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Economic and Financial Consulting and Expert Testimony

The Role of Economic Analysis in U.K. Shareholder Actions

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INTRODUCTION

Changes to the law and recent prominent cases indicate that high-stakes shareholder actions might be on the rise in the United Kingdom. The US experience in securities “class actions” (collective actions brought on behalf of a large group of investors) can provide valuable lessons on the importance of economic analysis in these disputes. In particular, event studies and other tools of financial economics can provide important insight into damages assessment. Experts can use event studies and other methods to analyse claims that alleged misstatements or omissions had an impact on stock prices.

Below we discuss recent relevant changes in the legal and regulatory landscape and three recent cases in the United Kingdom, before turning to a discussion of valuable economic tools.

Amidst a shifting litigation and regulatory landscape in the United Kingdom, financial economic tools commonly employed in US securities class actions may provide guidance for assessing damages in UK shareholder disputes.

LEGAL DEVELOPMENTS THAT MAY GIVE RISE TO AN INCREASE IN UK SHAREHOLDER ACTIONS

Financial Services and Markets Act 2000 (FSMA)[1]

The FSMA governs most aspects of the operation of securities markets, and provides the legal basis for the Financial Conduct Authority (FCA), the principal financial regulatory authority in the United Kingdom. Sections 90 and 90A of the FSMA, specifically, provide legal avenues for investors to recover losses suffered as a result of a company issuing false and/or misleading statements, or statements with material omissions. While private securities litigation remains largely untested in English courts, a number of recent shareholder claims in the United Kingdom, discussed below, relate to issues of statutory liability under the FSMA. The emergence of these cases—over ten years after the passing of the Act—is in large part due to a change in the landscape in the United States and the possibility of external investment in litigation.

Morrison v. National Australia Bank[2]

The US Supreme Court's 2010 ruling in *Morrison v. National Australia Bank* established that securities traded outside the United States are not within US jurisdiction, effectively prohibiting purchasers of securities on foreign exchanges from bringing lawsuits in the United States against the issuers of those securities. Parties wishing to recover losses for securities purchased outside the United States are now compelled to seek legal remedy elsewhere.

Funding

In the United Kingdom, a new wave of litigation funding may also fuel an increase in shareholder actions. Additionally, the issuance of "after the event" policies, in which insurers assume the claimants' risk of paying defendants' fees in a dismissed case, reduces the possible losses that claimants might face in a securities class action.[3]

Sources of litigation funding include existing funders, who are showing increased interest and involvement in pursuing shareholder class actions, as well as new entrants. For example, existing funder Therium announced a £200 million fundraising in May 2015, and recent entrant Bentham Europe placed conditional funding on the shareholder class action against Tesco.[4] This is a shift from earlier years, when the focus of funding was on traditional commercial claims.

RECENT HIGH-PROFILE U.K. SECURITIES CASES

Three recent cases in the United Kingdom highlight the types of shareholder actions that could become more prominent. Additional UK shareholder actions have been mentioned, although they have not yet been filed.

Royal Bank of Scotland (RBS)

This action related to a £12 billion rights issue in 2008. The claimants alleged that RBS's directors issued misleading statements in the period leading up to the offering, causing RBS's shares to trade at inflated prices. Specifically, claimants alleged that:

- RBS portrayed its acquisition of ABN AMRO Bank as proceeding well, when in reality the acquisition had damaged the balance sheet of RBS.
- RBS did not disclose its capital ratios or its reliance on nearly $12 billion of loans from the US Federal Reserve Bank.
- Investors claimed that these actions constituted a violation of Section 90 of the FSMA.[5]

RBS reached settlements between December 2016 and June 2017 with all claimant groups. The settlement amounts ranged from 41p to 82p per share purchased.[6]

Tesco

The Tesco case involved an alleged overstatement of profits that the firm reported for the first half of 2014. Specifically, on 22 September 2014, Tesco announced that it would revise its profits downward by £263 million for the half year. The same day, Tesco's shares fell 11.6 per cent.

