Section 496: A New Era in Civil Liability for Misstatements?

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I. Introduction

The Financial Markets Conduct Act (FMCA) came into force on 13 September 2013. The FMCA replaced several Acts, most notably in this context the Securities Act 1978 (SA). The SA was New Zealand's first attempt at a complete regime governing the primary securities market. However throughout the duration of the SA significant gaps in the liability regime came to light; firstly in the stock market crash of 1987 and more so in the wake of the financial crisis of the 2000s. The FMCA is the result of these events and also of various recommendations for reform. Comprehensively updating an area of law like this comes once in a generation. As such, the process of reform was long and extensive consultation was sought.

One of the significant changes in the FMCA is the civil liability regime for "defective disclosure" in offer documents.[1] Compensation for misstatement was ineffective under the SA. Accordingly, improving this was a primary focus when legislating the new Act. In a fundamental change from the civil liability provisions of the SA, s 496 FMCA introduces a rebuttable presumption of loss for defective disclosure. It is likely this will significantly change the structure of liability for issuers, with more exposure to civil liability and criminal liability left to the most serious violations of the FMCA. The theory underlying s 496 and the impact the new scheme is expected to have on securities law in New Zealand is the focus of this dissertation. Section 496 can be found in the appendix.

Chapter II discusses New Zealand's security law as it was under the SA and looks at the new regime for civil liability under s 496 FMCA. Chapter III then considers the financial theory that underlies the new civil liability provision. Following this, the methods employed in the United States, Australia and Canada are compared in Chapter IV. Finally, Chapter V looks at how the new section will be applied, and how successful it is likely to be as compared to the SA.

[1] Financial Markets Conduct Act 2013, s 496.

II. New Zealand Securities Law – Past and Present

This chapter provides a brief recent history of New Zealand securities law to give the issues context and to understand the fundamental change in our regime. It includes analysis of the key liability sections in the SA and how they operated. Also considered is the new FMCA, in particular civil liability under s 496, why the FMCA came about, and the policy underlying it. If the aim of the FMCA is achieved, the two Acts will have opposite liability regimes; the SA employing criminal liability as the main route of enforcement, and the FMCA making civil liability the primary method of enforcement – leaving criminal sanction to the most egregious of cases.

A. Securities Act 1978

The SA was the first Act in New Zealand to incorporate securities law into one piece of legislation. Prior to this the Companies Act 1955 governed some parts of securities law such as issuing prospectuses, but lacked specific provisions.[2] New Zealand was thus in need of some substantial securities laws. Subsequently, the SA came into force controlling fund raising and also providing for the establishment of the Securities Commission. The Securities Commission was the regulatory body responsible for overseeing the securities markets, which was replaced by the Financial Markets Authority (FMA) in 2011.

1. Why Did the Securities Act Come About?

"Nothing important might happen except in crisis".[3] This was a primary reason for the development of the SA, with the collapse of major companies such as Securitibank in the 1970s. Before the SA, companies were acquiring funds from the public in such a way that they could avoid the existing protection that was provided for the investing public.[4] The government accepted that "activity based" legislation was required, applying to everyone involved in the activity of raising money from the public and stepping away from the previous "entity based" legislation.[5]

Behind the SA was the idea that failure in the market can be improved by government intervention or regulation – the "market failure" theory of regulation.[6] Accordingly, after

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[2] Peter Fitzsimons "New Zealand Securities Commission: The Rise and Fall of a Law Reform Body" (1994) 2 WLR 87 at 89.
[3] Mark Roe "Chaos and Evolution in Law and Economics" (1996) 109 Harv. L. Rev. 641 at 663.
[4] Fitzsimons, above n 2, at 89.
[5] Gordon Walker "Chaos and Evolution in New Zealand Securities Legislation" (1997) 9 Otago L. Rev. 14 at 44.
[6] Fitzsimons, above n 2, at 90.

the collapse of these companies the government responded to control fund raising from the public with the main purpose being investor protection.[7] However, this came with the proviso that companies should not have to deal with inflexible regulation.[8]

Well before the development of the SA, the Barton Report noted in 1934 that corporate abuse would affect New Zealand's reputation and ability to attract potential investment.[9] This is an issue that still underlies securities regulation, with investor confidence in the market being of primary importance. Despite this early insight, none of the recommended reforms in the Barton Report were implemented in the subsequent legislation, which instead focused on specific companies.[10] Over 40 years later, the SA reflected some of the reforms anticipated in the report.

2. *Overview of Securities Act 1978 Liability Provisions*

Under the 1978 Act, criminal and civil proceedings could be brought for misstatements in advertisements or registered prospectuses under ss 55 to 60 SA. Under s 2A(2)(b) SA an "investment statement" is included within the meaning of advertisement. The investment statement is aimed at the "prudent but non-expert person" pursuant to s 38D and must advise investors that there is further information available in the registered prospectus. Accordingly, "the person reading the prospectus should be treated as the same 'prudent but non-expert person' to whom the investment statement is directed."[11]

(a) Section 55(a)

Pursuant to s 55(a) SA, a statement was deemed to be untrue if:

> (i) It is misleading in the form and context in which it is included; or
> (ii) It is misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included.

An untrue statement was required for liability for misstatements in advertisements or registered prospectuses under both the civil and criminal provisions of the SA.[12]

"Material" was not defined in the SA, though it was an important filter in determining the relevance of information. New Zealand adopted the American interpretation of

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[7] Fitzsimons, above n 2, at 90.
[8] Fitzsimons, above n 2, at 90.
[9] Walker, above n 5, at 38.
[10] Walker, above n 5, at 39.
[11] *R v Moses* HC Auckland CRI-2009-004-1388, 8 July 2011 at [63].
[12] Securities Act 1978, ss 55G and 58.

materiality that was expounded in *TSC Industries Inc. v Northway Inc* in the case of *Coleman v Myers*.[13] Although *Coleman* does not consider the SA, it has been accepted as adopting a relevant definition of materiality for the SA.[14] The case was regarding directors' duties and whether information that the director had but the shareholder did not have was material. Accordingly the case concerned disclosure and developed a test appropriate for the SA. The materiality standard involves considering whether "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[15] Heath J stated in *R v Moses,* a case regarding criminal liability under the SA, that the concept of materiality in regards to omitted facts should not be defined "too tightly"; if there was something that should have been disclosed and would likely have made a difference to the decision whether to invest, it would almost certainly be considered material.[16]

Moses also indicated that whether a statement is misleading must be judged contextually, not literally.[17] Deciding if the document contains an affirmative statement that is "untrue" is an objective inquiry and is to be viewed through the eyes of a "prudent but non-expert person", or the "notional investor".[18] Heath J summarized the notional investor in *Moses* as: somewhere between completely risk averse and someone prepared to take a high level of risk; sufficiently intelligent and literate with a general understanding of technical words; would seek assistance from a financial adviser and comprehend competent advice; and of modest financial means, neither rich nor poor.[19]

(b) Section 55G

Section 55G SA is a civil liability section and provides that:[20]

> The court may, on the application of the FMA or a subscriber, order a liable person to pay compensation to all or any of the persons who subscribed for any securities on the faith of an advertisement or registered prospectus that includes an untrue statement, for the loss or damage that the persons have sustained by reason of the untrue statement.

Investing "on the faith of" an advertisement or registered prospectus thus requires investors to prove reliance. In an early interlocutory appeal for *Saunders v Houghton* the

[13] *TSC Industries Inc v Northway Inc* 426 US 438 (1976); *Coleman v Myers* [1977] 2 NZLR 225 (CA).
[14] John Farrar and Susan Watson (eds) *Company and Securities Law in New Zealand* (2nd ed, Brookers, Wellington 2013) at [34.4.3(2)(a)].
[15] *TSC Industries Inc v Northway Inc,* above n 14, at 449.
[16] *R v Moses,* above n 11, at [51].
[17] At [42].
[18] At [43].
[19] At [65]-[70].
[20] Section 55G(1).

Court of Appeal appeared attracted to the idea that reliance on the fact of the prospectus was enough.[21] In particular, this was because shareholders were able to invest on the investment statement alone without receiving the prospectus.[22] Moreover, the Court recognised that indirect reliance was possible where the prospectus forms the basis of advice from a broker or a news report.[23] This idea was supported in the recent *Houghton v Saunders* decision from the High Court, where Dobson J noted that "on the faith of" connotes a "less direct connection than reliance on specific aspects of misleading content or omission."[24]

Despite allowing this "less direct connection", establishing reliance was nonetheless a tough hurdle for investors to prove. Additionally, cases were even more difficult because each investor arguably had to establish reliance individually.[25] This made the use of representative actions problematic in New Zealand; in reality this kind of "class" action option was almost impossible. However, the cost of bringing an action individually would generally outweigh the potential gain for most investors.

Section 55G also requires investors to show causation. The phrase "by reason of the untrue statement" necessitates that the untrue statement caused the loss or damage suffered by the plaintiff. Likewise, establishing this element was a significant challenge for investors, particularly when the idea of intervening causes come into play. For example, many of the recent cases under the SA were the result of finance companies collapsing in the wake of the Global Financial Crisis (GFC). Consequently, investors faced difficulties in claiming that the statement caused the loss when negative effects of the GFC were still being felt.

Plaintiffs therefore had to establish the elements of reliance, causation and, in the case of omissions, materiality, before they could gain compensation under the civil liability provisions. This proved almost impossible with the first case on s 55G, *Houghton v Saunders,* being decided only recently after the FMCA had already replaced the SA.[26]

Section 55B was introduced in 2006 and provides that a "civil liability event" is "a distribution of an advertisement or a registered prospectus that includes an untrue statement".[27] The purpose of this concept was "to enable a person who brings proceedings under section 55G to rely on the declaration in the proceedings for

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[21] *Saunders v Houghton* [2010] 3 NZLR 331; (2009) 20 PRNZ 215 (CA) at [86] and [88].
[22] At [88].
[23] At [90].
[24] *Houghton v Saunders* [2014] NZHC 2229 [15 September 2014] at [116].
[25] See *Houghton v Saunders,* [2012] NZHC 1828; [2012] NZCCLR 31 at [113] where the scope of reliance and whether it was an individual or common issue was discussed.
[26] Above n 24.
[27] Section 55B(a).

compensation, and not be required to prove the civil liability event."[28] A declaration is "conclusive evidence of the matters" stated in it, delivering some help to plaintiffs as they could rely on a civil liability event as established by the Securities Commission (now the FMA) for s 55G.[29]

(c) Section 58

Contrasting s 55G, criminal liability under s 58 employed strict liability for misstatements in an advertisement or registered prospectus. The section states:

> (1) … where an advertisement that includes any untrue statement is distributed [the issuer or, if the issuer is a body, every director] commits an offence.
>
> …
>
> (3) … where a registered prospectus that includes an untrue statement is distributed, every person who signed the prospectus, or on whose behalf the registered prospectus was signed for the purposes of section 41(1)(b), commits an offence.

