within the firm may allow managers to feign ignorance of the values they distribute.

573 The observation that 43% of analyst interactions occur after firm-initiated news releases may be an indication that public disclosure is incomplete from the perspective of professional financial analysts. *See* Soltes (n 488) 257.

released immediately and by providing a narrow regime of permissible delays, [574] but a response to the risk of convolution or fragmentation necessitates detailed review of disclosures by the regulatory agency tasked with enforcement, which is a member state issue.

In an interview-based UK study, Holland found that issuers produced voluntary public disclosure to satisfy good practice guidance and market benchmarks, but exceeded this with voluntary private disclosure to its core fund managers and analysts.[575] This study also found that managers deliberately provided fragmented public disclosure to allow maximum freedom for voluntary private disclosures, where it could signpost certain items and assist fund managers and analysts in completing their information mosaics. The reason why managers released private information in this manner was to build relationships with fund managers to exchange capital, information and influence for mutual benefit.[576] Another interview-based study found that CFOs participated in meetings with investors to support the share price and to build relationships and establish support within the investor community which they could use in a takeover situation or if adverse events occurred.[577] In a third study, an IR manager stated that the firm's procedure for earnings

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[574] MAR, Art 17(4).

[575] Holland (n 478) 15-22 (interviewing managers of 25 UK-listed issuers, 22 of which were FTSE100 companies).

[576] Ibid 20.

[577] Barker et al (n 472) (based on interviews with 18 CFOs and investor relations managers from 14 FTSE 100 companies).

announcements were to call selected analysts and offer private information to supplement the public disclosure which consisted only of "the bare minimum".[578] This study also found that managers perceived the firm benefits of selective disclosure to include stronger investor relationships, less volatile share price, and signalling of management quality.[579] In summary, public firms appear to consider selective disclosure as a separate disclosure method with its own benefits compared to public disclosure.

Opportunistic selective disclosure to financial analysts has been a long-standing concern of the regulator.[580] Although the FSA appeared to focus on how managers' control of information could lead to *analyst* conflicts of interest (as they would try to maintain profitable access by pleasing the managers with favorable research), *active investors* are equally dependent on management access. The nature of active investing means that such investors are reliant on NPI—information not incorporated into market prices—in order to outperform their benchmarks and stay in business over the long term. While disclosure to analysts may lead to more publicity, it is no less likely that managers use private meetings to also reward or deter investor behavior.

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578 McInnes, Beattie & Pierpoint (n 480) 41 (interviewing managers and various stakeholders of a large UK-listed company).

579 McInnes et al (n 480) 39-44.

580 Financial Services Authority, *Investment Research: Conflicts and Other Issues* §§ 4.24–26 (Discussion Paper No. 15, 2002).

An important reason for firms to take part in private investor meetings is to convince investors to become shareholders,[581] so managers may be able to influence the profile of shareholders who take or maintain a stake in the firm by granting one or more investors NPI and withholding it from others. Through such investor discrimination, managers can reduce their risk of attracting hostile shareholder action. For example, a manager may prefer a shareholder that is passive or strongly supportive of the firm's current strategy to one that is less cooperative, providing the former with useful NPI and withholding it from the latter.[582]

Discriminatory behaviour could also occur with investors who are already shareholders of the firm. Managers could use NPI to reward those shareholders who offer them tacit support by, for example, voting in favour of their compensation and withhold NPI from investors who challenge them.[583] Managers may also award NPI with an expectation or hope of such future action. Similarly, investors may indicate that they will support a manager if they are provided with useful NPI.[584] As the favoured investors in such cases

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581 *See* Section 7.2.2.1.

582 The investor relations literature acknowledges that managers may be inclined to favour certain investors. *See* Marcus (n 470) 27 (recognising such tendencies); *see also* Guimard (n 470) 161 (recommending that investor relations officers should attend private meetings to "avoid the CEO or CFO giving (*intentionally* or unintentionally) price-sensitive information") (emphasis added).

583 See John C. Coffee Jr, 'Is Selective Disclosure Now Lawful?' (1997) 218 New York Law Journal 5 (arguing that selective disclosures could be used by managers to buy votes).

584 Langevoort (n 522) 1042 makes a similar argument for analysts.

reciprocate by participating in ostensibly legitimate corporate actions that serve to compensate managers via the firm, there are no public signs of unethical or unlawful behaviour.

7.3.3. Selective disclosure compared to public disclosure

The choice between public and selective disclosure involves a trade-off from the perspective of the value conferred on the recipients: if the manager chooses broad public disclosure, it may benefit investors generally but no individual shareholder (or investor), but if selective disclosure instead is preferred, value may be bestowed on the selected recipient. Thus, managers exercise discretion over whether a piece of NPI should be turned into a public good through broad dissemination or a private good through selective disclosure.

Firm benefits of public disclosure may include reduced managerial agency costs and enhancement of price accuracy, which increases allocative efficiency, improves liquidity, and decreases share price volatility and the cost of capital.[585] Costs of public disclosure include preparation costs, risk of weakening the firm's competitive position, and increased risk of liability.[586] While reviews of the empirical disclosure literature have catalogued much research in the area of voluntary *public* disclosure (i.e., increased information in public reports), there

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585 Enriques & Gilotta (n 149).

586 Id.

is not much research in the field of voluntary *private* (i.e., "selective") disclosure.[587]

Healy and Palepu surveyed empirical research to identify different motives for voluntary public disclosure in the literature and found varying degrees of support for the hypotheses that voluntary disclosure increases in firms that expect to issue public debt or equity, firms subject to corporate control contests, and firms where managers are compensated more in stock, wish to trade in the stock or affect the share price in their favour prior to stock option awards.[588] At least the last two of these findings appear explainable on the basis of managerial agency costs. Graham et al. surveyed more than 400 executives of public firms on their voluntary disclosure decisions, although without

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587 Paul M. Healy & Krishna G. Palepu, 'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature' (2001) 31 Journal of Accounting & Economics 405, 427 (noting that private voluntary disclosure has typically not been included in prior studies of voluntary disclosure). Another review of theoretical and empirical work on disclosure did not note any theoretical work on the topic of selective disclosure. *See* Christian Leuz & Peter Wysocki, 'The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research' (2016) 54 Journal of Accounting Research 525. A third notes that one of the main outstanding questions in the disclosure literature concerns the costs and benefits of voluntary disclosure. *See* Anne Beyer et al., 'The Financial Reporting Environment: Review of the Recent Literature' (2010) 50 Journal of Accounting & Economics 296, 298, 314 (encouraging researchers to recognise the changing regulatory landscape).

588 The authors found only weak support for the hypothesis that firms voluntarily disclose to avoid litigation, no support either for or against the hypothesis that talented managers will voluntarily disclose to reveal their skill, and some support for the hypothesis that firms' disclosure policies are affected by their competitive position. Healy & Palepu (n 587) 420–25.

distinguishing between voluntary public and voluntary private disclosures, and found that firms make voluntary disclosures to "promote a reputation for transparent reporting," "reduce the information risk," and "address the deficiencies of mandatory reporting."[589] This survey also found that voluntary disclosure was constrained by managers' fears of establishing a pattern of disclosure which may not be sustainable in the long-term, disclosing proprietary information to the detriment of their firms, and drawing unwanted scrutiny.[590]

While firm benefits of selective disclosure are significantly less explored in the literature, the motives for private investor meetings[591] likely comprise the most important rationales for selective disclosure as well. As noted, these reasons involve monetisation of NPI for intangible value such as loyalty and goodwill.[592] This means that selective disclosure is essentially different from broad public disclosure.

Anecdotal evidence shows that both investors and managers may prefer not to make NPI a public good.[593] An investment manager reported in a recent

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589 John R. Graham, Campbell R. Harvey & Shiva Rajgopal, 'The Economic Implications of Corporate Financial Reporting' (2005) 40 Journal of Accounting & Economics 3, 53-65.

590 *Id.*

591 *See* Section 7.2.2.1.

592 *See* Section 7.2.2.1.

593 *Compare* Henry Manne, *Insider Trading and the Stock Market* (1966) 64-65 (arguing that managers should not be expected to readily surrender a valuable informational asset when some form of exchange is possible). *But see* references in n 607.

investor letter that it had been watching a firm's invitation-only investor day via a public webcast in order to gauge management's response to newspaper allegations about overstated sales figures only to learn after the event that they had answered such sensitive questions during a break.[594] Similarly, firms now often supplement the practice of having public earnings conference calls by individually calling analysts after such calls.[595] When firms choose to provide such private forums to investors and analysts, we should expect investors to utilize them as much and as far as firms allow, since information is more valuable in private.[596]

To be sure, information exchanges between investors and managers may often require a private setting. Managers may be reluctant to subject themselves to tough questioning in public as unexpected questions may produce answers that differ from the view they would otherwise carefully project.[597] Similarly, investors would not undertake the activity if the results were instantly available to other market participants, since they would be unable to use the information for profitable trading to cover their acquisition costs. Furthermore, some information that investors gather in private meetings cannot possibly be

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594 Letter from Greenlight Capital to Partners (Oct. 15, 2013) 4.

595 Brown et al. (n 471) 19.

596 *Compare id.* 20 (quoting an analyst stating that he does not ask questions on the public conference calls, as any useful information resulting from such would be shared with all participants).