The claimants sought compensation based on the price declines in Tesco stock that were allegedly caused by announcements related to allegedly improper accounting practices, in violation of Section 90A of the FSMA.[7]

Tesco agreed with the FCA in March 2017 that it would compensate eligible shareholders and bondholders who purchased shares or bonds at the inflated price. In the related Final Notice, the FCA determined the loss suffered by each purchaser should be calculated as the overpayment on each share or bond at purchase, less any mitigating amount, such as sales during the relevant period or hedging. A compensation scheme on Tesco's behalf was established for those affected to log their claims before 22 February 2018. The compensation could total more than £85 million plus interest.[8]

Lloyds Banking Group (Lloyds)

This action relates to Lloyds' acquisition of HBOS in January 2008. The claimants allege that Lloyds and some of its former directors encouraged shareholders to vote in favour of the acquisition without providing necessary information regarding the emergency liquidity assistance that HBOS was reliant upon.

The claimants are seeking losses suffered through the dilution of their shareholdings as a result of the issuing of shares to HBOS shareholders and the Treasury. The action is being brought through a Group Litigation Order in the English High Court.[9]

A judgement in December 2017 allowed Lloyds to increase its budget for this litigation. The trial began in October 2017 and continued through March 2018.[10]

TOOLS FROM FINANCIAL ECONOMICS

Since the passage of the U.S. Private Securities Litigation Reform Act (PSLRA) in 1995, shareholders in the United States have brought thousands of federal securities lawsuits. See Cornerstone Research, *Securities Class Action Filings—2017 Year in Review*. Experience there points to several areas where tools from financial economics may be particularly helpful in assessing issues related to liability, reliance and damages. For example:

- Was the omitted or misstated information important enough to give rise to liability under the securities laws?
- Did investors rely on the misrepresented information when they purchased the security?
- How much did investors overpay when they purchased the security at issue?
- How much did investors lose when corrective information was revealed to the market?

Event Studies Play a Prominent Role in Securities Cases

The event study—a tool from financial economics that examines the relationship between the public release of information and security price movements—plays a prominent role in U.S. securities litigation. When performed properly, an event study can often provide important insights into the above-discussed questions, since it can:

- Remove market and industry effects from price changes in order to isolate company-specific returns.
- Analyse whether a significant change in the total mix of public information regarding a company has occurred.

While an event study is often an important first step in a financial economist's analysis of a securities case, certain limitations mean that assessment of liability, reliance and damages generally requires financial analysis in addition to the event study itself. The event study and potential supplemental analyses are discussed below.

Event Studies as Typically Employed in Securities Litigation

Given the prominence and broad applicability of event study analysis, this section begins with a brief background discussion of event studies as economists often employ them in the context of US securities litigation.

An event study is a widely used and generally accepted analytical framework for investigating the effects of information on stock prices. Over the past fifty years, the event study methodology has been used and refined in academic research in the fields of finance and accounting.[11]

Securities class actions in the United States often proceed under the assumption that the security at issue trades in what economists call an "efficient market."[12] In an efficient market, stock prices quickly reflect the public release of new, value-relevant information.[13] To determine the stock price, the market uses all publicly available information. Such information includes data about the economy as a whole (market information) and the industry within which the company competes (industry information), as well as information about the company itself (company-specific information).

Because stock prices already reflect expected events and previous publicly available information, only "new" information (i.e., the unexpected portion of information) may cause price changes. Repetition of "old" information will not affect stock prices in an efficient market. Similarly, because stock prices reflect expectations of future cash flows (their level and risk), information that is not relevant for a company's future cash flows will not affect its stock price.

Isolating Company-Specific Price Movements

Event studies in US securities class actions typically employ the statistical method of linear regression to estimate market and industry effects in an attempt to isolate company-specific price changes. Market effects can often be estimated using a broad index of stocks (e.g., the Financial Times Stock Exchange (FTSE) 100 Index). Similarly, industry effects can often be estimated using an index comprising stocks of firms in the same industry. The price change that remains after attempting to extract the effect of market and industry information is often called the company-specific (or residual) price change.