Section 58 has consequently seen numerous prosecutions, the strict liability nature of the provision making it significantly easier for cases to be brought against issuers than under the civil provisions (see, for example, *R v Moses*[30] or *R v Petricevic*[31]). A defence was provided in subs (2) and (4) of s 58 where the defendant could prove "that the statement was immaterial, or that he or she had reasonable grounds to believe, and did…" believe that the statement was true.

(d) Lombard Case Scenario

In order to better understand how liability for misstatements under the SA operated and to illustrate the ease of bringing a criminal action, this section considers a case where s 58 has been put into practice. It is a useful task in considering the policy of the SA and whether it struck the right balance between people who consciously behaved 'badly' and those who simply made the wrong call. *R v Graham* is a suitable case to apply in this instance (referred to as Lombard).[32]

The directors of Lombard faced four counts laid under s 58 SA after investors lost significant amounts of money when Lombard went into receivership in April 2008. The first count contended that the prospectus contained statements that were untrue in a number of respects; the other three counts focused on distributed advertisements that

[28] Section 55D(1).
[29] Section 55D(2).
[30] *R v Moses,* above n 11.
[31] *R v Petricevic* HC Auckland CRI-2008-004-29179, 5 April 2012.
[32] *R v Graham* [2012] NZHC 575.

also contained untrue statements. Dobson J found that in the relevant sections of the prospectus there were untrue statements including assertions regarding the liquidity of Lombard.[33] He also found a material omission about the concerns of the directors that cash available to the company had markedly reduced.[34] While it is likely that there would have been little point in issuing a prospectus on such cautionary terms, the issue of what was required to be adequate disclosure still remained.[35]

The directors were found to be "honest men who took their responsibilities seriously but nonetheless, by reason of a misjudgment made in circumstances of pressure, were responsible for the issuing of a prospectus which was untrue as to liquidity."[36] However, the directors had not established that they had reasonable grounds to believe the prospectus was true, precluding them from the defence provided in s 58(4).[37] With this context in mind, it is difficult to rationalise how the principles of deterrence for a criminal conviction are applicable to those who simply made a "misjudgment". As noted in the appeal regarding sentences of the Lombard directors in the Supreme Court, deterrence must be applied proportionately.[38] Disproportionately severe punishments may result in too much deterrence, for example discouraging people to take up directorships.[39]

In *R v Moses*, considered in Lombard, Heath J started with the proposition that directors direct, and managers manage.[40] Directors must delegate responsibilities out of practicality. Accordingly, reliance by directors on information provided by management in their delegated areas of authority will generally be appropriate.[41] Traditionally, the role of directors has been at overarching levels to decide broad company policies and objectives to then be implemented by management. Thus directorship was a somewhat hands off role. But the string of criminal convictions resulting from the structure of the SA shifted directors' duties to require more involvement, as it was the directors who were liable for fines or imprisonment if things went wrong.

Until the collapse of several finance companies in the GFC, there had been little recent judicial consideration of the liability provisions of the SA. Since the sections have come into use in recent years they have proved problematic, resulting in almost exclusive use of criminal sanctions. A similar pattern can also be seen after the stockmarket crash of

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[33] *Graham v R* [2014] NZSC 55 at [2].
[34] *R v Graham* [2012] NZHC 265, [2012] NZCCLR 6 at [118].
[35] At [122].
[36] Above n 33, at [31].
[37] Above n 33, at [2].
[38] Above n 33, at [33].
[39] Above n 33, at [33].
[40] *R v Moses*, above n 11, at [74].
[41] *R v Moses*, above n 11, at [82].

1987, Fitzsimons noting that there had been “a significant number of criminal actions” notwithstanding the fact that the Securities Commission had recognized civil actions as a critical component in securities law.[42] It is remarkable to consider that the higher standard of proof required for criminal liability was still less of a challenge than demonstrating the elements required to establish civil liability. As such it is questionable whether cases like Lombard would have resulted in a different outcome had a civil action been brought requiring proof of causation, rather than a criminal prosecution.

Dobson J held that a misstatement or omission that was likely to be material to an investment decision should trigger liability.[43] Such liability was effectively only criminal. According to Dobson J, the role of s 58 was to ensure “that those responsible for offering securities to the public discharge their obligation fully, to ensure that the market is indeed adequately and accurately informed.”[44] But to employ criminal liability as the primary route of enforcement is unnecessary, with such obligations likely to be met with the threat of civil sanctions. The SA accordingly failed to recognize (and nor did it purport to recognize) the distinction between a misjudgment, as in Lombard, and knowingly making false statements, take for example, *R v Petricevic*.[45] Civil liability should be the primary tier in liability, covering the misjudgments made without an intention to mislead. This would enable the court to differentiate between those directors who made the wrong call, and those who knowingly or recklessly made untrue statements in offer documents by leaving the gravity and stigma of criminal prosecution for those who truly deserve it.

It will be interesting to see if the FMCA effectively makes this distinction. One of the main goals of the FMCA is to invert the liability pyramid (refer to Figure 1 at the end of the chapter) and the civil liability provision is worded to such effect. If this goal is achieved, as a corollary it is likely that the line between a misjudgment and ‘bad’ behaviour will be clear. In drawing this distinction the FMCA may realign directors’ duties to their traditional role due to the shift away from criminal prosecutions as the main route of enforcement. Consequently, directors may feel comfortable to take a step back from the more involved / managerial-type position that has been required under the SA, and more eligible people may be encouraged to take up directorships.

[42] Peter Fitzsimons “If the Truth Be Known: The Securities Act 1978 and Directors’ Liability for Misstatements in a Prospectus (Part II)” (2000) 6 NZBLQ 235 at 252; see, for example, the cases of *R v Rada Corp Ltd (No 2)* [1990] 3 NZLR 453; *R v Smith* [1991] 3 NZLR 740; *R v Reid* (1990) 5 NZCLC 66,483.
[43] Above n 32, at [39].
[44] Above n 32, at [39].
[45] *R v Petricevic* [2012] NZHC 665, [2012] NZCCLR 7.

B. Financial Markets Conduct Act 2013

1. Overview

The Financial Markets Conduct Bill (FMCB) was introduced in August 2011, compiling securities law into one Act, and replacing Acts including the SA and the Securities Markets Act 1988 (SMA), which regulated the secondary market. Subsequently, the FMCA passed into law in September 2013, with the main purposes of promoting the confident and informed participation of businesses, investors, and consumers in the financial markets; and promoting and facilitating the development of fair, efficient, and transparent financial markets.[46] The FMCA is coming into effect in phases. Phase one, including the enforcement and liability regime, was implemented in April 2014. Phase two is to be implemented in December 2014.

The FMCA regulates offers of "financial products", which include: a debt security; an equity security; a managed investment product; or a derivative.[47] Such offers require disclosure, a regulated offer being one where it is "an offer of financial products to 1 or more investors where the offer to at least 1 of those investors requires disclosure" under Part 3 of the FMCA (exclusions for disclosure can be found under Part 1 of Schedule 1 FMCA).[48] To make a regulated offer, a product disclosure statement (PDS) must be prepared and lodged with the Registrar, the purpose of the PDS being "to provide certain information that is likely to assist a prudent but non-expert person to decide whether or not to acquire the financial products".[49] Thus the "prudent but non-expert" standard has been carried forward from the SA. A PDS must be worded and presented in a "clear, concise, and effective manner".[50] Exactly what "clear, concise, and effective" means is an interesting topic that is beyond the scope of this dissertation, however the PDS will be much shorter than previous prospectuses.

The FMCA introduces greater civil liability. As will be discussed, under s 496 it is presumed that loss is caused by defective disclosure. However, issuers will not be able to counter this by disclosing further due to the more restricted disclosure standard.[51]

To supplement the PDS, a register entry may be made. The register entry must contain "all material information relating to the regulated offer that is not contained in the

[46] Section 3.
[47] Section 7.
[48] Sections 39 and 41.
[49] Sections 48 and 49.
[50] Section 61.
[51] Section 496.

PDS".[52] Under the FMCA, material information in relation to a regulated offer is defined in s 59(1) to mean information that:

> (a) a reasonable person would expect to, or to be likely to, influence persons who commonly invest in financial products in deciding whether to acquire the financial products on offer; and
> (b) relates to the particular financial products on offer or the particular issuer, rather than to financial products generally or issuers generally.

This definition is similar to the common law idea of materiality used under the SA, but with the addition of being aimed at those who "commonly invest". Thus it could be at odds with the "prudent but non-expert person" that the PDS is constructed for, as those who commonly invest are likely to have more knowledge and experience (and therefore possibly a different view on what is material) than the prudent but non-expert investor. Compensation orders can be made on the application of the FMA or any other person for a contravention of a civil liability provision.[53]

2. *Why Did the FMCA Come About?*

Coming into force in 1979, the SA was due for an update considering the large changes in the financial market over the 30 plus years that it had been in force. These changes spanned both the way in which capital is raised, and the products available for investment (for example, moving to more electronic forms in capital markets and the use of derivative products).

A comprehensive "Review of Financial Products and Providers" by the Ministry of Economic Development (MED) was conducted between 2005 and 2008. One of the documents included in this review regarded securities offerings, which was concerned in particular with the structure and content of disclosure documents.[54] Furthermore, the Capital Market Development Taskforce (CMDT) was established in 2008 to identify key constraints and opportunities for the development of New Zealand's financial system, to identify and debate options to improve the performance of the financial system, and to construct an action plan for the development of the financial system.[55] The CMDT recommended a fundamental review of the SA. One of the key recommendations of the CMDT was the improvement of information available to investors, such as the simplifying and standardizing of product disclosure to give investors a clearer

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[52] Section 57(1)(b)(ii).
[53] Section 494.
[54] *Financial Markets Legislation Handbook* (Brookers, Wellington, 2013) at 1.1.
[55] Ministry of Business, Innovation & Employment "Capital Market Development Taskforce" (2012) Ministry of Economic Development <http://www.med.govt.nz/business/economic-development/capital-market-development-taskforce>.

understanding of what they are investing in.[56] This, and many other of the recommendations from the CMDT, were supported by the government and incorporated into the FMCA.[57]

The FMCB was also introduced in part as a response to the "unfortunate activities" that occurred in the finance sector in the 2000s with the GFC proving detrimental.[58] This resulted in the collapse of many financial companies and significant losses of investor money, the consequent prosecutions highlighting the gaps in our previous law. While some New Zealanders lost savings due to investment failure or 'misjudgment' as in the case of Lombard, others lost money through more deliberate actions. So, with the FMCB comes the hope that the trust that has been lost by investors in our financial sector can be rebuilt, and consequently, the hope that investors will put capital back into New Zealand companies.

3. *Civil Liability Under the FMCA*

As discussed above, civil liability under the SA for misstatements was clearly ineffectual for investors, with the only successful enforcement under the SA thus far being criminal. One of the last opportunities for a successful civil liability case occurred this year in *Houghton,* but the case was decided in favour of the defendants.[59] Consequently, the FMCA deals with the previous barriers of reliance and causation by ostensibly removing the reliance requirement, and by introducing a rebuttable presumption of loss termed "loss causation". In a fundamental change from the SA, s 496 FMCA states that a person "must be treated as having suffered loss or damage *because of the contravention*", unless it is proved otherwise.[60] Loss causation looks at whether the statement or omission in question actually caused the loss.[61] In the recent United States Supreme Court decision of *Dura Pharmaceuticals,* it was held that an inflated purchase price does not prove loss causation.[62] This is because at the moment of purchase, the purchaser owns a share that possesses the same value as that of the inflated price.[63] Furthermore, in the time that lapses between purchasing a share and its decline in value, several other factors could have impacted on the price.