597 *Compare* Soltes (n 501) 265 (quoting a research director saying that in the interest of maintaining access to senior management, it is important for analysts not to pressure them with challenging questions on public conference calls).

publicly disclosed. This is the case for subtle pieces of information, such as managers' body language, tone, and cautiousness in answering questions, which may be useful to observe for monitoring or verification purposes.[598]

It is, of course, impossible to draw any general conclusion as to whether information disclosed in private would imply net benefits or net costs to a firm if it had been publicly disclosed instead.[599] The same is true for firms' monetization of NPI before its public release. All we can say with certainty is that when a firm creates an information asymmetry among investors through selective disclosure, it enables the recipients to reallocate value from uninformed investors to themselves through trading in the stock market. This is an activity with net negative social value as the trading among investors is a zero-sum game with added search and trading costs for investors and supply costs for the firm.[600] There is also a further cost of information asymmetry, since market makers and investors will adapt their bid-ask quotes to account for the risk of trading against an informed trader.[601] For selective disclosures to

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598 *See, e.g.,* Ng & Troianovski (n 476) (describing how a manager's unwillingness to elaborate in private on the firm's need to raise capital was correctly interpreted as a negative sign by meeting attendants, causing the share price to decline 15% before the firm announced an equity offering).

599 Furthermore, tacit information imparted in such meetings could not be publicly disclosed, and it would be fruitless to attempt to distinguish explicit statements from tacit information for purposes of regulating them differently.

600 See Jack Hirshleifer, 'The Private and Social Value of Information and the Reward to Inventive Activity' (1971) 61 Americal Economic Review 561, for the argument that private, but not social, foreknowledge of circumstances that will eventually be disclosed is valuable.

601 *See* Kraakman (n 433) 49.

be a socially useful activity, the sum of these costs would need to be outweighed by benefits to the firm[602] or investors.[603]

Regardless of the benefits of selective disclosures to investors collectively, the significant private value available to investors who successfully acquire or find such information will entice them to engage in the activity. The availability of selective disclosure could thus lead to a collective action problem: investors who know that they can receive information privately may not compel firms to improve their public disclosures, since private information is more valuable to them. Active investors may all seek to receive selective disclosures based on the belief that they are able to produce superior returns, even though the business model of active investment means that they on average do not.[604] Many active investors may then seek to have private meetings with managers, potentially using more of firms' (and their own) resources than if information was broadly disclosed. This collective action problem may even lead investors with management access to prefer less and less useful public disclosure, in order to be able to gain more from private meetings. As a result, investors as a collective could be worse off than if they had been able to agree to have managers publicly disclose as much information as possible. In particular, shareholders without access to private meetings may lose twice: both when

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602 *See* Section 7.2.2.1.

603 *See* Section 7.2.2.3.

604 *See* Kenneth R. French, 'Presidential Address: The Cost of Active Investing' (2008) 43 Journal of Finance 1537, 1561-62.

trading against more informed investors and when the firm spends its resources to help those investors gain trading advantages against them.

The value of public disclosure to managers comes from their share of the general shareholder benefits and their private benefits of public disclosure.[605] A cost, possibly to both the firm and the manager, will be that the potentially valuable option to monetize the information via selective disclosure is extinguished when it is publicly disclosed. Managers' personal costs of public disclosure may include time spent preparing or overseeing the disclosure, which may have to be provided on an ongoing basis since disclosure on a topic, once initiated, creates market expectations of similar disclosure in the future.[606] Given that managers tend to own minority stakes in their firms, voluntary public disclosure could in many cases produce net personal benefits in the form of private benefits, but often produce net personal costs. It is therefore unlikely that voluntary public disclosure would be a default choice for managers.[607]

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605 This could include the maximisation of incentive compensation through disclosure timing or signalling of management talent. *See* Healy & Palepu (n 587) 422, 424, and text accompanying note 587.

606 *See* text accompanying note 590.

607 Some commentators appear, however, to be taking the contrary view: that voluntary public disclosure would be the default choice for managers. *See* Goshen & Parchomovsky (n 164) 711, 723, 739 (arguing that competition among information traders (defined as not having access to inside information) incentivises managers to make disclosures beyond the level set by mandatory disclosure regulation to the benefit of all investors); Langevoort (n 522) 1028-29 (suggesting that capital markets benefits such as a lower cost of capital may predispose firms to public disclosure).

7.4. Preliminary conclusions

7.4.1. Investor relations and corporate access under EU capital markets regulation

Many instances of selective disclosure of sub-material NPI are arguably incidental to the management of the firm. The regulator may therefore sensibly decide not to interfere if a firm discloses information of only small value-relevance, in order to allow the firm to conduct its business without being overly concerned about potential enforcement actions. Recent calls for increased shareholder engagement may also increase the pressure on the regulator not to be too vigilant in its enforcement.

Shareholder engagement with managers of the public firms they invest in is an issue that involves difficult trade-offs for regulators: On the one hand, they usually want to encourage engagement and stewardship; on the other hand they cannot accomplish this by creating loopholes that allow for market abuse. As the government,[608] regulators,[609] investors,[610] and experts[611] all highlight the

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However, neither article seeks to conduct a review of the relative appeal of the various possible uses of corporate information.

608 See, e.g., Department for Business, Innovation and Skills, *Implementation of the Kay Review: Progress Report* (October 2014).

609 See, e.g., Marc Teasdale, Director of Market Oversight, Financial Conduct Authority, Speech: Investor Engagement in A Changing Regulatory Landscape, 13 July 2015, available at https://www.fca.org.uk/news/speeches/investor-engagement-changing-regulatory-landscape.

610 See, e.g., Investment Association, Supporting UK Productivity with Long-Term Investment (March 2016).

importance of engagement, corporate managers are in a difficult situation, since they commit a civil or criminal offense if they give selected shareholders too useful information. From the investor perspective, The Kay Review expressed the core problem as follows:

> "There is . . . a potential inconsistency of policy in advocating more effective engagement between companies and investors, and at the same time prohibiting investors from deriving financial advantage from such engagement beyond the limited extent that such engagement benefits all holders of stock."[612]

Interestingly, the FCA has also categorised corporate access as part of the discussion about investor stewardship and shareholder engagement while noting the same issue.[613]

Many investor relations practices, including corporate access, have been brought to Europe from the US.[614] As noted above, US disclosure and insider trading regulation differs to Europe's in several respects. In the US, the act of selective disclosure to investors is not part of the insider trading framework, not a criminal offense, and only subject to a civil regulation. Further, recipients of selective disclosure are generally able to trade on the information they

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611 See, e.g., The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report, July 2012.

612 Ibid, para 10.17.

613 FCA CP13/17 para 1.20.

614 Hopt (n 483), Brinkley (n 533).

receive, even if it is material. And, in the insider trading context, the Supreme Court has repeatedly reinforced the idea that the informational playing field among investors in public firms does not need to be level, which means that managers may provide selected investors with better quality information than others.[615]

The EU takes a different approach, however, and this means that US practices cannot simply be transplanted. The EU has a strong focus on equal access to information from public firms.[616] Indeed, the EU focus on equal access to information means that the practice noted above[617] where an issuer regularly supplemented its public earnings releases with private calls with selected investors to give them an informational advantage, does not sit comfortably with the Transparency Directive.

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[615] Basic Inc. v. Levinson, 485 US 224, 240 n.18 (1988) (holding that the standard of materiality is not automatically reached simply because insiders or a "favoured few" profited from trading on the information); Dirks v. SEC, 463 US 646, 661–62 (1983) ("All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders."); Chiarella v. United States, 445 US 222, 232 (1980) ("[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b)").

[616] See, for example, Recital 22 of the Transparency Directive: "Ongoing information to holders of securities admitted to trading on a regulated market should continue to be based on the principle of equal treatment", Article 17.1 of the same: "The issuer of shares shall ensure equal treatment for all holders of shares who are in the same position", and Recital 24 of MAR: "the purpose of this Regulation . . . is to protect the integrity of the financial market and to enhance investor confidence, which is based, in turn, on the assurance that investors will be placed on an equal footing and protected from the misuse of inside information."

[617] See text accompanying note 578.

It is generally accepted that the market for secondary information about a public firm is tiered in that an investor can choose whether and to what extent he wants to pay for information to reduce uncertainty about projections relevant to the pricing of a security. Such secondary information sources may range from a free newspaper to an expensive database containing daily sales figures for certain products.[618] However, in light of the EU focus on equality, it may be less acceptable that firms themselves supply information to investors by employing a similar tiered pricing structure. Observing the methods for corporate disclosure discussed above suggests, however, that an investor can choose between only receiving public disclosures from a company, typically available on the company website, or pay an intermediary to meet with management in private or small-group meetings. While intermediaries' assistance in the trading of non-material NPI for cash is not problematic per se, the fact that professional investors willingly spend £500 million per year to engage in this practice would suggest that the regulator needs to consider how

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618 *See* Peter Landers, 'Chasm on Drug Data Punishes Small Investors' (6 Oct. 2003) Wall Street Journal, available at http://online.wsj.com/news/articles/SB106539214144185600 (claiming that subscribers to certain databases costing between $25,000 and $50,000 per year were able to observe daily sales data for hepatitis C medications and conclude ahead of other investors that Schering-Plough was losing market share to Roche), *cited in* Robert A. Schwartz and Reto Francioni, *Equity Markets in Action: The Fundamentals of Liquidity, Market Structure and Trading* (2004) 37-38.

to ensure that the popularity of the market for private meetings does not contravene these fundamental principles of EU capital markets regulation.[619]

7.4.2. The EU's removal of interim reporting requirements

The EU Transparency Directive[620] was amended in June 2013 to remove the requirement to publish interim management statements or quarterly financial reports.[621] The reasons for this change were that such requirements "represented an important burden for many small and medium-sized issuers [...] without being necessary for investor protection" and that these obligations "encourage short-term performance and discourage long-term investment".[622]

This assessment marked a significant change compared to the Commission's position on quarterly reporting just a few years earlier. A 2009 assessment of

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619 Securities regulators in other countries have started to look into these practices. See Matthew Drummond, 'ASIC targets briefings in crackdown' (8 July 2013) The Australian Financial Review 3 (stating that the Australian Securities and Investments Commission intends to sit in on analyst briefings and one-on-one meetings); Kara Scannell, 'SEC Pushes for Hedge-Fund Disclosure' (19 Sep. 2007) Wall Street Journal C3 (stating that the SEC had requested lists of all one-on-one meetings at investor conferences arranged by brokerage firms); Charlie Gasparino, 'Regulators may expand definition of insider trading' (February 15, 2012), Fox Business (noting that an SEC official expressed concern over issuer practices of one-on-one meetings and private calls in relation to Regulation FD).