Testing for Statistical Significance

Financial economists conduct standard statistical tests on company-specific price changes to assess their significance. Significant price changes indicate a significant change in the total mix of public information. To determine whether a price change is significant, "normal" stock price volatility is typically estimated over a control period. A standard statistical measure of normal behaviour during the control period is defined as the range that contains a specified fraction of observations. This range, or "confidence interval," depends on the normal variation or volatility of the residual price changes for a particular stock.[14] Residual stock price returns that fall within the normal confidence interval are not statistically significant and cannot be reliably attributed to company-specific information.

Event Study Limitations

The standard one-company event study employed in US securities class actions can measure only the combined effect of all information that reaches the market during the study's measurement window—typically one trading day. When multiple pieces of new information enter the market during that time frame, isolating the effect of any one piece of information on the company's stock price may require additional analysis, such as modifying the event study, conducting intraday stock price analysis, or constructing a fundamental valuation model.

Moreover, an event study can only measure the effect on a specific date of information that is actually disclosed. If one wants to estimate the effect of information different from that which is actually disclosed, or estimate the effect of information on a different date from that of the actual disclosure, additional assumptions and/or analyses to supplement the event study are required.

ASSESSING DAMAGES

While event studies and other financial economic analysis can be useful in assessing liability and reliance as well, we focus below on assessment of damages. Section 90 of the FSMA discusses damages as follows:

> Any person responsible for listing particulars is liable to pay compensation to a person who has (a) acquired securities to which the particulars apply; and (b) suffered loss in respect of them as a result of (i) any untrue or misleading statement in the particulars; or (ii) the omission from the particulars of any matter required to be included. . . .[15]

Damages in the United States are driven by the difference between the price actually paid for a security and its "real" value absent the alleged misstatements and omissions (inflation), and commentary suggests that a similar approach will be adopted in the United Kingdom: "An investor is entitled on a Section 90 claim to recover its full loss on the securities in question, calculated by reference to the true value of the securities (i.e., their price had the inaccuracy or omission not be made) against the actual price paid."[16]

In the United States, loss causation is another important consideration. Pursuant to the U.S. Supreme Court's decision in *Dura*,[17] any recoverable damages also are limited by the actual price declines caused by revelation of the allegedly withheld truth (corrective disclosures). Purchasing at an inflated price is not sufficient to establish recoverable damages, but rather plaintiffs must also show that they suffered losses in the real world attributable to revelation of the relevant truth, as opposed to other factors unrelated to the alleged fraud.

Event Studies in Damages Analysis

Because they can provide insight into the level of inflation and the magnitude of any losses caused by the alleged misstatements or omissions, event studies are frequently used to assess damages in U.S. securities class actions. Indeed, because they attempt to isolate company-specific price changes and indicate whether those changes can be reliably attributed to company-specific information (as opposed to statistical noise), many U.S. courts have, in fact, required them.[18]

Event studies can be used to analyse price changes at the time of the alleged misrepresentations, or at the time that the corrective information is revealed. These price impacts can provide valuable insight into damages by providing information relevant for assessing inflation (the amount by which the stock was overvalued due to the alleged misrepresentations) and/or loss causation (the magnitude of any price declines caused by correction of the alleged misrepresentations).

Using price changes at the time of an alleged misrepresentation to establish inflation. In some cases, using an event study to evaluate stock price movements following an alleged misrepresentation may be helpful in estimating damages. When the alleged misrepresentation is an affirmative misstatement, the company-specific return subsequent to that statement may establish how much inflation was introduced into the stock price at that time.

In many instances, however, analysis in addition to an event study may be required. For example, when other company-specific news is announced simultaneously, a financial economist may need to perform additional analysis to assess the stock price impact of that other news in order to isolate the price impact (if any) of the alleged misrepresentation and hence measure any inflation introduced into the stock.