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[56] Capital Market Development Taskforce *Capital Markets Matter: Executive Summary* (Ministry of Economic Development, Wellington, 2009) at 8.
[57] Capital Market Development Taskforce *Government Action Plan – Response to Taskforce Recommendations* (Ministry of Economic Development, Wellington, 2012) at 2.
[58] (27 August 2013) 693 NZPD 12985.
[59] *Houghton v Saunders,* above n 24.
[60] Section 496(3) (emphasis added).
[61] *Dura Pharmaceuticals, Inc. v Broudo* 544 US 336 (2005) at 6.
[62] At 6.
[63] At 6.

Controversially, the evidentiary burden is therefore shifted onto the issuer to rebut the presumption of causation by showing that the "decline in value was caused by a matter other than relevant statement, omission or circumstance".[64] However, due to the numerous factors that can affect financial markets and because of the complexities of investor behavior, difficulties will be faced in establishing this evidence and attributing an appropriate value to such factors. It appears reliance is also presumed, so as to reflect the "reality of how information is processed in financial markets" (i.e. through analysts, internet, news articles etc. that can influence investor decisions).[65] This means individual investors do not have to show reliance on a particular statement or on the PDS, which proved to be an almost impossible hurdle in previous SA litigation.

Section 496 introduces a "fraud on the market" type justification for the removal of reliance and causation (this idea will be discussed in the next chapter). However, the use of this concept comes at a cost. As we will see, the incorporation of this idea may not be entirely suitable for the New Zealand market, but it is possibly the most workable option to achieve the goal of making civil liability the primary consequence for misstatements. It is yet to be told how difficult it will be for issuers to rebut this presumption, and at what cost. In practice, expert evidence will be required from economists and other specialists to assess the decline in value that can be attributed to the misstatement or omission, and to the other factors established. The latest *Houghton* hearing is evidence of the length of securities litigation, the trial lasting 12 weeks not even including deliberation of the quantification of loss.[66]

Section 496 was originally clause 480 under the FCMB. Submissions on the Bill illustrate that the introduction of a rebuttable presumption of loss was not well received. The general feeling from major companies and law firms was that clause 480 should be removed. The FMCA was consequently clarified to establish that the presumption does not flow into the quantification of the loss, leaving this task up to the courts. Section 496(5) broadly allows "the court to make any order it thinks just to compensate an aggrieved person for the loss or damage in whole or in part". The joint firm submission of Bell Gully, Chapman Tripp, Russell McVeagh, and Simpson Grierson, was that clause 480(2), which states "A must be treated as having suffered loss or damage because of the contravention…" could not "be justified on orthodox legal and economic principles."[67] Minter Ellison Rudd Watts further submitted that "it is unprincipled to assume that all devaluation in a share's price is attributable to a contravention,

[64] Section 496(3).
[65] Investment Law *Financial Markets Conduct Bill – Officials' Report Part A: Main Issues* (Ministry of Business, Innovation & Employment, Wellington, 2012) at [59].
[66] *Houghton v Saunders*, above n 24. The hearing went from 17 March 2014 - 12 June 2014, with a judgment on 15 September 2014.
[67] Financial Markets Conduct Bill, cl 480(2); Commerce Select Committee *Financial Markets Conduct Bill: Summary of Submissions* (House of Representatives, Wellington, 2012).

particularly in circumstances where a trader's reliance on the defective disclosure cannot be established."[68] While it is true that a contravention will not necessarily make up the entire cause of the loss, this concern is somewhat balanced by the fact that the defendant has the opportunity to rebut the presumption by bringing factors to show that the loss was not caused purely by the defective disclosure.

However, short of weighing up competing expert evidence, it is not clear exactly how the court would attribute a value each of these factors, with no guidance given on the quantum of damages to be awarded. Allowing any order that the court thinks is "just" under s 496(5) leaves a lot of potential scope for each individual judge to decide what amount they see as appropriate; "in whole" or "in part" giving the judge discretion as to what extent they are satisfied with the evidence brought by defendants to rebut the presumption.

BNZ was the only company in support of the presumption of loss in clause 480.[69] Nonetheless, the clause was kept in the FMCB and remained largely unchanged in the FMCA. There are, however, some changes to note that arguably make the scope of s 496 even wider. Section 496 FMCA explicitly includes in subs (1) that the purpose of the section is "to provide that certain contraventions must be treated as causing a person to suffer loss or damage unless the contrary is proved" leaving no room for dispute about the presumption of causation. Furthermore, the section now extends to where "a person", no longer just "the offeror", contravenes the relevant sections or clause.[70] "Misleading or deceptive" in the FMCB is replaced with a statement that is "false or misleading" in the FMCA, perhaps making the section more targeted at statements or representations. Section 496 thus elucidates just how strong the parliamentary desire was to open up civil liability for misstatements – not only going against the majority of submissions on the FMCB, but taking the section even further.

4. *Policy Behind Section 496 Financial Markets Conduct Act*

"The liability regime is fundamental to the Bill".[71] This is to promote compliance with the regime, to deter conduct that undermines market integrity and confidence, and to provide effective compensation for those who suffer harm.[72] The main consideration for s 496 was the difficulty investors faced in obtaining compensation where a misleading or deceptive statement was made. Demonstrating causation and reliance under s 55G

[68] Commerce Select Committee *Financial Markets Conduct Bill: Summary of Submissions* (House of Representatives, Wellington, 2012) at 24.
[69] Commerce Select Committee, above n 68, at 6.
[70] Compare Financial Markets Conduct Bill, cl 480(1)(a)(iii) and Financial Markets Conduct Act 2013, s 496(2)(a)(iii).
[71] Investment Law, above n 65, at 3.
[72] Investment Law, above n 65, at 3.

proved almost impossible, hence the lowering of the standard of proof in the FMCA to make it easier for investors seeking recompense. MED acknowledged that this could result in more risk adverse behaviour by issuers, with the temptation to create larger disclosure documents to reduce liability.[73] However, this is countered by a shorter and more prescribed PDS. The aim of the more concise set of information in the PDS is to promote comparability between products, though still ensuring the most pertinent information is provided to prospective investors.[74]

Furthermore, MED recommended that a combination of serious criminal offences with the possibility of a significant period of imprisonment, regulatory offences with criminal penalties (mainly fines), and civil offences with pecuniary penalties be used.[75] It was recognized that while the penalties should be sufficient to deter contraventions, they should also be proportionate with the conduct. As essentially all consequences for misstatements under the SA were criminal, this was the impetus behind the shift towards a more effective civil liability provision.

With s 496, the FMCA is likely to be successful in inverting the liability pyramid to the logical and desired form, as illustrated in Figure 1. Submissions were that criminal liability should require a mental element of knowledge or recklessness, stepping away from the previous strict liability in the SA. Equally, concerns were also voiced about using a 'reckless' standard in the context of securities law, as the line between honest misjudgment and dishonest risk taking can be difficult to judge.[76] Conversely, civil liability provisions now involve strict liability, but defences are available and are a "critical part of the liability regime".[77] These include a due diligence defence and a reasonable reliance defence. By including these defences, guidance is provided as to a minimum standard of behavior for issuers to avoid liability.[78]

As for the presumption of loss in clause 480, MBIE stated "an effective civil liability regime is at the heart of the Bill."[79] Despite a lot of opposition, considering the policy reasons for the clause, in particular the desire for a stronger civil regime, it is clear why such a broad provision was chosen for compensation.

It is possible that with a civil section that is more favourable to investors, the FMCA could encourage investors to take responsibility for themselves instead of waiting for a

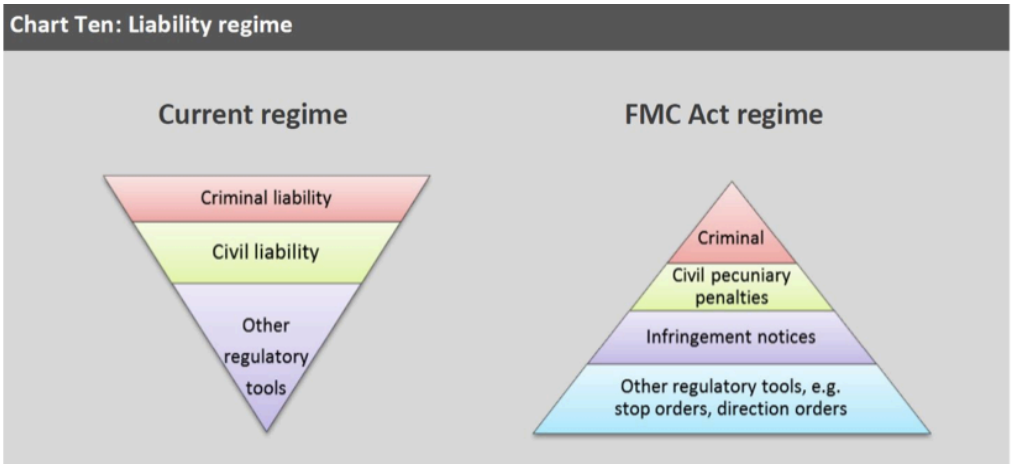
[73] Ministry of Economic Development *Review of Securities Law Regulatory Impact Statement* (Ministry of Business, Innovation & Employment, 2012) at 22.
[74] At 9.
[75] At 21.
[76] *Financial Markets Legislation Handbook,* above n 54, at 1.4.8.
[77] Investment Law, above n 65, at 7.
[78] See for example section 499.
[79] Investment Law, above n 65, at 8.

criminal charge to be brought by the Crown or relying on the FMA to take action. But there is a large cost associated with litigation, and in the New Zealand legal system litigants risk having to pay for costs of the other side if they are not successful. Hence for many investors, there will be no point in holding issuers to account. Civil redress may only be logical for large investors who lost significant amounts of money so that the potential gain would outweigh the cost of litigation, making it worth their while. Furthermore, there is no point in pursuing directors for civil damages unless they have the funds to compensate investors. Realistically, many directors will have structured their finances so as to 'not have access' to their money.

Saunders v Houghton opened up the possibility of a quasi class action in New Zealand, which will be discussed in the next chapter.[80] Section 496 may be of more use to investors if this quasi-class action scenario is accepted and becomes more widely used. Rule 4.24 of the High Court Rules allows for representation orders, a type of "class" action, for "persons having the same interest". However, this must be balanced with High Court Rule 1.2, which calls for "just, speedy and inexpensive determination of the proceeding". This "just" requirement is "overriding".[81] In *Saunders*, the Court of Appeal was wary that the position of the defendants was "just"; if the procedure were to leave an element of the defence unaddressed, it may be fatal to the application.[82] However, if an application were successful, it would allow investors who invested smaller amounts of money to pool together their resources and leave them with less exposure to liability. This would open up a new era for investor compensation in New Zealand, giving purchasers who suffered loss a realistic opportunity to enforce their rights.