620 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004, OJ L390/38 (Transparency Directive).

621 It did so through Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013, OJ L294/13 (TD Amending Directive).

622 TD Amending Directive, Recital 4.

the Transparency Directive for the Commission, which included consultations with stakeholders such as issuers, institutional investors and financial analysts, had concluded that the TD achieved a satisfactory balance between informing investors and providing a "short-termist effect".[623] The report noted in particular that 69% of all stakeholders and 70% of issuers believed that the publication of financial information on a quarterly basis enhanced transparency and market efficiency.[624] When the Commission summarised the findings of this report, it appeared to recommend against removing the interim reporting requirement, noting that quarterly financial information was well perceived by market participants and even that there was demand for more detailed rules on the contents of these statements.[625]

Concerns about short-termism illustrate an ambivalence regarding the requirement in the quoted motivation above for firms to distribute "timely" information. In its report on the TD, the Commission presented the problem

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623 Mazars, Transparency Directive Assessment Report (prepared for the European Commission Internal Market and Services DG) (2009) 63.

624 Ibid, p. 88. When stakeholders outside the EU were consulted, 74% answered that they found quarterly reports useful. See ibid, 200. This report also noted that "A strong majority of users of financial information (65.1%) consider that the Interim Management Statements specified in the Directive, is valuable information for the market." *See* Mazars, Transparency Directive Assessment Report (prepared for the European Commission Internal Market and Services DG) (2009), Annex B, 104.

625 European Commission, Report on the Operation of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, (Report) COM (2010) 243 final (27 May, 2010) 4.

of short-termism as one that is created by investors.[626] The reason for removing the quarterly reporting requirement seems to be that investors would pressure managers into meeting short-term targets, and that managers would respond to such pressures by forsaking projects that would be better in the longer term.

The "short-termism" problem raised by the Commission appears to involve a relatively complex argument, although the Commission did not consider it in this way. The Commission's argument seems to be that shareholders knowingly pressure managers to take actions that will not maximise long-term shareholder value. Since this would be value-destroying to such shareholders themselves, it also appears to imply that investors will not penalise such short-term managers with a lower share price, even though some value is surrendered. This argument then, implicitly, appears to require some degree of market inefficiency since the value of the firm would otherwise be reduced to reflect the value destruction. Furthermore, since firms are still allowed to voluntarily publish quarterly reports, it is not clear why investors (in the opinion of the Commission) would not simply keep applying the short-termism pressure and demand that firms maintain their short-term reporting on a quarterly basis. The Commission's other argument for this rule change – that it wants to lessen the burden on smaller firms – consequently appears more straight-forward.

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[626] Id.

The UK Government "strongly supported" the abolishment of the quarterly reporting requirement,[627] and as of October 2016, 30 FTSE 100 companies and 139 FTSE 250 companies had stopped publishing such reports.[628]

In light of the analysis in this chapter, there are a few points worth making in relation to the removal of the interim reporting requirement.

First, firms' assessment of what constitutes inside information may become more important when they no longer report on a quarterly basis. This may result if a firm would previously have regularly disclosed borderline inside information in their periodic reports as a cautionary measure, but now must consider whether to separately disclose, and draw attention to it, instead.

Secondly, for firms who seize the opportunity to cease their quarterly reporting, the general investing public will have access to less current information. While issuers still have to disclose inside information as it arises, investors at large will receive less commentary on ongoing events that only constitutes sub-material information. As such information may still have value to them, they may be worse off.

Thirdly, the removal of the quarterly reporting requirement does not remove investors' demand for information about public firms. With less information

[627] See Department for Business, Innovation and Skills (n 608) para 2.35.

[628] Investment Association, Public Position Statement: Quarterly Reporting and Quarterly Earnings Guidance (October 2016).

publicly available, we may expect the amount of private investor meetings to increase so that investors can acquire sub-material information from firms.

Fourthly, and following from the third point, the resulting information environment would be expected to favour institutional investors who either are large enough to be able to procure meetings with corporate managers in their own right or who are able to pay to meet with them through corporate access. We may consequently expect large institutional investors to be in favour of less public reporting, independently of other motives, such as the often referenced motive of curbing investor short-termism.

A fifth point is that the removal of a quarterly reporting requirement means that insiders will be subject to fewer periodic trading bans, since such are defined in relation to reports "which the issuer is obliged to make".[629]

Finally, on a comparative note, the EU rule change has been met with approval by at least one influential commentator in the United States.[630] In the US framework for information deployment, outlined in section 7.1.5 above, the removal of quarterly reports would be more significant than in the EU since their public firms do not have a general obligation to disclose material information when it arises. Removing the quarterly reports, which have to contain all material information, could thus result in material information

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[629] MAR, Art 19(11).

[630] *See* Martin Lipton, 'Legal & General Calls for End to Quarterly Reporting' (Aug. 19, 2015) Harvard Law School Forum on Corporate Governance & Financial Regulation, http://corpgov.law.harvard.edu/2015/08/19/legal-general-calls-for-end-to-quarterly-reporting.

existing within firms for long periods, which may be a concern from an agency perspective.

7.4.3. Would a selective disclosure reporting obligation prevent market abuse?

The matrix of information deployment options in Section 7.1.5 demonstrates a lack of tools to detect selective disclosure, even though the Commission has acknowledged that transparency is essential to detection and deterrence of market abuse. It thus seems interesting to explore whether firms could be made subject to a reporting obligation when they disclose information selectively, so that their shareholders and investors may monitor to what extent this occurs and the risk of significant information leakage.

As part of the revisions to the Shareholder Rights Directive, a new requirement was included to the effect that institutional investors and asset managers develop and disclose their policy on shareholder engagement, which shall include information on how they monitor and conduct dialogues with investee companies.[631] Against this background, it does not seem far-fetched to ask public firms to disclose "their side" of the same interaction. Best practices in investor relations already involve keeping records of private meetings and

[631] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017.

other methods of selective disclosure, [632] so firms will already have a compliance framework in place to collect this data.

A proposed reporting obligation could cover communications with securities market professionals, such as analysts and investors, as well as others that may be expected to trade in the market using the information. In deciding on the details to report, it should be recognized that it would be a large administrative burden to require managers to keep detailed notes of conversations.[633] It would also be undesirable to publicize the details of private discussions, as it may cause managers and investors to participate in fewer beneficial meetings. To accomplish deterrence of undesirable transactions, it should be enough to require disclosure of the fact that a discussion occurred. It seems reasonable to include in the transaction reporting some standard details about the meeting such as the identity of the counterparty, date, start and end time and a brief description of the corporate purpose of the meeting to allow an assessment of the risk for market abuse in light of the issuer's other activities. Selective disclosures could be reported at regular intervals with some delay, for example, quarterly or semi-annually, as the purpose is not to prevent recipients from profiting on sub-material information or to allow non-participating investors to trade on it, but to provide investors with the tools to assess the amount of asymmetric information that may exist (and thereby also deter market abuse).

[632] Guimard (n 470) 191.

[633] *But see* Solomon & Soltes (n 285) (suggesting firms should publicly provide transcripts of private meetings).

It could be stipulated that firms make this information available on their websites. In total, such a regulation would not be expected to be particularly costly.

The idea that companies should report their private meetings may be particularly relevant as a monitoring device for investors in those firms that have chosen to stop reporting on a quarterly basis.

7.4.4. Is selective disclosure always harmful?

Viewing corporate information as a resource of the firm, we may ask the question why it is of such importance that firms do not use this asset for trading themselves.

For a public firm, confidential information that it will later release to the stock market is an asset with different attributes than other firm property, even other intangible property. Unlike an invention that is patentable, such NPI is incidental to the firm's productive activities and can be immediately monetized in the stock market. Consider two identical debt-free firms, one with publicly traded stock currently worth £100 million and the other privately held. The CEO of each firm knows that the actual value of their firm is actually £150 million due to a significant contract win which will be disclosed to the market in a few days. In the case of the private firm, this information is useless for a professional investor.[634] Where it relates to the public firm, it is incredibly

[634] One may, of course, imagine an oligopoly or other industry composition scenario where the state of a private firm may predict the state of one or more public firms. This is not considered here.

valuable. In the absence of regulation, the manager of a public firm could opt to confer this value on chosen recipients via selective disclosure before its public disclosure.

This begs the question of whether the public firm can be worth more than the private firm. After the disclosure of the contract win, the productive assets of each firm are worth £150 million. Before the disclosure, however, the public firm is able to monetize the information about its own true value in the stock market. Assume the public firm provides this information to an information trader and receives consideration worth £25 million for the trading advantage. When both firms later publicly disclose the contract win, is the public firm then worth £175 million while the private firm is worth £150 million? And, if so, where did this value come from?