Moreover, in cases where the alleged misrepresentation comprises an omission, event study findings at the time of that alleged misrepresentation are not relevant. An event study only measures stock price reaction to information that was actually disclosed, and cannot measure the impact of information that was not disclosed. In the case of an omission, a different analysis would be required to establish the amount of any inflation introduced, such as analysing stock price movement subsequent to the release of corrective information or building a fundamental valuation model.

Using price changes at the time of a corrective disclosure to establish inflation or losses caused by the alleged misrepresentations. In many cases, using an event study to estimate the residual stock price movement following an alleged corrective disclosure is a critical component of the damages analysis. Under certain circumstances, it may be feasible to equate company-specific price changes subsequent to an alleged corrective disclosure with earlier inflation caused by an alleged misrepresentation. Although, as discussed in the next section, additional analysis is frequently required.

In the United States, assessing stock price changes at the time of alleged corrective disclosures is also important because damages are limited by real-world losses caused by the alleged misrepresentations. Thus, to calculate recoverable damages, a financial economist must at a minimum isolate the portion of any stock price decline that occurred only in response to public revelation of the allegedly withheld truth. An event study can provide valuable insight into any such declines.

Situations Necessitating Supplemental Analysis

In some cases, once the allegedly withheld truth is defined, the standard event study discussed in the preceding section will be sufficient to estimate inflation and/or isolate losses caused by the alleged fraud by estimating company-specific stock price movements following alleged corrective disclosures. However, complications requiring analysis in addition to an event study are frequent—for example, when one or more of these circumstances are present:

- Disclosure with information unrelated to the plaintiffs' allegations
- Disclosure related to multiple alleged misrepresentations
- Disclosure related to misrepresentations that change in nature or severity during the class period
- Over- or under-disclosure of an alleged misrepresentation

Even assuming any loss caused by an alleged misrepresentation is measured appropriately, that loss (if any) cannot necessarily be used to measure alleged inflation earlier in the class period. For example, if non-fraud-related conditions change meaningfully between the time of the alleged misrepresentation and the time of the corrective disclosure, the price reaction to the corrective disclosure may not accurately measure earlier inflation.

Potential Supplemental Analysis

When an event study itself is insufficient to estimate price impact and hence alleged damages, the financial economist has supplemental economic tools to draw upon. For example:

- Review of prior public press can be useful in isolating what information disclosed on a particular day was new. In an efficient market, only new (unexpected) information will affect a stock's price.
- Review of investment analyst reports may provide insight into what importance (if any) financial professionals assigned to the alleged misrepresentation or correction at the time it was made.
- Fundamental financial analysis can be useful to assess what impact (if any) the alleged misrepresentation would be expected to have on future cash flows or discount rate, and hence stock price. In an efficient market, a company's stock price reflects market consensus regarding the value of future cash flows to its stockholders.
- Intraday stock price analysis may help disaggregate the stock price effects of multiple announcements which occur within the event study's analysis window but which are not simultaneous.
- Additional regression analysis—for example, modifying the length of the study event window or analysing past stock price reaction to similar events over time or across multiple companies—may also help estimate the price impact of alleged misrepresentations or corrective information.

TYPICAL PLAINTIFF DAMAGES APPROACH

A typical plaintiff approach to estimating damages in the United States is to "backcast," using residual price declines following alleged corrective disclosures, to estimate earlier inflation. Per-share damages for an individual plaintiff are then calculated as inflation at the time of purchase, less any inflation that remains at the time of sale.[19]

Using this typical plaintiff-style approach makes the following assumptions, among others:

- No confounding news: No other value-relevant, company-specific information was disclosed at the same time as the alleged corrective information.
- Equivalent disclosures: The corrective information disclosed is equivalent to what allegedly could and should have been disclosed earlier.
- Equivalent price effect: The mix of other information has not changed the value of the allegedly corrective information over time.
- No complications due to the changing nature or severity of misrepresentations: The allegedly withheld truth (i.e., what defendants could and should have disclosed to investors) did not change during the class period.

If any one of these assumptions does not hold, then this typical plaintiff approach will not reliably estimate damages. More rigorous economic analysis is required.