So, in order to achieve this reversal of the liability regime the FMCA employs a version of the fraud on the market theory that has been used in United States securities regulation for 30 plus years. In short, this theory links investors' loss with the relevant misstatement by presuming that any public misrepresentation will be incorporated into the stock price. Consequently when the truth comes out and prices drop, investors can be presumed to have indirectly relied on the false statement. Fraud on the market is predicated on the relevant market being efficient; the market in an IPO is not efficient. Thus we can see a tension between the market conditions that s 496 will be useful in and the market assumed in the theory underlying the provision. The concept of fraud on the market and the underlying efficient markets hypothesis will be discussed in more depth in the following chapter.

[80] *Saunders v Houghton,* above n 21.
[81] *Saunders v Houghton*, above n 21, at [13].
[82] *Saunders v Houghton*, above n 21, at [13].



Financial Markets Authority *A Guide to the Financial Markets Conduct Act 2013 Reforms* (Financial Markets Authority, Auckland, 2013) at 24

Figure 1

III. Financial Theory And Section 496

Considering that civil liability and compensation under the SA was so unsuccessful, Parliament required an effective new regime that would provide prompt relief for wronged investors. With the advantage of decades of tested securities law from the United States, the fraud on the market concept was introduced in New Zealand making the elements of civil liability under the FMCA much easier to satisfy. This section discusses fraud on the market and the theory underlying it, the efficient markets hypothesis (EMH). Traditionally, the EMH is required to invoke the fraud on the market concept, though it seems this may have been overlooked in New Zealand. A possible alternative to this theory called "fraudulent distortion" is also considered, which could potentially be a more suitable alternative in the context of New Zealand securities.

A. Financial Theory

1. Efficient Markets Hypothesis

Eugene Fama introduced the "efficient markets hypothesis" in his seminal paper *Efficient Capital Markets: A Review of Theory and Empirical Work* in 1969.[83] He defined an efficient market as a market in which "prices always 'fully reflect' available information."[84] The EMH comes in three forms: weak, semi-strong and strong form. The weak form of the EMH supposes that the information set available composes only historical prices; semi-strong form looks at "whether prices efficiently adjust to other information that is obviously publically available"; and strong form states that all information, public or private, is reflected in the price.[85] The semi-strong form of the EMH is the standard used in securities law.[86] Thus by employing the semi-strong form of the EMH, we are effectively regulating publically available information. This is so because in using the semi-strong standard, which looks at readily available public information, we are concerned with the accuracy of information that the notional investor would have access to when they are making investment decisions.

2. Fraud on the Market

The EMH is the basis for the fraud on the market theory. The theory states that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business… Misleading

[83] Eugene Fama "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 J. Finance 383.
[84] At 383.
[85] At 383.
[86] *Basic Inc. v Levinson* 485 US 224 (1988) at 992.

statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements".[87] Using the EMH, information that is publically available is incorporated into the stock price, thus any misleading statements made in offer documents are also incorporated into that price and may falsely inflate the amount purchasers pay for their securities. Because of this apparent price impact, the theory also presumes that an investor in an efficient market relies on the integrity of that market price, including the public statements or omissions embedded in it.

Consequently, the theory invokes a rebuttable presumption of reliance rather than requiring investors to prove direct reliance on a misrepresentation.[88] In securities litigation, the fraud on the market theory has its origins in the United States, where class actions are common. The critical question in securities class actions in the United States will normally center on the predominance requirement of Federal Rule of Civil Procedure 23(b)(3).[89] Pursuant to this rule, plaintiffs must show that questions common to the proposed class prevail over individual questions.[90] The presumption of reliance has accordingly been of significant value to plaintiffs bringing securities class actions in the United States. When the market in question is considered efficient, the inherently individual question of reliance can be turned into a class-wide presumption by using fraud on the market.

Because of the requirement of an efficient market, fraud on the market has only been applied in cases involving transactions on the secondary market. In fact, case law in America has ruled that it would not be available in an initial public offering (IPO), as the IPO market is not efficient one.[91] In an IPO, directors of the company set the price. Thus the mechanism of public trading is not available to impound all of the publically available information into the price to ensure that the price theoretically represents a share's 'true value'.

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[87] At 989.
[88] *Halliburton Co. v Erica P. John Fund Inc.* 134 US 2398 (2014) at [18]
[89] At [31].
[90] Federal Rules of Civil Procedure: Rule 23(b) "Types of Class Actions. A class action may be maintained if Rule 23(a) is satisfied and if: …(3) the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. The matters pertinent to these findings include: (A) the class members' interests in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already begun by or against class members; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and (D) the likely difficulties in managing a class action."
[91] *In re Initial Public Offerings Securities Litigation* 471 F 3d 24 (2d Cir) 24 (2006) at 18.

3. *Where it all Began – Basic v Levinson*

Basic v Levinson involved material misrepresentations surrounding a denial of merger negotiations prior to an official announcement being made.[92] Those who sold their stock prior to the formal announcement of the merger brought an action under r 10b-5, the rule promulgated by the Securities and Exchange Commission (SEC) corresponding to the anti-fraud provision section 10(b) Securities Exchange Act 1934.[93] The rule prohibits fraud, misrepresentation, and deceit in the sale and purchase of securities in the secondary market.[94] In 1988, *Basic* established that a presumption of reliance could be invoked in securities actions under this rule by using the fraud on the market theory. The court stated that the presumption was "supported by common sense and probability", noting that buyers and sellers rely on market integrity.[95]

To invoke the presumption of reliance investors must show:[96]

(1) that the alleged misrepresentations were publically known,
(2) that they were material,
(3) that the stock traded in an efficient market, and
(4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed.

Each of these elements must be satisfied before class certification stage. That is, plaintiffs cannot merely plead that common questions of reliance predominate over individual ones; *Basic* requires them to prove such predominance with the elements in the test above.[97] Without the advantage of invoking the presumption, class actions would be effectively prevented as individual issues would overwhelm the common ones, making class certification under Rule 23 unachievable.[98]

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[92] *Basic Inc. v Levinson,* above n 86.
[93] Securities and Exchange Act 15 USCS § 78d established the Securities and Exchange Commission (SEC), the body responsible for regulating securities markets.
[94] Securities Exchange Commission 17 CFR § 240.10b–5 states: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,
b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

[95] *Basic Inc. v Levinson*, above n 86, at [991].
[96] *Halliburton Co. v Erica P. John Fund Inc.,* above n 88, at [19] and [31].
[97] *Halliburton Co. v Erica P. John Fund Inc.,* above n 88, at [31].
[98] At [31].

Basic has since faced criticisms, an overview of which can be seen in the recent dissent in *Halliburton*.[99] One of the principle criticisms is against the validity of the EMH itself, with evidence to show that even well developed markets such as the New York Stock Exchange do not consistently incorporate information into prices efficiently.[100] Secondly, Justice Thomas stated that plaintiffs must show that they were actually defrauded by the defendant's misrepresentation.[101] He noted that without a connection between the defendant's misrepresentation and a plaintiff's injury, "Rule 10b-5 is reduced to a 'scheme of investor's insurance' because a plaintiff could recover whenever the defendant's misstatement distorted the stock price – regardless of whether the misstatement had actually tricked the plaintiff into buying (or selling) the stock in the first place."[102] Furthermore, the assumption that investors unconditionally rely on the integrity of the market price is "simply wrong".[103] In fact, many investors trade for the opposite reason, believing that the market has under or over priced the stock, and that they can profit from that mispricing.

These criticisms are all pertinent to the New Zealand market – we must be careful to not be too hasty in presuming causation and reliance when our market is significantly smaller than the American markets, thus amplifying doubts about the EMH and a potential "investors insurance scheme".

B. *Financial Markets Conduct Act 2013*

1. *Section 496*

The Financial Markets Conduct Act 2013 incorporates some of this theoretical background into New Zealand securities legislation via section 496, but according to the Ministry of Business, Innovation and Employment (MBIE), it "does not go as far" as fraud on the market.[104] A person can be liable under s 496 for contravening ss 82 and 99 or cl 27(1)(a)(i) of sch 1.

Section 82 deals with false or misleading statements, omissions and new matters requiring disclosure; s 99 deals with defective ongoing disclosure, and cl 27 of sch 1 deals with false or misleading statements or omissions. False, misleading and deceptive statements and information may be so by reason of:[105]

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[99] See Justice Thomas' dissent in *Halliburton Co. v Erica P. John Fund Inc.*, above n 88.
[100] At [55].
[101] At [48].
[102] At [49].
[103] At [54].
[104] Investment Law, above n 65, at [56].
[105] Section 13(1).

(a) the form or context in which the statement or information is made, published or provided; or
(b) the omission of any other information that is material in the form and context in which it is made, published or provided.

Each of these sections require that the matter is "materially adverse from the point of view of an investor" and provide that a statement must be misleading if it is a statement about a future matter, and the person making it does not have "reasonable grounds" for doing so.[106] As noted in the previous chapter, material information is defined in s 59(1) FMCA. If we consider this in light of previous case law, materiality is to be judged from the point of view of the reasonable investor, not any one actual investor.[107]

2. *How Does The Financial Theory Fit With Section 496?*

Fraud on the market customarily establishes a rebuttable presumption of reliance in the United States. However, in New Zealand, it is a rebuttable presumption of loss causation that is created through the idea of fraud on the market. Reliance is not mentioned under s 496 meaning investors presumably no longer have to show individual reliance on the relevant misstatement. Together, these two changes should make a notable difference in the success of civil liability actions.

With the removal of any individual reliance requirement, the provision could also make it easier for the possibility of quasi class actions to be established in New Zealand. In the absence of class action rules, French J used the inherent jurisdiction of the court to allow hearing on issues common to the class in *Houghton v Saunders*.[108] It was recognized that reliance is required, but the scope of reliance (i.e. actual reliance or something less) and whether it was an individual or a common issue was contentious.[109] Thus by deeming reliance under s 496 FMCA, the issue of scope of reliance is avoided, and can easily be made a common issue so as to aid forming a "class" action in New Zealand.

By introducing a fraud on the market type idea to New Zealand securities legislation, Parliament has implicitly accepted the EMH. The EMH has strong supporters (for example, Eugene Fama), and critics (for example, Robert Shiller). Thus parties on either side of securities litigation can find legitimate academic support for or against the validity of a fraud on the market type justification. This makes it difficult for judges to decide what economic theory should be applied, or whether a particular market is efficient. When hearing oral argument for *Halliburton,* Chief Justice Roberts highlighted

106 Sections 82(1)(b) and s 82(2); ss 99(1)(b) and 99(1)(2); cls 27(1)(b) and 27(2).
107 *TSC Industries Inc v Northway Inc,* above n 14, at 449, accepted in *Coleman v Myers,* above n 14.
108 *Houghton v Saunders,* above n 25, at [34].
109 *Houghton v Saunders,* above n 25, at [27].

this problem saying: "how am I supposed to review the economic literature and decide which of you is correct on that?"[110] Court is not the appropriate place to decide what economic theory should be applied. Though perhaps the efficiency of the relevant market or the economic theory will not come into question at all in New Zealand, as the fraud on the market concept was introduced through legislation rather than by the courts. Therefore our courts would not have to consider market efficiency or what type of economic theory to apply, rather just take the wording of the statute on its plain meaning.