The answer is yes, and the value will come from shareholders who sell their shares below the new fair market value to the intermediary informed by the firm. The receipt of this value enables the intermediary to, in turn, provide value to the firm. The value of the public firm's property right in NPI that will soon be released to the public thus comes from its agreement to, in effect, issue a license to the selected investor to transact with its uninformed shareholders at a favourable price. Public firms could consequently use selective disclosure to effectively raise equity from shareholders when they enter and exit the firm in a way that is similar to imposing a transaction cost on them via a chosen information trader. Of course, one could also imagine a situation where the firm executes such a transaction for its own account through a share buy-back.

There may be situations where it could be beneficial for firms to be able to participate in its own share price appreciation in the way described, especially where it is costly to raise equity. It does not seem unthinkable that shareholder of a growing firm in regular need of equity infusions could agree to allow the firm to transact in its own shares, on the basis that the shareholders that sell to the firm desired to leave it anyway.

If the shareholders of a public firm are aware that the firm is monetizing information in this way, it should face a higher cost of capital, however, since the bid-ask spread of the firm's stock should reflect the risk of trading against the better informed firm.

7.4.5. Systemic implications

Selective disclosure is an activity in which only active investors, by definition, participate. While firms may derive important benefits from selective disclosure of information, active investors also spend significant resources on obtaining private information from public firms. While the amount of money spent compensating brokers for provision of corporate access services is notable, it must be the case that amounts several magnitudes greater are spent by active investors on procuring and attempting to profit from private information, considering that they require private information to outperform their benchmarks and survive in the long term.

Active investment activities can improve price discovery and the efficient allocation of resources in society but active investment products can still be overproduced.[635] From the perspective of the ultimate investors in active investment vehicles, the risk is that private investor meetings manifest a collective action problem where investment managers participate in an expensive and largely futile pursuit of private information instead of agreeing on a general demand for public firms to issue high-quality public disclosure for common benefit. Mandatory public disclosure of corporate information is a justifiable legal strategy on the grounds that companies are the lowest-cost providers of information about themselves and that it reduces investors' otherwise duplicative costs of searching for information.[636] Private investor meetings therefore fundamentally contradict the regulatory strategy of mandatory disclosure. The practice may even result in investors with private access demanding less public disclosure.[637] If and where the practice of private investor meetings is widespread, we would expect to see negative effects on share liquidity as traders widen the bid-ask spread to protect themselves from the asymmetries of information that arise.

The practice of private investor meetings presents difficult trade-offs. It appears unattractive to ban such meetings, since they can contribute to market efficiency. Instead, it appears more appropriate to enforce the quality of public

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[635] French (n 604) has estimated that society's capitalised cost of active investing (which includes all active investment strategies and not just those where investors meet with managers) exceeds 10% of the capitalisation of the stock market.

[636] See Chapter 3.

[637] *See* Section 7.3.3 for the discussion of collective action problems.

disclosures, as the US SEC does,[638] to ensure that companies' public disclosures are as meaningful as possible and contain all material inforrmation. This will ensure that the residual information available to investors from private meetings is below the materiality threshold and of less consequence. I am also in favour of improved transparency of the extent to which managers of public firms and professional investors engage in these activities, since it would allow the ultimate investors the opportunity to assess the scale and perceived utility of private investor meetings as a phenomenon. This will not only enable investors to understand the extent of the information asymmetries that may be present in a firm at any time, but also provide information for holding management to account about how and why they engage in such practices.

[638] See note 263 and accompanying text.

8. Tesco: A case study in disclosure enforcement

8.1. Overview of Tesco's misstatement

Tesco plc's misstatement event in 2014 is worth a detailed examination for several reasons: it was the first time the FCA required a listed company to implement a restitution scheme for market abuse; it was the first time the Serious Fraud Office (SFO) took action in what was primarily a corporate disclosure issue, and there are ongoing investor actions on the basis of the new issuer liability regime in s. 90A FSMA. It thus offers the ability to examine the various legal frameworks 'in action' and to analyse the role played by the 90A regime.

In the time leading up to the misstatement, Tesco was in a period of turmoil. It had issued its worst-ever annual results in April 2013, and the CFO left just days before another underwhelming results announcement in April 2014. Even though no new CFO had been appointed, the then-CEO reportedly asked the CFO not to attend Tesco's offices again.[639] The departure of the CEO himself was then announced a few months later in July 2014 simultaneously with a profit warning.[640]

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[639] David Oakley and Andrea Felsted, Tesco shareholders shift focus to chairman after profits overstatement, Financial Times (23 September 2014). https://www.ft.com/content/bbead64a-433c-11e4-8a43-00144feabdc0

[640] Nathalie Thomas and John Aglionby, Timeline: Tesco's slump to £6.4bn loss, Financial Times (22 April 2015).

On 29 August 2014, Tesco announced a "Trading update" which referenced "challenging trading conditions" and included an expected trading profit for the six months just ended of "in the region of £1.1bn".[641] This would turn out to be a misstatement. On 22 September 2014, Tesco issued a press release to inform the market that, "principally due to the accelerated recognition of commercial income and delayed accrual of costs", its expected trading profit of £1.1bn was overstated by approximately £250 million.[642] It also announced that it had appointed Deloitte and Freshfields to "undertake an independent and comprehensive review" of the issue.

The timeline of Tesco's unusually disorderly leadership transition in relation to its misstatement is outlined in Table 3 below.

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641 Tesco PLC, Trading Update, (29 August 2014), available at https://www.tescoplc.com/news/news-releases/2014/trading-update-2/.

642 Tesco PLC, Trading Update, (22 Sep. 2014), available at https://www.tescoplc.com/news/news-releases/2014/trading-update-1/.

Table 3:.Tesco's leadership transition around the time of its misstatement

	CEO news	**CFO news**
4 April 2014		Announced that CFO (Mr McIlwee) would leave the company but remain as "CFO Emeritus" to assist with transition to successor (not yet appointed).[643]
10 July 2014		New CFO announced, but start date not yet settled.[644]
21 July 2014	Announced that new CEO would take over on 1 Oct. 2014.[645]	
28 July 2014		The new CFO's start date announced as 1 Dec 2014.[646]
29 Aug 2014	***Date of misstatement in "Trading Update"***	
	Announced that the CEO would start earlier, already on 1	

643 Tesco PLC, Directorate Change (4 April 2014). https://otp.tools.investis.com/clients/uk/tesco/rns/regulatory-story.aspx?cid=55&newsid=403103

644 Tesco PLC, Appointment of new Chief Financial Officer (10 July 2014).

645 Tesco PLC, Appointment of Chief Executive Officer and Trading Update, 21 July 2014. https://otp.tools.investis.com/clients/uk/tesco/rns/regulatory-story.aspx?cid=55&newsid=433971

646 Tesco PLC, Notification pursuant to Listing Rule 9.6.11 (28 July 2014).

	September 2014, when current CEO would step down and resign from the board. [647]	
22 Sep 2014	***Date of correction of misstatement***	
23 Sep 2014		The new CFO's start date was brought forward so that he started immediately on this day. [648]

As seen from Table 3 above, Tesco did not have a CFO at the time of the misstatement and its CEO was in a 'caretaker' role, waiting for the new CEO to arrive so that he could leave the company. Further details of the main Tesco misstatement and correction announcements are outlined in Table 4 below.

Table 4: Tesco's misstatement and correction announcements

Date	Event	Tesco share price (day's change)[649]
2014-08-29	Tesco issued a "Trading update" which included an expected trading profit of "in the region of £1.1bn".	229.95p (-16.35p)
2014-09-22	Tesco announced that its expected trading profit of	203p (-26.60p)

[647] Tesco PLC, Notification pursuant to Listing Rule 9.6.11 (29 August 2014). https://otp.tools.investis.com/clients/uk/tesco/rns/regulatory-story.aspx?cid=55&newsid=441933

[648] Tesco PLC, Notification pursuant to Listing Rule 9.6.11 (23 September 2014).

[649] Share prices are as at close of day, sourced from Yahoo! Finance.

	£1.1bn was overstated by approximately £250 million.	(Opened at 204p)
2014-10-23	Tesco issued interim results, noting that Deloitte had completed its review and that the total overstatement was £263m, of which £118m was first half trading profit, approximately £70m related to 2013/14 and £75m to earlier years.	171.0p (-12.00p)
2015-04-22	The commercial income adjustments for prior years (previously £70m and £75m), were revised to £53m and £155m, respectively.	222.65p (-12.10p)

When trading started in Tesco on Monday 22 September, after the company's announcement (and estimate) of the misstatement, the share which had closed at 229.6p the previous Friday opened at 204.0p; a combined loss to those who held Tesco shares over the weekend of approximately £2.1 billion.[650] The 'misstatement period' lasted from 29 August to 22 September,[651] meaning that investors who bought shares in that period and still held their shares when trading opened on Monday 22 September would be eligible for compensation in a typical issuer liability regime. The FCA estimated that approximately 10,000 investors were eligible for compensation, having purchased

650 Using the number of shares as disclosed by Tesco in its 1 September 2014 RNS statement.

651 Investors who have sued Tesco have argued that misstatements of historical accounting figures lasted for much longer time periods, but Tesco and its auditors decided not to restate prior years' accounts since the sums were not material for any of those years.

approximately 320 million shares during the misstatement period, and that the total amount of compensation payable under the scheme was £85 million.[652]

As a result of the misstatement, Tesco became subject to an inquiry by the Serious Fraud Office as to criminal corporate liability, an FCA inquiry as to market abuse, private actions under the new 90A regime, and three senior executives were charged with crimes of fraud and false accounting. Tesco settled a New York class action with holders of its American Depository Receipts for $12 million in 2015,[653] entered into a deferred prosecution agreement (DPA) with the SFO and agreed to a restitution scheme with the FCA. Two 90A proceedings are still ongoing. The criminal trials against the three executives ended up a drawn-out affair. The first trial was ordered abandoned when one of the defendants suffered a heart attack,[654] and their subsequent re-trial led to a notable defeat for the SFO when the judge ordered acquittals on the basis of SFO's failure to present sufficient evidence for the jury to consider.[655]

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652 Financial Conduct Authority, Press release: Tesco to pay redress for market abuse (28 March 2017), available at https://www.fca.org.uk/news/press-releases/tesco-pay-redress-market-abuse.

653 Tesco PLC, US Litigation Update (26 November 2015), available at https://www.tescoplc.com/news/news-releases/2015/us-litigation-update/.

654 Alex Ralph, Serious Fraud Office pursues a retrial of Tesco bosses, The Times (3 March 2018) (noting that the costs of the first trial were estimated to exceed £10 million).

655 Serious Fraud Office, '"No case to answer" ruling in case against former Tesco executives' (6 Dec. 2018), available at https://www.sfo.gov.uk/2018/12/06/no-case-to-answer-ruling-in-case-against-former-tesco-executives/

8.2. How did it happen?

Tesco explained the cause of its misstatement as "principally due to the accelerated recognition of commercial income and delayed accrual of costs".[656] Further details of what happened may be pieced together from newspaper articles and media reports of testimony at the criminal trial. According to these sources, the senior Tesco executives subject to criminal trials had pressured their subordinates to falsify figures and instructed them to 'pull forward' income from future accounting periods in order to meet internal profit targets.[657] As many as 400 to 600 people within Tesco's purchasing department had allegedly been involved in falsifying records by improperly recognising income, and senior members of the Tesco leadership team had been informed at various times that the targets were unachievable.[658] At least two employees felt so uncomfortable about the situation that they chose to resign.[659] The situation finally came to an end after a UK finance manager prepared a paper (referred to as the 'legacy paper') on the extent of the accounting irregularities. The

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656 Tesco PLC, Trading Update, (22 Sep. 2014).

657 Alex Ralph, Tesco staff 'quit as fears of accounts fraud grew', The Times (4 October 2017). Similar media reports may be found in connection with the retrial; see Jane Croft, 'Two ex-Tesco executives accused of improperly boosting profits', Financial Times (8 October 2018). Details about the aggressive culture are also reported in Sarah Butler, 'Tesco whistleblower commissioned report on scale of profit hole, court hears', The Guardian (5 October 2017), available at https://www.theguardian.com/uk-news/2017/oct/05/tesco-whistleblower-commissioned-report-on-scale-of-profit-hole-court-hears.

658 The Times, 'Tesco bosses "knew of profit errors"' (9 October 2018).

659 Ralph (n 657), Croft ((n 657).

finance manager allegedly provided the legacy paper to the three executives who became subject to criminal charges and, when they failed to take action, sent it to the legal department who escalated it to the CEO and board level.[660] The previous CEO of Tesco has not been charged with any crime, but evidence at the criminal trial indicated that he received and ignored warnings from the senior management team that the company's profit forecasts were not achievable.[661] The whistleblower finance manager stated that he was relieved when the CEO left the company because much of the internal pressures were due to the CEO's faltering strategy.[662] The Tesco misstatement therefore appears to have similarities with the typical example in Arlen and Carney's paper of an executive last-period problem.[663]

After Tesco had issued its correction which served to stop the misstatement period, Tesco conducted an internal inquiry and suspended eight executives or managers, including such senior personnel as the UK managing director (Mr

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660 The Times (n 658); Thomas Colson, ''The whistle is about to blow': Secret report exposed Tesco's £250 million accounting scandal, court hears', Business Insider (4 Oct 2017), available at http://uk.businessinsider.com/tesco-fraud-trial-whistleblower-report-accouting-black-hole-2017-10.

661 Ashley Armstrong, 'Tesco boss Dave Lewis reveals grocer's internal strife before 2014 profit warning at fraud trial of former execs', The Telegraph (2 November 2017), available at https://www.telegraph.co.uk/business/2017/11/02/tesco-boss-dave-lewis-reveals-grocers-internal-strife-2014-profit/.

662 Jane Croft, Tesco 'whistleblower' testifies of pressure to meet targets, Financial Times (4 October 2017), available at https://www.ft.com/content/04b97e82-a922-11e7-ab55-27219df83c97.

663 See section 4.3.3.

Bush), the Group commercial director, the UK finance director (Mr Rogberg), and the UK food commercial director (Mr Scouler).[664] The SFO subsequently opened a criminal investigation into Mr Bush, Mr Rogberg and Mr Scouler, alleging that they had abused their positions contrary to section 1 and 4 of the Fraud Act 2006 and were guilty of false accounting in contravention of section 17 of the Theft Act 1968.[665] While none of them had been a director of Tesco plc (the listed parent company), both Mr Bush and Mr Scouler had served on the Group's executive committee.[666] Mr Bush was also a director of Tesco Stores Limited at the relevant time (until November 2014). As already mentioned, they were all ultimately acquitted on the basis that the SFO failed to present a case against them.

8.3. Consequences

8.3.1. Criminal proceedings

Tesco became subject to a criminal investigation by the Serious Fraud Office which ended in Tesco Stores Limited agreeing to a deferred prosecution agreement (DPA) and paying a £129 million penalty.[667] The SFO's own

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[664] David Oakley and Andrea Felsted, Tesco shareholders shift focus to chairman after profits overstatement, Financial Times (23 Sep. 2014); Andrea Felsted and Caroline Binham, Tesco parts company with three executives, Financial Times (27 Nov. 2014).

[665] Serious Fraud Office, Case information: Tesco plc, available at https://www.sfo.gov.uk/cases/tesco-plc/ (accessed 1 Oct. 2018).

[666] Tesco, Annual Report and Financial Statements 2014, p. 28-29.

[667] Serious Fraud Office, SFO confirms DPA in principle with Tesco, 28 March 2017, available at https://www.sfo.gov.uk/2017/03/28/sfo-confirms-dpa-principle-tesco/.

reporting does however make clear that the DPA only concerns the potential criminal liability of Tesco Stores Limited and 'does not address whether liability of any sort attaches to Tesco PLC or any employee or agent of Tesco PLC or Tesco Stores Ltd'.[668]

The leading method for imposing criminal liability on a company is known as the 'identification doctrine' and requires that a natural person committed the crime in question and is shown to be the 'directing mind and will' of the company.[669] The decision by Tesco Stores Ltd to settle with the SFO and enter into a DPA could be seen as an acknowledgement that a person who was the 'directing mind and will' of the company' (such as Mr Bush, one of its directors) committed a criminal offense. This is the picture presented in the Statement of Facts agreed between Tesco Stores Ltd and the Serious Fraud Office, which names all three Tesco executives as dishonestly perpetuating the misstatement and 'thereby falsifying or concurring in the falsification of accounts'.[670] However, the decision to settle could, of course, also be seen as a way for Tesco, and its newly appointed senior executives, to quickly and conveniently resolve an embarrassing situation created by the company's previous leaders. The failure by the SFO to present a case against the

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668 Ibid.

669 See generally, Law Commission, *Criminal Liability in Corporate Contexts*, Consultation Paper No. 195 (2010).

670 Serious Fraud Office v Tesco Stores Limited, Statement of Facts prepared pursuant to paragraph 6(1) of Schedule 17 to the Crime and Courts Act 2013, para 9.

individuals allegedly masterminding the misstatement would indicate that a case against the company would fail on the same grounds.

Tesco Stores Ltd settled with the SFO on the basis of s. 17 of the Theft Act in relation to false accounting between February 2014 and September 2014, paying a £129 million fine.[671] Some striking remarks in the judgment include the following. First, Justice Leveson's admission that "there is no specific gain made or loss caused" and that "Tesco Stores did not and never could derive gain from what happened".[672] Second, that the calculation of the penalty that Tesco was required to pay had no connection to reality and was instead based on an estimate of 10%–20% of the revenue of the business area.[673] Justice Leveson then attempted to reconcile this amount with the amount in the FCA's restitution scheme, even though they clearly had no relation to each other. He achieved this by deciding that the appropriate percentage of the business area's revenue in this case was 11.25% and thereby managed to arrive at an amount of estimated harm of £86 million, close to the amount in the FCA restitution scheme. Finally, Justice Leveson noted that he was required to

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671 Tesco PLC, 'Deferred Prosecution Agreement in Relation to Historic Accounting Practices (28 March 2017), available at https://www.tescoplc.com/news/news-releases/2017/deferred-prosecution-agreement-in-relation-to-historic-accounting-practices/ and Serious Fraud Office, 'SFO confirms DPA in principle with Tesco (28 March 2017) available at https://www.sfo.gov.uk/2017/03/28/sfo-confirms-dpa-principle-tesco/.

672 Serious Fraud Office v Tesco Stores Limited, Approved Judgment, Case No U20170287 (10 April 2017) paras 83, 89.

673 Ibid.

ensure that the effects were that all gains of the wrongdoing were removed and that the DPA could act as a deterrent.[674] He never discussed either requirement, however, and it may be suspected that this was because of the poor fit between the applicable rules and the situation at hand. In the case of Tesco, it is not clear that the individuals or the company benefitted – in fact, by pulling forward revenues and delaying the recognition of costs, Tesco probably paid *too much* tax.