In any case, the United States has formulated a test to decide on the efficiency of markets that could be helpful for New Zealand. In *Cammer v Bloom* a five-factor test for market efficiency was established, though other factors may also be looked at.[111] The five factors are:[112]

(1) the stock's trading volume
(2) the number of analysts that followed and reported back on the stock
(3) the number of market makers
(4) the eligibility to file an S-3 Registration statement (this applies to those companies listed on a stock exchange)
(5) the reaction of the stock price on unexpected new events.

Many of these factors could be useful guidance in assessing the efficiency of New Zealand markets. Generally, companies listed on the New Zealand Stock Exchange (NZX) will be regarded as efficient, though this can also depend on the market capitalization of the company, and the liquidity of it's stock. The smaller companies on the NZX may struggle to meet the threshold of an efficient market. If the market is considered efficient, then the basis for the fraud on the market idea underlying s 496 could be acceptable as a tool to establish civil liability. One of the key objectives of the FMCA was to create effective remedies, including compensation.[113] Employing a presumption of causation and deemed reliance in s 496 is a workable way of achieving this aim.

However, as discussed above, an IPO situation will almost certainly not be an efficient market as directors set the initial price and there is accordingly no time lapse for public information to be incorporated into the stock price. This makes it difficult to justify the use of a fraud on the market type argument as the basis for s 496 in a primary market situation, as the underlying premise of an efficient market is not satisfied. It does,

[110] Lucian Bebchuk and Allen Ferrell "Rethinking Basic" (2014) 69 Bus. Law. 671 at 673.
[111] *Cammer v Bloom* 711 F. Supp. 1264 (D.N.J. 1989) at 1286-89.
[112] Above n 110, at 690.
[113] Investment Law, above n 65, at [54].

however, solve the policy problem of too many criminal charges and too few civil charges as the provision makes it much easier for investors to bring an action for compensation for misstatements in offer documents. Furthermore, before the presumption of causation is applied it is likely that a court must first find that there has been a misstatement that is materially adverse from the point of view of the investor.[114] This differs from the United States where materiality is left to the 'merits' stage, after class certification (established through the use of the fraud on the market theory) has been approved. Materiality thus acts as a filter for claims in New Zealand, providing some level of protection for issuers. Issuers can also bring evidence to rebut the presumption, with MBIE considering it is the issuer that is in the best position to know what outside factors may have impacted on share prices.[115]

The policy choice to use the EMH as the underlying basis for recovery under s 496 is therefore an imperfect one in many situations that may arise. However, it is a pragmatic response to the difficulties faced with the previous securities legislation. The United States has had over 30 years to consider the issues with the EMH and the fraud on the market theory, with a chance to overrule *Basic* this year in *Halliburton*. Yet the United States Supreme Court chose to remain with the rule formulated in *Basic*. Thus it is possibly the best alternative New Zealand could have opted for, as the policy decision was made with the advantage of being informed by the rich case history in the United States.

3. *Is There a More Suitable Alternative?*

Earlier this year, *Halliburton Co. v Erica P. John Fund Inc.* reached the United States Supreme Court and was a chance to re-evaluate the economic realities that underlie the *Basic* presumption.[116] Halliburton, an oil services company, was accused of lying about asbestos liabilities, overstating its revenues, and building up hype about its merger with another company. While considering the *Halliburton* case, Lucian Bebchuk and Allen Ferrell proposed an alternative approach to the fraud on the market theory called "fraudulent distortion".[117] The key question in fraudulent distortion is whether the public information that is the subject of the litigation affected market prices, as opposed to a question of market efficiency regarding all public information.[118] Bebchuk and Ferrell reformulated the *Basic* rule into the following three propositions for fraudulent distortion:[119]

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[114] Investment Law, above n 65, at [57].
[115] Investment Law, above n 65, at [55].
[116] *Halliburton Co. v Erica P. John Fund Inc.,* above n 88.
[117] Above n 110.
[118] Above n 110, at 686.
[119] Above n 110, at 686.

(1) The price of a security traded in a public market will reflect some publically available information about a company;
(2) Accordingly, a buyer of the security in a public market may be presumed to have relied in purchasing the security on the market price not being fraudulently distorted, i.e., not being different from what it would have been absent the disclosure deficiency; and
(3) Where the market price for a security is not fraudulently distorted, a plaintiff cannot invoke the class wide reliance presumption.

Under this test the contention about whether the market in question is efficient, or if the EMH actually holds, is avoided. Considering the New Zealand context of an IPO, or even in the case of thinly traded stocks on the secondary market, fraudulent distortion may be more appropriate than fraud on the market. The test allows the burden to be placed either on the plaintiff or defendant depending on what policy objectives are viewed as the most important; the issuer could still have the burden of showing other factors to prove the decline in value was not due to the contravention, as was suggested by MBIE. Fraudulent distortion does not prove loss causation or materiality, which would still be required. Therefore, the hurdle of causation would be re-introduced into our securities law, which may not be so desirable given past difficulties.

To identify fraudulent distortion, common tools of economists such as event studies can be used. These studies involve a regression analysis with the aim of showing that the market price of the defendant's stock generally responds to relevant publicly reported events.[120] This can be carried out at the time of contravention, though it may be of little help if the misrepresentation was a confirmatory lie (as there would not necessarily be any change in price because the statement would be confirming what is already public knowledge, and thus already incorporated in the stock price).[121] An event study can also be carried out at the time of corrective disclosure by looking at whether there was a price reaction when the market learned the truth about the misstatement. Equally, an event study could be used even if not looking for fraudulent distortion in particular, rather to gauge market efficiency / as a general study on the change in share prices relative to the misrepresentations.

4. *Measuring Loss in New Zealand*

While there is no useful authority for measuring loss caused by a misstatement in offer documents, the insider trading provisions from the SMA provide some aid. By looking

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[120] *Halliburton Co. v Erica P. John Fund Inc.,* above n 88, at [38].
[121] Above n 110, at 692.

at the case of *Haylock v Patek*, we can gain insight into some of the methods used to value different contributing factors.[122]

Haylock was the first insider trading proceedings to go trial in New Zealand, following almost 9 years of litigation. The case was regarding a takeover of Southern Petroleum (Southern) by Fletcher Challenge Energy (FCE). It was alleged that FCE was aware of a deep gas prospect containing significant amounts of gas that could be commercially extracted, and consequently Mr. Patek (who held Chief Executive and directorship roles of various companies involved) possessed inside information that was not publicly available but that was likely to materially affect the price of Southern's shares. Plaintiffs sought compensation based on the difference between what they were paid for their shares of Southern during the takeover (75 cents per share) and the estimated market value of the shares had the information been disclosed to the public (values ranging from an additional $1.24-$11.35 per share).[123]

To reach the potential differences in the value of the share price with and without the information about the gas prospect, technical and expert evidence was given in three categories: geological and gas valuation; experts' price analysis based on geological and other expert evidence; and evidence from share brokers. Experts used variations of a net present value (NPV) calculation of the gas prospects to reach a counterfactual situation. The NPV was then calculated to reach a per share price difference.[124] It was concluded that share price variability of plus or minus 10% was normal for listed companies, with up to a 15% margin for exploration and production companies due to the inherent volatility of prices for such companies.[125] Thus the plaintiffs in *Haylock* were required to show that the share price was likely to be materially beyond the 15% margin, which they did not.

From *Haylock*, we can see that expert evidence is commonly used in litigation to examine the possible difference in share price with and without certain information available to the public. The case also shows that the stock market as a whole as well as industry specific factors may be considered in studying whether movement in share price is material. These methods are reminiscent of an event study, and could be used to identify fraudulent distortion in the market due to a misstatement or omission in offer documents.

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[122] *Haylock v Patek* [2009] 1 NZLR 351, [2009] NZCCLR 7.
[123] Russell McVeagh Litigation Alert "Shell Successfully Defends Insider Trading Claim" (2008) <https://www.russellmcveagh.com/Portals/1/Documents/Litigation%20Alert%20Archive/LitigationAlert_Nov2008_175.pdf> .
[124] *Haylock v Patek,* above n 122, for example at [417].
[125] At [465].

However, fraud on the market and fraudulent distortion are not the only methods used to establish civil liability for misstatements. The following chapter will consider the approaches taken in the United States, Australia and Canada. Each jurisdiction employs a different scheme for civil liability, though there are also some similarities that will be highlighted. Moreover, attributing a value to the particular loss is difficult in all jurisdictions. Both the United States and Ontario include a general formula in their legislation to quantify damages, providing a simple starting point for litigants. Considering civil liability and the method for loss calculation in each jurisdiction makes for an interesting comparison in the next chapter.

IV. Comparison to the United States, Australia and Canada

Although s 496 draws from US law, it is interesting to consider the requirements other jurisdictions have under their civil liability regimes. The United States, Australia and Canada have all employed different methods of imposing civil liability for misstatements and omissions in offer documents. This chapter provides a general comparison between the different requirements of materiality, causation and reliance in each jurisdiction. Securities legislation is the focus, but it is noted that investors have other avenues for relief outside of this regime. Such possibilities include the torts of deceit or negligent misstatement, or under other appropriate fair trading legislation.[126]

A. United States of America

As noted in the previous chapter, the United States can be seen as the home for the fraud on the market theory, which is employed in the secondary market under SEC r 10b-5. Also of interest is s 11 Securities Act 1933, which provides an avenue for recovery of damages for misstatements or omissions in the registration statement, and includes guidance on quantum of damages.[127]

1. Legal Tests

The United States uses the concepts of 'transaction causation' and 'loss causation' in securities law. Transaction causation is comparable to reliance in New Zealand – showing that the plaintiff would not have made the investment if he or she knew of all the facts. This must be proven in traditional reliance based actions, for example where a purchaser was involved in a face-to-face transaction such as buying shares from a non-publically listed issuer, or in an IPO.[128] These are situations where there is no reason to presume an efficient market exists and are in contrast to an efficient secondary market where transaction causation can be shown by the fraud on the market theory. As may be recalled, loss causation is the causal connection between the material misrepresentation and the loss.[129]

(a) Rule 10b-5

[126] For example see Trade Practices Act 1974 (Cth), ss 52 and 82.
[127] Securities Act 15 USCS §77K.
[128] Merritt Fox "After *Dura:* Causation in Fraud-on-the-Market Actions" (2006) *J. Corp. L.* 829 at 838.
[129] *Dura Pharmaceuticals, Inc. v Broudo*, above n 61, at 5.