The £129 million fine imposed on Tesco Stores would effectively be paid by its ultimate shareholders, who are the shareholders of the listed parent company that issued the misstated profit estimate. If the stock market had perfect predictive ability, this amount would thus have been part of the decline in market capitalization at the time the misstatement was announced. If we imagine that there at some point in the future will be an exact repeat of the Tesco misstatement, we would expect the market capitalization adjustment on the date Tesco corrects its misstatement to include £129 million of expected fines. (The market knows this amount will need to be paid, so the value of Tesco should decline with the same amount.)

8.3.2. The FCA's restitution scheme

The FCA also took action, imposing a restitution scheme on Tesco plc and Tesco Stores Limited under its powers in s. 384 FSMA.[675] The legal basis for

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[674] Ibid, para 91.

[675] Financial Conduct Authority, Final notice: Tesco plc, Tesco Stores Limited (28 March 2017).

the scheme was that Tesco had contravened s. 118(7) FSMA which classified as market abuse behaviour amounting to the dissemination of false or misleading information:

> '… where the behaviour consists of the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading.'[676]

The FCA did not find that the board of Tesco plc knew about the misstatement, but came to relatively damning conclusions about the Tesco group's internal controls:

[676] Section 118(7) FSMA. This provision is no longer in force, since the MAR has direct effect in member states, but an equivalent provision is now found in its Article 12(1)(c).

> 'Tesco Plc knew or could reasonably be expected to have known that the information it published in the August Statement was false or misleading. In making this finding, the Authority does not suggest that the Tesco Plc Board knew, or could reasonably be expected to have known, that the information in the August Statement was false or misleading. However, the Authority has found that there was knowledge at a sufficiently high level but below the level of the Tesco plc Board as to the false and misleading nature of the August Statement for that knowledge to constitute the knowledge of Tesco plc, within the specific context of, and for the purposes of, market abuse. The publication of the August Statement disseminated that false or misleading information.'[677]

Based on the above, we know that the FCA determined that a person within Tesco plc actually knew (not just should have known) that the information disseminated in their August Statement was false or misleading. The knowledge of this person was possible to attribute to Tesco plc even though they were not on the board. This illustrates the difference between the criminal law's 'identification doctrine' and the civil law. The FCA then, having established the knowledge necessary for attribution to Tesco under the market abuse rules, did not need to continue to also attempt to 'pin' knowledge to any director of

[677] Financial Conduct Authority, Final notice: Tesco plc, Tesco Stores Limited (28 March 2017) 8, para 5.5.

Tesco plc (the publicly listed company). What the Tesco plc board knew or did not know is thus not an issue that the FCA attempted to establish. The FCA probably phrased its findings this way so as not to interfere with the then-ongoing criminal proceedings against the individual defendants, some of whom were on the Tesco plc Executive Committee.

Recognising that Tesco would pay a substantial penalty as part of the DPA with the SFO, as well as its exemplary co-operation, the FCA decided to not impose a penalty.

In setting up the restitution scheme, the FCA explained that it approached the question of compensation based on the fall in Tesco's share price between the close of trading on 19 September 2014 and the close of trading on 22 September, 'adjusting for economy-wide and industry-wide effects on price movements'.[678] The restitution amount had thus been set to 24.5p/share. This is slightly less than my calculation in Table 4 above (of 26.6p/share), likely due to the FCA's adjustment for market-wide factors unrelated to the misstatement. Both Tesco and the FCA estimated the eligible compensation payments to approximately £85 million.[679]

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[678] Financial Conduct Authority, Final notice: Tesco plc, Tesco Stores Limited (28 March 2017), Annex 2: Arrangements pursuant to which Tesco plc and Tesco Stores Limited are to pay restitution, clause 36-37.

[679] Tesco PLC, Deferred prosecution agreement in relation to historic accounting practices (28 March 2017).

The FCA's calculation appears generous since it does not take into account that some of the losses which formed part of the share price correction would have been reflective of Tesco's own loss. Sections 4.2.1 and 6.4.3 above outlined four categories of losses, where only the first of those four categories of losses would be non-reflective. Further, the Court of Appeal in *Gardner v Parker* clearly held that the reflective loss doctrine applies to restitution.[680] Seemingly in direct contradiction of *Gardner v Parker*, the FCA used the price drop in Tesco's shares on the day Tesco announced the misstatement as the measure of the damage to shareholders, without distinguishing between different types of losses. As a result, the FCA likely secured higher compensation payments than courts would have awarded investors in an action under the 90A regime. Should Tesco seek and be awarded compensation for its corporate costs (those that are "reflective" from the shareholders' perspective), investors awarded payment in the FCA's scheme would consequently be compensated twice. The FCA's calculation, which sets damages with reference to the share price fall, could also, through iteration, cause larger and larger losses and concomitant declines in market value of companies that announce earelier misstatements, which would be highly undesirable.

8.3.3. Private 90A actions

It may be suspected that, to the extent Tesco were able to negotiate the terms of the restitution scheme and final notice with the FCA, they would have been

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[680] *See* text accompanying note 409.

particularly focused on including the wording in the final notice (in the text accompanying note 677) that the FCA 'did not suggest that the Tesco plc board knew or could reasonably have been expected to know that the information was false or misleading'. While the language is neutral from the FCA's point of view as it does not take a stand on the issue of board knowledge, it means Tesco since did not concede this potentially important point for s. 90A actions.

The legal actions initiated under s. 90A FSMA are still ongoing. To participate in the FCA restitution scheme, investors needed to waive their right to bring future claims with respect to the misstatement, but it appears that the s. 90A claimants decided not to join the FCA scheme but continue with their own action instead. Stewarts Law, who brought the claim together with third-party litigation funder Bentham Europe, stated that their clients intended to press ahead with their action on the basis that their claim was not limited to the period of the Tesco restitution scheme and were seeking compensation for a wider period of overstatement.[681]

8.3.4. Reputational effects

To examine whether Tesco's misstatement had any professional consequences for the directors who presided over the company at the time, I examined the extent to which Tesco's directors at the time of misstatement left the company

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[681] Stewarts Law, Tesco shareholder action forges ahead – CDR Magazine article (25 April 2017), available at https://www.stewartslaw.com/news/tesco-shareholder-action-forges-ahead-cdr-magazine-article/.

before they were due to stand for re-election at the next Annual General Meeting. Table 5 below shows the extent to which Tesco's directors left the company.

Table 5: Tesco directors as of the misstatement

Director	Subsequent developments
R. Broadbent (Chairman)	Retired with effect from 1 March 2015.[682]
P. Clarke (CEO)	Retired with effect from 1 September 2014.[683]
P. Cescau	Retired with effect from 7 April 2015.[684]
M. Armour	Remained.
G. Bullock	Retired with effect from 5 March 2015.[685]
S. Chambers	Retired with effect from the 2015 AGM.[686]

682 Tesco PLC: Appointment of John Allan as Chairman (17 February 2015).

683 The new leaving date announcement of 1 September 2014 was announced on 29 August 2014, see https://otp.tools.investis.com/clients/uk/tesco/rns/regulatory-story.aspx?cid=55&newsid=441933.

684 Tesco PLC, Non-Executive Board Changes (23 March 2015).

685 Tesco PLC, Non-Executive Board Changes (4 March 2015).

686 Tesco PLC, Non-Executive Director Changes (5 May 2015).

Director	**Subsequent developments**
O. Garfield	Retired with effect from the 2015 AGM.[687]
K. Hanna	Retired with effect from the 2015 AGM.[688]
D. Oppenheimer	Remained.
J. Bakker	Retired with effect from the 2015 AGM.[689]
L. McIlwee (CFO)	*The CFO had stepped down from the role and the board with effect from 4 April 2014, and the new CFO did not join until the day after the correction of the misstatement.*[690]

The amount of changes in the board of directors shown above is highly unusual – of Tesco's ten directors at the time of the misstatement, the CEO left before the misstatement was corrected and seven other directors resigned voluntarily before they were due to stand for re-election at the next Annual General Meeting. This appears to have been caused by informal shareholder pressures to reform the board, that is, shareholders informing directors that they had failed in their oversight role and would not have their support were they to stand for re-election.

687 Tesco PLC, Non-Executive Board Changes (26 February 2015).

688 Tesco PLC, Non-Executive Director Changes (5 May 2015).

689 Tesco PLC, Non-Executive Board Changes (26 February 2015).

690 https://www.tescoplc.com/news/news-releases/2014/chief-financial-officer-start-date/

8.4. Analysis of the Tesco outcome

The financial consequences to Tesco of the misstatement were announced as £235 million, consisting of the DPA penalty (£129 million), the FCA compensation scheme (£85 million), and related costs which thus amount to approximately £21 million.[691]

The deadline for investors to claim under the FCA restitution scheme was 22 February 2018. Tesco's financial reports show that, of the £85 million originally provisioned for the FCA scheme, £40 million was subsequently released, which indicates that only approximately half – £45 million – was actually claimed by investors.[692] The scheme aimed to compensate both shareholders and bondholders, and it is not known how the payout was divided between these categories of investors. However, even if the full £45 million were paid to shareholders, it would be a relatively small amount in relation to the investor losses. The FCA calculated the loss (and restitution amount) to 24.5 pence per share, which equates to a total shareholder loss of £1.99 billion at t_1. Even if the £45 million was paid to shareholders, it would still only correspond to compensation of 2.26% of shareholders' losses on the misstatement announcement day.

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691 Tesco PLC, Deferred prosecution agreement in relation to historic accounting practices (28 March 2017).

692 £25 million were released in its results for the 2017/18 financial year, and another £15 million in its results for the first six months in the following financial year. *See* Tesco plc, Annual Report and Financial Statements 2018, 13-14, and Tesco plc, Interim results 2018/19 31 (dated 3 Oct. 2018).

While the private suits under s. 90A FSMA are still subject to litigation, the financial effect on Tesco, as estimated based on the completed UK regulatory actions are set out in Table 6 below.[693]

Table 6: Tesco payouts and beneficiaries

Reason for payment	**Beneficiary**	**Amount**	**Share of payouts**
DPA with the SFO	UK Government	£129m	66%
FCA compensation scheme	Investors (shareholders and debtholders)	£45m	23%
Related costs	Legal advisors (presumably)	£21m	11%
		£195m	**100%**

The main beneficiary of the Tesco misstatement is thus the Government, which secured the lion's share of the payouts. The reason for the DPA penalty

693 The amounts are from the estimates in Tesco PLC, Deferred prosecution agreement in relation to historic accounting practices (28 March 2017), updated for the FCA compensation scheme provisions that were released as described above. As noted earlier (n 653), Tesco also entered into a $12 million (£8 million) settlement with holders of American Depositary Receipts, representing approximately 2% of all Tesco shares, in November 2015.

is presumably to deter other companies from engaging in similar practices. The deterrence problem here appears, however, very similar to that of issuer liability to shareholders analysed in chapter 4: it is not clear that deterrence is created if shareholders have to pay such penalties. All investors who held Tesco shares when the market opened on 22 September would be paying any compensation, but only those who bought shares while the misstatement persisted would be eligible to receive such compensation. Tesco shareholders who bought their shares before 29 August and still held them on 22 September would thus be "net payers". Issuer liability for this misstatement would consequently reallocate wealth from Tesco's longer-term shareholders to those who purchased their shares only recently. The difference between the DPA penalty payment and issuer liability payments is that there cannot possibly be a compensation rationale with a DPA penalty – instead, it is a further cost on the holders of the 98% (or more) of t_1 shares that are "net payers".

8.5. Preliminary conclusions

The Tesco misstatement makes for an interesting case study of the interaction between civil, criminal, and administrative enforcement techniques in practice. It is a notable development that the FCA decided to enter this arena by arranging an investor restitution scheme, even though private actions were already in process, but the take-up of the scheme appears to have been lower than expected. The FCA also appears to have ignored the doctrine that shareholders cannot get compensated for losses that are merely reflective of their company's losses. The regulator should articulate principles on a firmer foundation if the aim is to impose investor restitution schemes for corporate disclosure misstatements on a regular basis going forward, in order to guide investor expectations.

9. Conclusions

9.1. Overview

As noted in the Introduction, the analysis in this thesis has proceeded by drawing preliminary conclusions at the end of each chapter with the aim of synthesising them here. A few themes can be identified in those preliminary conclusions for the analysis to follow:

- the significance of the new 90A regime,
- the importance of information traders and the extent to which the disclosure system does and should support their work,
- the design of liability rules and their effect,
- the interplay between public and private enforcement,
- the relevance of agency problems in the corporate disclosure context.

9.2. The significance of the new regime

I started in chapter 2 by questioning not the significance of the new 90A regime, but – more fundamentally the need for it. The further analysis in chapter 6 showed that the tort of negligent misstatement survived the introduction of the 90A regime. As a result, the 90A regime fails to address the main problem it was introduced to solve – preventing an expansionary development of the tort of negligent misstatement into the corporate disclosure context – and both heads of liability may now be available in many disclosure misstatement cases. This renders the purpose of the new regime unclear. If pressed to take a kind view of the regime's existence, one could arguably say that it funnels a wide array of disclosures in under its purview and delineates the liability options available. This, however, was hardly the point of its introduction.

It is, however, currently unlikely that we will see significantly increased private disclosure litigation in the UK. Section 1.2 described how the UK regulatory setting does not support US-style private disclosure litigation through class actions and the analysis of the substantive rules in this thesis has shown that the 90A regime presents significant hurdles for shareholders.

9.3. The role of information traders

A second theme of this thesis has been the role of information traders and the extent to which regulation supports their work. In chapter 3, I argued that the substantive rules of the EU's continuous disclosure regime are well-designed to support the work of information traders and that this is also a suitable policy goal for disclosure regulation. This provided an interesting backdrop for the examination of whether or not the liability framework could similarly be said to support information traders. In chapter 4, I argued that the issuer liability framework offered in the 90A regime could be seen as having the role of protecting information traders, since they would often be the type of short-term traders that benefit from such a regime. In chapter 6, I supplemented this view by noting that an issuer liability regime could be targeted at information traders by requiring actual reliance on disclosure misstatements rather than the inferred fraud-on-the-market variety. However, the role of disclosure liability should be focused on *ex ante* deterrence of disclosure misstatements rather than *ex post* compensation. From this perspective, I argued that an issuer liability regime would enlist *existing* investors as monitors while a regime with no issuer liability would enlist *new* investors as monitors. If we then consider this choice of regulatory design in light of the evidence presented in chapter 7 that most public companies' managers engage in hundreds of private meetings with investors each year a picture emerges where information traders do not need the downside protection offered by issuer liability since they already do extensive pre-investment due diligence themselves.

Chapter 7 also provided another piece of the puzzle of how the regulatory framework supports information traders. Even though the EU regulation of insider trading appears very strict, due to a low threshold of when information becomes "inside information" and activates civil and criminal law frameworks, the FCA takes a relatively relaxed approach to enforcement of selective disclosure in private investor meetings. The evidence that investors pay £500 million per year for private meetings with managers of UK public companies indicates that they gain profitable trading opportunities from these meetings. While the dissonance between the strict rules and their relaxed enforcement may appear unsatisfactory, it arguably also encourages professional information traders to meet with and assess company managers. When this process works well, information traders are thus encouraged to monitor corporate managers.

9.4. The design of liability rules

Chapter 4 analysed the arguments presented during the Davies Review, as well as in the literature generally, in favour of issuer liability and found them wanting. We should not expect issuer liability to provide meaningful deterrence of disclosure misstatements since it is not aimed at the individuals who actually engage in this misbehaviour.

I further argued that deterrence will often fail as a regulatory strategy because it is based on the idea that concentrated liability risk creates incentives to monitor, but fails to consider that concentrated liability risk also creates equally powerful incentives to diffuse that risk. The more expensive and difficult it is to monitor (and monitoring companies for misstatements is *very* expensive), the more attractive will it be to instead seek to diffuse the liability risk. Issuer liability is thus not a suitable regulatory strategy, but I argued that targeted liability provisions that aim to hurt directors and officers in a financially meaningful way when misstatements occur would be expected to provide meaningful deterrence.

Such liability, which by its nature would aim to achieve deterrence by making it costly to engage in misstatements, could be supplemented by regulatory strategies that provide benefits to those able to detect misstatements in order to encourage such activity. The evidence suggests that the most important stakeholders in detecting fraud inside companies are their own employees. I argue that employees are a powerful constituent since they are typically unable to diversify their human capital investment in the issuer. We should therefore consider ways to mobilize employees as "whistle-blowers" by offering financial incentives.

I would recommend that regulators move away from issuer liability regimes in favour of director and officer liability coupled with positive incentive regimes. In addition to whistle-blowing rewards, positive incentives can be created by empowering information traders to meet with and question issuers' insiders. In considering information traders, a further advantage of not offering issuer liability is that it means that information traders will not have downside protection in the case of misstatements. By not offering issuer liability, the regulator should thus encourage information traders to perform more due diligence. In conclusion, the issuer liability regime in section 90A FSMA is not only unnecessary, but from this perspective also unhelpful.

The potential attractiveness of issuer liability should also be tempered by the findings of the analysis in chapter 6 delineating the scope of the "rule against reflective loss" in the disclosure setting. This rule, which prevents shareholder compensation for corporate losses, was found to be applicable and well-justified in the disclosure setting, even though it was not discussed in the Davies Review. Its existence would thus reduce the compensation available to shareholders in issuer liability cases.

9.5. The relationship between public and private enforcement

Admittedly, this thesis has not focused on enforcement. This is due to the lack of UK disclosure litigation. For example, we do not yet have a single case on the 90A regime to study. However, chapter 8 took the opportunity to review the Tesco misstatement in detail, since it offers the most recent insight into how UK authorities view disclosure misstatements.

The most significant development was the FCA's initiative of requiring that Tesco establish an investor restitution scheme to compensate for losses flowing from the misstatement. Without such a scheme, smaller investors financially unable or unmotivated to sue under section 90A FSMA would not have been able to receive compensation. From an investor perspective, such schemes also appear attractive compared to private litigation since the FCA appears to consider itself unrestrained by the company law doctrine against "reflective loss" which would traditionally prevent shareholder compensation for corporate losses.

The quantum of public enforcement will also affect the necessity of a civil liability system. The Davies Review, for example, assumed that the FCA would continue with a low amount of enforcement in the corporate disclosure context and formulated its recommendations accordingly. If the Tesco restitution scheme means that the FCA intends to take a central role in providing investor compensation for disclosure misstatements, the regulator should clearly articulate this so investors know whether or not to prepare their own private suits under section 90A FSMA or the tort of negligent misstatement.

The FCA restitution scheme is similar to a private action where the FCA takes on the role of lead plaintiff, allowing shareholders to opt in if they wish to receive the per-share compensation it has negotiated with the issuer. This means that the arguments against issuer liability apply equally to such schemes. I would consequently advise against them on the basis that they would not be expected to create meaningful deterrence.