SEC r 10b-5 provides for claims against an issuer for misrepresentations or omissions of material facts.[130] To establish a claim under r 10b-5, a plaintiff must prove:[131]

(1) A material misrepresentation or omission by the defendant;
(2) Scienter (knowledge of the relevant person / issuer);
(3) A connection between the misrepresentation or omission and the purchase or sale of a security;
(4) Reliance upon the misrepresentation or omission;
(5) Economic loss; and
(6) Loss causation

In the case of an omission, it is problematic to prove reliance as it is difficult to say that there has been reliance on matters that are not stated. To demonstrate reliance, a plaintiff would have to show that they had the opposite of the omitted facts in mind, which would be almost impossible.[132] Presumed reliance through fraud on the market therefore also circumvents this issue.

The United States Supreme Court found in *Basic* that defendants are able to rebut this presumption of reliance by showing that the price was not affected by their misrepresentation.[133] This would rebut the fraud on the market theory itself by showing that the underlying assumption of an efficient market is not present. *Basic* also established that showing that the plaintiff did not trade in reliance on the integrity of the market price could rebut the presumption of reliance.[134]

Without the need to prove causation or reliance in an efficient secondary market, materiality is left as the main filter for securities class actions under r 10b-5 – "it is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant".[135] *Basic* emphasized the importance of the materiality requirement, stating that disclosure is required when the information becomes material for a reasonable investor's decision.[136] The definition of materiality from *TSC Industries* was applied in *Basic*, and states that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[137] While it is difficult to define the reasonable investor, the *Texas Gulf Sulphur* case highlighted

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[130] Securities and Exchange Act 15 USCS §78l; Securities Exchange Commission 17 CFR § 240.10b–5
[131] *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds* 133 US 1184 (2013) at 1192.
[132] Michael Duffy "'Fraud on the Market': Judicial Approaches to Causation and Loss from Securities Nondisclosure in the United States, Canada and Australia" (2006) 29 MULR 621 at 626.
[133] *Basic Inc. v Levinson,* above n 86, at [248-249].
[134] Duffy, above n 132, at 630.
[135] *Basic Inc. v Levinson,* above n 86, at [987].
[136] At 231-232.
[137] Above n 14, at [449].

that the materiality test involved the reasonable person, not simply a "prudent" or "conservative" investor.[138]

(b) Section 11 Securities Act 1933

Section 11 Securities Act 1933 makes issuers liable for registration statements that "contained an untrue statement of a material fact or omitted to state a material fact required" to make the statements not misleading.[139] A purchaser can bring a suit under s 11 even if he or she bought the security on the secondary market, as long as he can trace the purchase back to the initial offering.

When legislating s 11 Securities Act 1933, it was recognized that recovering damages at common law was extremely difficult due to the requirement of establishing knowledge, reliance and causation.[140] Thus to achieve the objectives of securities legislation, which included "a philosophy of full disclosure", purchasers are not required to show reliance on any particular misstatement in the registration statement.[141] The exception to this is "where the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement".[142] In this situation the right of recovery is conditional "on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying on upon the registration statement and not knowing of such omission."[143] Even so, the plaintiff need not show that he or she actually read the statement to prove reliance.[144]

Section 11 also relieves the plaintiff from the burden of proving causation. Though as a sort of reverse causation, the defendant can mitigate the amount payable in damages by showing that the decline in price was not caused by his or her misconduct.[145] Therefore s 11 again leaves materiality as the primary filter in United States securities litigation.

All defendants apart from the issuer have a due diligence defence.[146] Because of this, section 11 is generally regarded as a strict liability offence for the issuer. However, there

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[138] *SEC v Texas Gulf Sulphur Co*. 401 F.2d 833 (2d Cir 1968) at 849.
[139] Securities Act 15 USCS §77k.
[140] Greg Golding "The Reform of Misstatement Liability in Australia's Prospectus Laws" (LLD Thesis, University of Sydney, 2001) at 144.
[141] Michael Duffy "'Fraud on the Market': Judicial Approaches to Causation and Loss from Securities Nondisclosure in the United States, Canada and Australia" (2006) 29 MULR 621 at 624.
[142] Securities Act 15 USCS §77K.
[143] Securities Act 15 USCS §77K.
[144] Securities Act 15 USCS §77K.
[145] Notes "Causation of Damages Under Section 11 of the Securities Act of 1933" (1976) 51 N.Y.U. L. Rev. 217.
[146] Securities Act 15 USCS §77K.

is one exception: all defendants can show that the plaintiff knew of the untruth or omission at the time of his or her acquisition of the security.[147]

2. *Measure of damages*

(a) Rule 10b-5

There is no statutory guidance for calculating the appropriate measure of damages in r 10b-5. However, the measure of damages under r 10b-5 is based on the expectation measure of tort damages, putting the plaintiff into the position they expected from the performance of the promise. In the United States this is called "benefit of the bargain" damages.[148]

Inherent in r 10b-5 and the fraud on the market concept is the idea that the price of the security has deviated from its true value, hence investors should be compensated for the difference between these two values. However, establishing the true value of the security is difficult. Sneed J proposed the comparison of a "price line" and a "value line" in *Green v Occidental Petroleum Corp,* stating that the method would help each class member to "compute his damages by simply subtracting the true value of his stock on the date of his purchase from the price he paid therefor."[149] But because of the difficulty of estimating a value line, including attributing an appropriate portion of the decline to market and industry trends, it is accordingly difficult to measure damages.

Common methods used to estimate damages under r 10b-5 include event studies and a comparable index approach. The comparable index approach looks at the returns on a market and on an industry portfolio to estimate the value for each day of the class period.[150] Event studies on the other hand look at the impact on the security's price in the market on the specific event days.

(b) Section 11 Securities Act 1933

In contrast to r 10b-5, s 11 Securities Act 1933 stipulates the measure of damages recoverable in s 11(e). The amount recoverable is capped at the price that the security was offered to the public.[151] Damages under s 11(e) are a modified tort measure, which

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147 Louis Loss and Joel Seligman *Fundamentals of Securities Regulation* (5th ed, Aspen Publishers, New York, 2004) at 1230.
148 *McMahan & Co. v Wherehouse Entertainment Inc.* 65 F 3d 1044 (2d Cir 1995) at [1050].
149 *Green v Occidental Petroleum Corp.* 541 F 2d 1335 (9th Cir 1976) at 1344.
150 Paul Grier "Establishing Upper and Lower Limits for Settlement Negotiations in Rule 10b-5 Class Action Litigation" (1994) 4 J. Legal Econ. 1 at 2.
151 Securities Act 15 USCS §77K.

in basic terms equal the purchase price of the securities less their value at the time of the suit.[152] Section 11(e) states:

> The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and
> (1) the value thereof as of the time such suit was brought, or
> (2) the price at which such security shall have been disposed of in the market before suit, or
> (3) the price at which such security shall have been disposed of after suit but before judgment…

While the price of the security will be easy to ascertain, the "value" of the security at the time the suit is brought is not so clear. In *McMahan & Co. v Wherehouse Entertainment Inc.,* the Court noted the distinction between the term "value" and the terms "amount paid" and "price", indicating that price does not necessarily always reflect the value of the security.[153] However, the Court stated that market price was a good starting point in determining the value of a security, despite it not always being reliable.[154] The burden of showing that the defendant's statements artificially inflated the market price is on the plaintiff.[155] Furthermore, in general, any decline in the price of securities before the relevant disclosure may not be charged to the defendants.[156] It is also open to defendants to bring evidence to show that some or all of the decline in the price of the security is not due to the part of the registration statement in respect of which he or she is liable.[157]

This somewhat simple calculation is frequently used as an acceptable 'ballpark' figure in settlement negotiations, though it often reaches different results to an exact calculation from experts.[158] In practice, if a settlement is not reached expert witnesses will also be used to ascertain a more accurate figure for damages.[159]

B. *Australia*

The Corporations Act 2001 (Cth) governs securities law in Australia. Three types of disclosure documents are regulated under the Corporations Act: the prospectus, the profile statement and the offer information statement.[160]

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[152] Loss and Seligman, above n 147, at 1238.
[153] *McMahan & Co. v Wherehouse Entertainment Inc.,* above n 148, at [1049].
[154] *McMahan & Co. v Wherehouse Entertainment Inc.,* above n 148, at [1049].
[155] Loss and Seligman, above n 147, at 1238.
[156] *McMahan & Co. v Wherehouse Entertainment Inc.*, above n 148, at [1049].
[157] Securities Act 15 USCS §77K.
[158] Grier, above n 150, at 101.
[159] Grier, above n 150, at 101.
[160] Corporations Act 2001 (Cth), s 9 "disclosure document". See also ss 710, 714 and 715.

1. Legal Test

Underlying the Corporations Act is a principle-based approach, leaving issuers to decide what to put into disclosure documents rather than following a prescribed list. For example, s 710 provides a general disclosure test for prospectus content. Under this section a prospectus must contain all of the information that "investors and their professional advisers would reasonably require to make an informed assessment" of the securities.[161] The content of the statement extends only to information which it is reasonable for investors and their professional advisors to expect to find, and only if a person whose knowledge is relevant actually knows the information or ought reasonably to have obtained the information.[162] In deciding what is reasonably required, s 710(2) states that regard should be given to: the nature of the securities and of the body; the matters that likely investors may reasonably be expected to know; and the fact that certain matters may reasonably be expected to be known to their professional advisers. Section 710 also tables the type of offer with the relevant matters attaching to the offer. Such matters include the "rights and liabilities attaching to the securities", and "the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue (or issued) the shares, debentures or interests".[163]

Section 728(1) of the Corporations Act states that a person must not offer securities under a disclosure document if there is:

(a) a misleading or deceptive statement, or
(b) an omission from the disclosure document of material required by various sections, or
(c) a new circumstance that has arisen since the disclosure document was lodged, and would have been required to be included in the document.

Subsection (3) imposes criminal liability where the contravention is materially adverse from the point of view of an investor. [164]

Civil liability can be imposed for any of the three disclosure documents under s 729. The section creates a right to compensation for loss or damage "because" of an offer that contravenes s 728(1)[165]. Section 729 contains a table that imposes liability on people referred to for certain losses or damages. Strict liability is imposed on such persons for

[161] Section 710(1).
[162] Section 710(1).
[163] Section 710(1).
[164] Section 728(3).
[165] Section 729(1).

the corresponding contravention, generally being any contravention of s 728(1) in relation to the disclosure document, or the inclusion of the statement in the disclosure document.[166] However, several defences are available such as due diligence, lack of knowledge, and reasonable reliance.[167]

(a) Reliance, Causation and Materiality

The Australian provisions require materiality for criminal liability only in s 728(3) Corporations Act. In regards to omissions, liability is imposed for matters that are required by the stated sections to be included, with no reference to materiality.[168] However, underlying Australia's principle-based approach is the assumption that information that is reasonably required for investors to make an informed assessment inherently includes a materiality test.[169]

In the previous Australian Corporations Law 1989 (Cth), s 996 gave a defence for false or misleading statements in, or omissions from the prospectus, if "the statement or omission was not material"[170]. Under the Corporations Act, in place of this specific materiality requirement "recovery of damages will depend on establishing that loss has been suffered as a result of the misleading or deceptive statement, omission or new matter."[171] This indicates that the test has shifted from materiality to causation.