9.6. Agency concerns in the corporate disclosure setting

Chapter 5 deals with the risk that directors will behave strategically to avoid liability under the 90A regime attaching to the company. I argued that, if the purpose of the 90A regime is deterrence of misstatements, then the 90A regime should encourage companies to put in place strong internal control systems rather than reward delegation for purposes of "strategic deniability" with a lack of corporate liability. In that chapter, I also offered a different view of the current law than Professor Davies in that I considered courts to be free to impose liability on an issuer under the 90A regime in cases where the requisite mental element is only present on the sub-director level. I believe that cases such as *Meridian* (on disclosure) and *FCA v Da Vinci Invest* (on market abuse) support this view. The potential detrimental impact of agency problems in this setting should therefore be limited in my view.

If I have thus far presented a positive view of information traders, it is because of their importance in guiding markets towards efficient share prices. However, I fully agree with Professor Fox's argument (presented in chapter 3) that all corporate disclosures have an agency component and chapter 7 aimed to provide further substance on what this means in practice. The picture that emerged from this analysis is concerning in some respects. Prior non-legal studies based on interviews with insiders indicate selective disclosure behaviour that appears to contradict the spirit of the Transparency Directive which requires equal distribution of information. It is also not clear that shareholders at large actually benefit from private investor meetings since they do not know whether or not such meetings have taken place at all, or which particular information trader purportedly conducts such monitoring on behalf of investors. I believe more transparency would be helpful here and that regulators should consider requiring the reporting of some basic information of private investor meetings as outlined in that chapter.

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11. Appendix A: The 90A regime in FSMA

Financial Services and Markets Act 2000

[F1 SCHEDULE 10A

Section 90A

LIABILITY OF ISSUERS IN CONNECTION WITH PUBLISHED INFORMATION

Annotations:

Amendments (Textual)

F1 Sch. 10A inserted (1.10.2010 with effect in accordance with reg. 3(1) of the amending S.I.) by The Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2010 (S.I. 2010/1192), reg. 2(3), **Sch.**

PART 1

SCOPE OF THIS SCHEDULE

Securities to which this Schedule applies

1 (1) This Schedule applies to securities that are, with the consent of the issuer, admitted to trading on a securities market, where—

(a) the market is situated or operating in the United Kingdom, or

(b) the United Kingdom is the issuer's home State.

(2) For the purposes of this Schedule—

(a) an issuer of securities is not taken to have consented to the securities being admitted to trading on a securities market by reason only of having consented to their admission to trading on another market as a result of which they are admitted to trading on the first-mentioned market;

(b) an issuer who has accepted responsibility (to any extent) for any document prepared for the purposes of the admission of the securities to trading on a securities market (such as a prospectus or listing particulars) is taken to have consented to their admission to trading on that market.

(3) For the purposes of this Schedule the United Kingdom is the home State of an issuer—

(a) in the case of securities in relation to which the transparency obligations directive applies, if the United Kingdom is the home Member State for the purposes of that directive (see Article 2.1 of the directive);

(b) in any other case, if the issuer has its registered office (or, if it does not have a registered office, its head office) in the United Kingdom.

Published information to which this Schedule applies

2 (1) This Schedule applies to information published by the issuer of securities to which this Schedule applies—

(a) by recognised means, or

(b) by other means where the availability of the information has been announced by the issuer by recognised means.

(2) It is immaterial whether the information is required to be published (by recognised means or otherwise).

(3) The following are "recognised means"—

(a) a recognised information service;

(b) other means required or authorised to be used to communicate information to the market in question, or to the public, when a recognised information service is unavailable.

(4) A "recognised information service" means—

(a) in relation to a securities market situated or operating in the EEA, a service used for the dissemination of information in accordance with Article 21 of the transparency obligations directive;

(b) in relation to a securities market situated or operating outside the EEA, a service used for the dissemination of information corresponding to that required to be disclosed under that directive; or

(c) in relation to any securities market, any other service used by issuers of securities for the dissemination of information required to be disclosed by the rules of the market.

PART 2

LIABILITY IN CONNECTION WITH PUBLISHED INFORMATION

Liability of issuer for misleading statement or dishonest omission

3 (1) An issuer of securities to which this Schedule applies is liable to pay compensation to a person who—

(a) acquires, continues to hold or disposes of the securities in reliance on published information to which this Schedule applies, and

(b) suffers loss in respect of the securities as a result of—

(i) any untrue or misleading statement in that published information, or

(ii) the omission from that published information of any matter required to be included in it.

(2) The issuer is liable in respect of an untrue or misleading statement only if a person discharging managerial responsibilities within the issuer knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading.

(3) The issuer is liable in respect of the omission of any matter required to be included in published information only if a person discharging managerial responsibilities within the issuer knew the omission to be a dishonest concealment of a material fact.

(4) A loss is not regarded as suffered as a result of the statement or omission unless the person suffering it acquired, continued to hold or disposed of the relevant securities—

(a) in reliance on the information in question, and

(b) at a time when, and in circumstances in which, it was reasonable for him to rely on it.

4 An issuer of securities to which this Schedule applies is not liable under paragraph 3 to pay compensation to a person for loss suffered as a result of an untrue or misleading statement in, or omission from, published information to which this Schedule applies if—

(a) the published information is contained in listing particulars or a prospectus (or supplementary listing particulars or a supplementary prospectus), and

(b) the issuer is liable under section 90 (compensation for statements in listing particulars or prospectus) to pay compensation to the person in respect of the statement or omission.

Liability of issuer for dishonest delay in publishing information

5 (1) An issuer of securities to which this Schedule applies is liable to pay compensation to a person who—

(a) acquires, continues to hold or disposes of the securities, and

(b) suffers loss in respect of the securities as a result of delay by the issuer in publishing information to which this Schedule applies.

(2) The issuer is liable only if a person discharging managerial responsibilities within the issuer acted dishonestly in delaying the publication of the information.

Meaning of dishonesty

6 For the purposes of paragraphs 3(3) and 5(2) a person's conduct is regarded as dishonest if (and only if)—

(a) it is regarded as dishonest by persons who regularly trade on the securities market in question, and

(b) the person was aware (or must be taken to have been aware) that it was so regarded.

Exclusion of certain other liabilities

7 (1) The issuer is not subject—

(a) to any liability other than that provided for by paragraph 3 in respect of loss suffered as a result of reliance by any person on—

(i) an untrue or misleading statement in published information to which this Schedule applies, or

(ii) the omission from any such published information of any matter required to be included in it;

(b) to any liability other than that provided for by paragraph 5 in respect of loss suffered as a result of delay in the publication of information to which this Schedule applies.

(2) A person other than the issuer is not subject to any liability, other than to the issuer, in respect of any such loss.

(3) This paragraph does not affect—

(a) civil liability—

(i) under section 90 (compensation for statements in listing particulars or prospectus),

(ii) under rules made by virtue of section 954 of the Companies Act 2006 (compensation),

(iii) for breach of contract,

(iv) under the Misrepresentation Act 1967, or

(v) arising from a person's having assumed responsibility, to a particular person for a particular purpose, for the accuracy or completeness of the information concerned;

(b) liability to a civil penalty; or

(c) criminal liability.

(4) This paragraph does not affect the powers conferred by sections 382 and 384 (powers of the court to make a restitution order and of the Authority to require restitution).

(5) References in this paragraph to liability, in relation to a person, include a reference to another person being entitled as against that person to be granted any civil remedy or to rescind or repudiate an agreement.

PART 3
SUPPLEMENTARY PROVISIONS

Interpretation

8 (1) In this Schedule—

(a) “securities” means transferable securities within the meaning of Article 4.1.18 of the markets in financial instruments directive, other than money-market instruments as defined in Article 4.1.19 of that directive that have a maturity of less than 12 months (and includes instruments outside the EEA);

(b) “securities market” means—

(i) a regulated market as defined in Article 4.1.14 of the markets in financial instruments directive,

(ii) a multilateral trading facility as defined in Article 4.1.15 of the markets in financial instruments directive, or

(iii) a market or facility of a corresponding description outside the EEA.

(2) References in this Schedule to the issuer of securities are—

(a) in relation to a depositary receipt, derivative instrument or other financial instrument representing securities where the issuer of the securities represented has consented to the admission of the instrument to trading as mentioned in paragraph 1(1), to the issuer of the securities represented;

(b) in any other case, to the person who issued the securities.

(3) References in this Schedule to the acquisition or disposal of securities include—

(a) acquisition or disposal of any interest in securities, or

(b) contracting to acquire or dispose of securities or of any interest in securities,

except where what is acquired or disposed of (or contracted to be acquired or disposed of) is a depositary receipt, derivative instrument or other financial instrument representing securities.

(4) References to continuing to hold securities have a corresponding meaning.

(5) For the purposes of this Schedule the following are persons "discharging managerial responsibilities" within an issuer—

(a) any director of the issuer (or person occupying the position of director, by whatever name called);

(b) in the case of an issuer whose affairs are managed by its members, any member of the issuer;

(c) in the case of an issuer that has no persons within paragraph (a) or (b), any senior executive of the issuer having responsibilities in relation to the information in question or its publication.

(6) The following definitions (which apply generally for the purposes of Part 6 of this Act) do not apply for the purposes of this Schedule:

(a) section 102A(1), (2) and (6) (meaning of "securities" and "issuer");

(b) section 102C (meaning of "home State" in relation to transferable securities).]