The move to causation as the main filter is made clear under s 729. The section requires that investors show they suffered loss or damage "because" of a contravention of s 728(1), with the relevant person being liable for the loss or damage "caused by" the contravention.[172] In the recent case of *Bolitho v Banksia Securities Ltd.,* the Supreme Court of Victoria considered cases under s 82 Trade Practices Act 1974 (Cth) (TPA).[173] Section 82(1) TPA provides that where a person suffers loss or damage "by an act of another person" that contravenes a relevant part (in this case regarding misleading and deceptive representations) that person could recover the relevant loss. Causation in this section is required through the use of the word "by", and can be likened to the requirement under s 729 that the damage is "because" of a contravention. Thus case law regarding the TPA is helpful in interpreting causation and reliance in the Corporations Act.

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[166] Section 729(1).
[167] See ss 731, 732 and 733.
[168] Section 728(1).
[169] Joanna Khoo "Civil Liability for Misstatements in Offer Documents: Striking the Right Balance" (2010) 6 Int'l L. & Mgmt. Rev. 49 at 60.
[170] Corporations Act 1989 (Cth), s 996(2)(a).
[171] Corporate Law Economic Reform Program Bill 1998 (Explanatory Memorandum) (Cth) at 8.8.
[172] Section 729(1).
[173] *Bolitho v Banksia Securities Ltd* [2014] VSC 8 at [26].

In *Janssen-Cilag Pty Ltd. v Pfizer Pty Ltd.*, considered in *Bolitho,* the judge found that the loss must directly result from the contravening conduct.[174] Furthermore, when considering the more general provision regarding misleading and deceptive conduct in relation to securities under s 995 Corporations Act, the judge in *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd* held that merely providing the opportunity to enter into a transaction will not suffice; compensating investors regardless of the effect of the misleading conduct on their decision is not warranted.[175] The misleading behaviour in question must therefore have an impact on the investor's decision. *Campbell v Backoffice Investments Pty Ltd* considered a similar misleading and deceptive conduct provision under the Fair Trading Act 1987 (NSW), Giles JA noting that the "essential question" was causation.[176]

Therefore it is evident that proof of causation is the fundamental requirement in Australia. The burden of demonstrating causation is somewhat balanced by the deemed reliance provided in s 729. Pursuant to s 729(2) a person who "acquires securities as a result of an offer that was accompanied by a profile statement is *taken to have acquired the securities in reliance* on both the profile statement and the prospectus for the offer".[177] The profile statement is a document that sets out limited key information about the company and the offer. Under s 721, the profile statement may be sent out with offers with ASIC approval. The prospectus must still be prepared and lodged with ASIC, and investors are entitled to a copy if they ask for it.[178] Thus a form of deemed reliance on the relevant statements or omissions would appear to apply even if the investor did not so much as receive a copy of the prospectus.

Under s 729 recovery is allowed from persons "even if the person did not commit, and was not involved, in the contravention." This strict liability indicates that the investor need not show reliance upon the particular persons or the statements made by those particular persons. It would seem, therefore, that reliance on a misstatement by one director, for example, would be adequate to show causation for claims against all directors, the company and the underwriter.[179]

2. *Measure of Damages*

[174] At [26].
[175] At [29].
[176] *Campbell v Back Office Investments Pty Ltd* [2008] NSWCA 95.
[177] Section 729(2) (emphasis added).
[178] Section 705. Contents of the profile statement is prescribed in s 714.
[179] Duffy, "Investor Loss From Securities Non-Disclosure: A Statutory Presumption of Causation on the Canadian Model?", above n 132, at 972.

The Corporations Act is silent on the measure of damages that is to be awarded to investors for loss or damage for a contravention of s 728. In theory, the amount of damages should be the value between the "actual value" of the securities at the time of allotment and the amount the investor paid for those securities.[180] In reality, however, it is much more difficult to ascertain what the actual value would have been. The value of securities can be affected by not only the misstatements in, or omissions from, the prospectus, but also various other market factors (despite the EMH). The true value of a security will consequently be difficult to discern, particularly in the context of an IPO.

Under *Leadenhall Australia Ltd v Peptech Ltd,* the Supreme Court of New South Wales held that the onus was on the plaintiff to lead whatever evidence was relevant to show the amount of their loss when assessing the quantum of the damages.[181] This case was in regards to civil liability for alleged breaches of misleading and deceptive conduct under the Fair Trading Act (NSW), the TPA and the Corporations Law.[182] However, it would be reasonable to presume the same principles should apply to recovery of damages under s 729 Corporations Act given the similarities in the legislation.[183]

C. Canada

Canada, in particular Ontario, is of interest due to the method it has taken in regards to calculating damages for loss following from a misrepresentation in a prospectus. A formulaic approach is taken in s 138.5 of the Ontario Securities Act 1990 (OSA), giving the court more guidance than is found in the equivalent New Zealand and Australian provisions.[184]

1. Legal test

Liability for a misrepresentation in a prospectus is set out in s 130 OSA. Subsection 130.(1) provides that when a prospectus contains a misrepresentation, a purchaser of the securities offered during the distribution period has "without regard to whether the purchaser relied on the misrepresentation" a right of action for damages against the issuer, the underwriter, every director, every person whose consent to disclosure of information in the prospectus has been filed, and every person who signed the prospectus.

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[180] Golding, above n 140, at 130.
[181] *Leadenhall Australia Ltd v Peptech Ltd* [2001] NSWCA 272 at [16].
[182] See Fair Trading Act 1987 (NSW), s 68; Trade Practices Act, ss 52 and 82; and Corporations Law, s 1005.
[183] Robert Austin and Ian Ramsay *Ford's Principles of Corporations Law* (14th ed, LexisNexis, NSW, 2010) at [22.430].
[184] Securities Act RSO 1990 c S.5, s 138.5.

Under section 1.(1) OSA, a misrepresentation means:

(a) an untrue statement of material fact, or
(b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

Material fact is defined as "a fact that would reasonably be expected to have a significant effect on the market price or value of the securities".[185] In relation to an issuer other than an investment fund, material change is defined in s 1 as (i) "a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer" or (ii) "a decision to implement a change referred to in subclause (i)…".[186] In *Kerr v Danier Leather Inc*, the Ontario Supreme Court upheld the decision that poorer fourth quarter results than projected was a material fact, but was not a material change.[187] *Kerr* illustrates a how "material change" is to be distinguished from a "material fact". Material fact is defined more broadly than material change, and an important difference in these two standards is that issuers are not required to update "material facts" occurring after the prospectus is delivered unless they amount to a "material change".[188]

Ontario introduced a deemed reliance provision for liability for misrepresentation in prospectuses using direct language in s 130 OSA. This presumption makes certification for securities class actions possible, as it removes the requirement for each individual to prove that they relied on the misrepresentation.

Looking at s 130 in conjunction with the definition of misrepresentation, it is clear that the materiality of the relevant statement must be established, somewhat balancing out the advantage of presumed reliance. If a statement is not material, the presumed reliance afforded in s 130.(1) is of no use to investors as a misrepresentation would not be established, thus rendering the right of action invalid.

Most Canadian courts have rejected the fraud on the market concept, as their securities legislation does not include the same concept that is contained in the United States SEC r 10b-5.[189] Furthermore, actual reliance is necessary in tort for negligent and fraudulent

[185] Section 1.(1).
[186] Section 1.(1).
[187] *Kerr v Danier Leather Inc* [2007] 3 SCR, (2007) SCC 44 at 332.
[188] At 332.
[189] *CC&L Dedicated Enterprise Fund (Trustee of) v Fisherman* 18 B.L.R. (3d) 260, 15 C.P.R. (4th) 289, 8 C.C.L.T. (3d) 240, 109 A.C.W.S. (3d) 860 at [61].

misrepresentation.[190] However, in the Ontario case *Silver v Imax Corporation*, Justice van Rensburg held that it was open to the plaintiffs to attempt to establish reliance by class members as a fact by reference to the EMH – the basis for fraud on the market.[191] It thus appears that the EMH could be applied in Ontario, at least at the pleading or certification stage.

Section 130 provides defences such as showing that the purchaser had knowledge of the misrepresentation at the time of purchase, that the prospectus was filed without the person's knowledge or consent, or that the person had reasonable grounds to believe that the opinion of an expert was not a misrepresentation.[192] A due diligence defence is available to those other than the issuer or selling security holder if it is shown that they did not actually believe there was a misrepresentation, and that they carried out "such reasonable investigation as to provide reasonable grounds for a belief that there had been no misrepresentation."[193] The standard for reasonableness is that of a prudent person in the particular circumstances of the case.[194] Defendants may also show that a portion of the damages does not represent the depreciation in the value of the securities that were a result of the misrepresentation that was relied upon.[195]

2. *Measure of damages*

The OSA includes a formula to calculate the relevant loss. Section 138.5 assesses damages in favour of the person who acquired securities after the release of a document or public oral statement containing a misrepresentation, or after a failure to make timely disclosure.[196] In summary, the formulae are:[197]

1. For those where the securities are disposed of on or before the 10th trading day after the public correction of the misrepresentation, the damages will be the difference between the average price paid for the securities and the price received upon the disposition of the securities.
2. For those disposed after the 10th trading day of the public correction of the misrepresentation, assessed damages will be the lesser of
    a. An amount equal to the difference between the average price paid for the securities and the price received upon disposition of the securities, and

[190] At [61].
[191] *Silver v Imax Corporation* [2009] 86 C.P.C. (6th) 273, 184 A.C.W.S. (3d) 28 at [66].
[192] Sections 130(2) and (3).
[193] Section 130(5)(a).
[194] Christopher Nicholls *Corporate Finance and Canadian Law* (Thomson Canada Limited, Ontario, 2000) at 186.
[195] Section 130(7).
[196] Section 138.5 (1).
[197] Section 138.5.

   b. An amount equal to the number of securities that the person disposed of multiplied by the difference between the average price per security paid.
3. If the securities have not been disposed of, the assessed damages will be the number of securities acquired multiplied by the difference between the average price per security paid for those securities for the 10 days following the correction.
4. If there is no published market, damages will be the amount the court considers just.

Damages payable by the issuer are capped at the greater of five percent of the issuer's market capitalization or $1 million. However, this will not apply where a person knowingly made a misrepresentation or omission.[198]

Section 138.5(3) brings in the idea of "loss causation", providing that the "assessed damages shall not include any amount that the defendant proves is attributable to a change in the market price of securities that is unrelated to the misrepresentation or the failure to make timely disclosure." This would presumably allow a defendant to present evidence of a general downward movement in the market or other factors. Placing a cap on damages payable provides some security for issuers, hopefully preventing them from collapse if a large suit is brought. It is not clear, however, if the defendant could show that the market is inefficient, such that the foundation of the section itself does not hold. Nor does the law consider the possibility of loss for those who sell at undervalue during a period where positive news has not been disclosed.[199]

This simple formulation in s 138.5 provides a starting point for litigants to calculate approximate damages, such guidance potentially aiding settlement prior to court. This pre-trial settlement is often very significant where there are class actions. The section acts as a deterrent for issuers by placing the burden on the defendant to show that other factors contributed to the decline in value of the securities, otherwise giving the benefit of the doubt to the investor that the loss is entirely due to the issuer's wrongdoing. Expert opinion would still be required to calculate what portion of damages is attributable to factors other than the relevant misrepresentation. Though as discussed above, economists commonly use event studies and other tools for such calculations.

The purposes of the OSA are "to provide protection to investors from unfair, improper or fraudulent practices; and to foster fair and efficient capital markets and confidence in

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198 Duffy "Investor Loss From Securities Non-Disclosure: A Statutory Presumption of Causation on the Canadian Model?", above n at 132, at 982.
199 At 983.

capital markets".[200] Providing a route for effective compensation will help instil confidence in the markets by delivering assurance to investors that they will not unjustly lose money. The section also encourages investors to act as private enforcers of securities disclosure laws because they have a simple way to bring actions against issuers, moreover with the recent facilitation of class actions.

D. Comparison

Looking at each jurisdiction, it is clear that no one standard is used to create liability for misstatements in offer documents. Materiality is the main filter used in the United States, with no requirement of causation or reliance due to the use of the fraud on the market theory. Materiality also plays a role in Canada through the definition of misrepresentation, and is possibly also required for civil liability in Australia, though this is not so explicit.

Interestingly, Australia is the only jurisdiction considered that does not employ the fraud on the market theory in some form (assuming that Ontario courts continue to accept the EMH), instead placing the most emphasis on the causation element. While fraud on the market has been essential in the United States for the extensive use of class actions, Canada and Australia have only recently developed statutory procedures to facilitate class actions. The financial markets of Canada and Australia are of a similar size and sophistication, and the common law systems and jurisprudence are also comparable.[201] Thus it is interesting to consider that one jurisdiction has chosen to use fraud on the market, and one has not.

Conversely, reliance does not need to be proven in any of the jurisdictions considered. The Ontario Act uses very direct language in the removal of the reliance requirement, while Australia deems reliance under s 729(2). In the United States, the fraud on the market theory creates a rebuttable presumption of reliance.

Common to each jurisdiction considered is the opportunity for defendants to present evidence that other market factors were at play when considering the appropriate amount of damages. Each jurisdiction also effectively aims to distinguish between 'price' and 'value' in determining quantum of damages, but just how value is assessed is difficult everywhere. Hence formulations can be provided as a guide, but expert evidence will be required in essentially all securities litigation when attributing actual numbers to the relevant factors brought by defendants.

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[200] Section 1.1.
[201] Duffy "Investor Loss From Securities Non-Disclosure: A Statutory Presumption of Causation on the Canadian Model?", above n 132, at 973.

In light of this comparison, s 496 FMCA will be reconsidered in the final chapter. This will be done by applying s 496 to the Lombard scenario, and by contemplating if the wording and theory of this section was the best alternative for New Zealand out of those previously considered.

V. Where to From Here?

This chapter will reconsider the Lombard case scenario, and how it may have played out had it been decided under the FMCA. Doing so is beneficial to consider how the new section will be applied, and to contemplate if the aims of the new legislation (namely an effective liability regime) will be achieved. Finally, this chapter will consider whether parliament has adopted the best alternative for New Zealand from those considered in previous chapters.

A. Lombard Scenario Under Section 496?

By way of review, Dobson J found a number of untrue statements regarding liquidity in the Lombard prospectus and advertisements, as well as material omissions about the concerns directors held regarding the decreased cash available to the company. The elements of s 496 are set out below and will be applied to this scenario.

1. Did the Investors of Lombard acquire a financial product, as required by s 496(2)(a)(i) FMCA?

Financial product is defined under s 7(1)(a) to include a debt security. Investors of Lombard acquired debenture stock and unsecured notes. These investments come under the definition of debt security in s 8(1)(b)(i), being "a debenture, bond, or note".

2. Did the offer contravene s 82 as required by s 496(2)(a)(i)?

Section 82(1)(a)(i) requires that an offeror must not offer financial products of a regulated offer if there is a PDS or register entry that is false or misleading or likely to mislead, or an omission from the PDS or register entry of information that is required to be contained. The Lombard offer would be regulated offer under s 41(1)(a) as it was made to one or more people who would require disclosure. The prospectus and advertisements issued by Lombard would fall somewhere between a PDS and a register entry, though they would not strictly fall within a category due to the change in disclosure requirements under the new Act. Analysis will continue on the basis that these documents would have been in the required form. Because Dobson J found untrue statements and material omissions, which was defined under s 55(a) SA as (i) being misleading in the form or context, and (ii) being misleading by reason of omission, these statements would therefore also be found to be misleading or likely to mislead under s 82 FMCA.

3. *Is the matter materially adverse from the point of view of an investor pursuant to s 82(1)(b)?*

The SA required an omission to be material, thus Dobson J's ruling initially indicates the matter would also be material under the FMCA. Under s 59(1) FMCA, material is defined as meaning:

> (a) a reasonable person would expect to, or to be likely to, influence persons who commonly invest in financial products in deciding whether to acquire the financial products on offer; and
> (b) relates to the particular financial products on offer or the particular issuer, rather than to financial products generally or issuers generally.

The statements and omission were in regard to the particular issuer, i.e. the liquidity of Lombard who was issuing the products, thus satisfying s 59(1)(b). Moreover, those who commonly invest would consider the liquidity of the company they are investing in and the reduction of cash available to the company as influential in their decision making, therefore most likely satisfying s 59(1)(a). This is especially so in the context of finance companies.

4. *Did the financial products decline in value after the contravention as per s 496(3)?*

The products became essentially worthless when Lombard collapsed, clearly showing a decline in value.

5. *Outcome*

Section 496(3) therefore requires that the investors in Lombard must be "treated as having suffered loss or damage because of the contravention". Consequently, it is likely the directors would be found liable under s 496 for defective disclosure. No mental element is required on the part of the directors for this section. This is in contrast to the criminal provision, s 510, which covers offences of "knowingly or recklessly contravening prohibition on offers where defective disclosure in PDS or register entry". The directors were "honest men" who took their responsibilities seriously; as such they would not have been found to have knowingly or recklessly contravened s 82 as required for an offence under s 510 and accordingly would not have been criminally liable under the FMCA.

Thus liability would have been civil rather than criminal in this case, as was the aim for the FMCA. Conversely, a case such as *Petricevic* that found that the directors knowingly mislead investors would still be considered under s 510, with the directors of Bridgecorp likely to still be criminally liable. The FMCA would therefore identify between those who made an honest misjudgment and those who acted in bad faith.

B. Section 496 – the Best Alternative?

Section 496 is a better alternative than the previous civil liability section in the SA. The goal of more effective civil liability will almost certainly be achieved with the removal of causation and reliance requirements from s 496, which were the main hurdles in s 55G. Fraud on the market is used to achieve this end, following on from extensive consideration in United States law. However, s 496 has been implemented against the direction given from United States decisions, which held that fraud on the market should not be applied in an IPO. Instead, s 496 does not distinguish between the primary market and an efficient secondary market. Consequently it applies to situations where an efficient market may not be found and therefore the justification for fraud on the market does not apply.

Moreover, for clarity s 496 could have been more direct in removing the reliance requirement. Both the Ontario and Australian provisions overtly state the relevant position on reliance. The Ontario Act states that investors have a right of action "without regard to whether the purchaser relied on the misrepresentation", while the Australian provision deems investors to have "acquired the securities in reliance on both the profile statement and the prospectus". Conversely, the FMCA makes no mention of reliance, though given the aims of the Act this can almost certainly be interpreted to mean reliance is not an element in the provision.

Furthermore, a formula for damages could have been included for guidance. Both Ontario and the United States have devised reasonably simple formulas that could prove helpful to settle matters before trial. Instead no direction is given at all, which leaves even more room for considerable dispute in litigation – the recent *Houghton* decision evidence of just how long a securities trial already takes without even getting into damages.[202]

It is also curious that the formulation chosen for New Zealand does not follow the Australian provision more closely, considering the desire to bring the law of the two countries into closer alignment. However, the Australian formulation involves evidence

[202] *Houghton v Saunders,* above n 24.

of causation, which has clearly proved too difficult for New Zealand investors in the past (though it seems to be working in Australia). In the end, New Zealand has ended up with a position fairly similar to Canada with (what appears to be) deemed reliance, causation shown through fraud on the market, and materiality coming in as a filter through related sections / definitions. This is probably the most suitable option to achieve the aims of the FMCA.

VI. Conclusion

As can be seen, a wide range of factors must be contemplated when implementing a new civil liability regime for securities law. It seems that after a widely considered reform, New Zealand has a new regime that is not perfect on the financial theory, but which is suitable for the aims of the Act. Consequently, it is predicted that the new regime under the FMCA will successfully reverse the liability pyramid, creating greater civil liability and less criminal liability. This is desirable so that a distinction is made between those issuers who made a "misjudgment" and those who knowingly made misstatements.

After looking at other jurisdictions, there is no one regime that stands out as striking the perfect balance between investors and issuers. It is only with the policy of each jurisdiction and their respective markets in mind that a thorough comparison of each regime can be carried out. For New Zealand, the previous SA regime for civil liability was clearly too stringent in necessitating investors show causation, reliance and materiality, hence the lack of successful civil cases under that Act. As such, criminal liability was the only form of enforcement under the SA and was not effective in compensating investors for their loss. In contrast, s 496 FMCA moves closer to the approaches of the United States and Ontario, making civil liability much more investor-oriented – a drop in price of the security coupled with a respective misstatement is all that is required to invoke the presumption of loss. Just how courts will apply s 496 and calculate the relevant loss will be an interesting issue to follow.

Appendix

Section 496 Financial Markets Conduct Act

496 Person treated as suffering loss or damage in case of defective disclosure

(1) The purpose of this section is to provide that certain contraventions must be treated as causing a person to suffer loss or damage unless the contrary is proved.

(2) This section applies if—

(a) a person (A)—

(i) acquires financial products under an offer that contravenes section 82; or

(ii) acquires financial products, or makes further contributions, investments, or deposits in respect of financial products, after the issuer of the financial products contravenes section 99; or

(iii) acquires financial products under an offer where a person contravenes clause 27 of Schedule 1 in relation to that offer; and

(b) the financial products, contributions, investments, or deposits referred to in paragraph (a) have declined in value after the contravention referred to in paragraph (a).

(3) A must be treated as having suffered loss or damage because of the contravention unless it is proved that the decline in value was caused by a matter other than the relevant statement, omission, or circumstance.

(4) In this section, the relevant statement, omission, or circumstance is, as the case may be,—

(a) the statement that is false or misleading or is likely to be misleading referred to in section 82(1)(a)(i) or 99(1)(a)(i) or clause 27(1)(a)(i) of Schedule 1; or

(b) the omission referred to in section 82(1)(a)(ii) or 99(1)(a)(ii) or clause 27(1)(a)(ii) of Schedule 1; or

(c) the circumstance referred to in section 82(1)(a)(iii).

(5) This section does not limit section 495 (which provides for the court to make any order it thinks just to compensate an aggrieved person for the loss or damage in whole or in part).

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