CONCLUSION

Until recently, shareholder actions alleging violations of UK securities laws have been virtually nonexistent. This is in stark contrast to the United States where securities class actions have been an integral part of the legal landscape for many years. However, recent cases and a number of legal developments point to a possible rise in the number of such actions in the United Kingdom. Because they are a relatively recent phenomenon, questions exist as to how certain key issues will be resolved by the courts. In this context, the US experience regarding the role of economic analysis in assessing issues related to liability, reliance and damages is likely to become increasingly relevant. In particular, valuable insight into these issues can be provided by the use of event studies and other tools from financial economics to analyse claims that alleged misstatements or omissions affected share prices.

ENDNOTES

[1] "The Securities Litigation Review," *Law Business Research*, June 2015.

[2] Morrison et al. v. National Australia Bank Ltd. et al., 561 U.S. 247 (2010).

[3] "Legal Expense Insurance," Financial Ombudsman Service.

[4] "Therium Raises £200m in Litigation Funding," *Financial Times*, 5 May 2015.

[5] Royal Bank of Scotland Group PLC, Form 20-F, filed 24 March 2016, p. 338; "The Future of Securities Litigation? Shareholders Sue RBS (in London)," *Reuters*, 3 April 2013; "RBS Investors Launch $6B Suit Over Pre-Bailout Stock Sale," *Law360*, 3 April 2013; "Scottish Prosecutors End Probe of RBS' $17.3B Stock Offer," *Law360*, 12 May 2016.

[6] "RBS £200m payout could set a precedent for shareholder action," *Financial Times*, 9 June 2017; "RBS Settlement with Majority of Claimants in 2008 Shareholder Rights Issue Litigation," RBS News Release, 5 December 2016.

[7] "Interim Results 2014/15," Tesco PLC, 23 October 2014; "Tesco to Face European Claim over Accounting Blunder," *Law360*, 24 March 2015.

[8] "Tesco to Pay £129M Fine for Market Abuse in Deal with SFO," *Law360*, 28 March 2017; "Tesco Compensation Scheme," *KPMG*, 23 February 2018; "Final Notice to Tesco Plc and Tesco Stores Limited," Financial Conduct Authority, 28 March 2017.

[9] Lloyds Banking Group PLC, Form 20-F, filed 8 March 2016, p. 9; "More Than 5,000 Join Lawsuit against Lloyds over HBOS Deal," *Financial Times*, 9 November 2014; "Lloyds Fails to Remove Key Allegation in HBOS Pre-trial Hearing," *Reuters*, 23 October 2015.

[10] "Lloyds Can Fatten Defense Fund in Shareholders' HBOS Suit," *Law360*, 2 January 2018.

[11] See, e.g., Eugene F. Fama et al., "The Adjustment of Stock Prices to New Information," *International Economic Review* 10, no. 1 (1969): 1–21; Stephen J. Brown and Jerold B. Warner, "Measuring Security Price Performance," *Journal of Financial Economics* 8 (1980): 205–258; Stephen J. Brown and Jerold B. Warner, "Using Daily Stock Returns: The Case of Event Studies," *Journal of Financial Economics* 14 (1985): 3–31; Eugene F. Fama and Kenneth R. French, "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics* 33, no. 1 (1993): 3–56; Mark L. Mitchell and Jeffry M. Netter, "The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission," *Business Lawyer* 49, no. 2 (1994): 545–590; John J. Binder, "The Event Study Methodology Since 1969," *Review of Quantitative Finance and Accounting* 11 (1998): 111–137; A. Craig MacKinlay, "Event Studies in Economics and Finance," *Journal of Economic Literature* 35, no. 1 (1997): 13–39.

[12] The U.S. Supreme Court's ruling in *Basic* allows claimants to establish reliance indirectly using the "fraud on the market" theory if they can establish that the stock at issue traded in an efficient market. Basic Inc. v. Levinson, 485 U.S. 224 (1988). The most important test of whether a stock trades efficiently is whether a cause-and-effect relationship between new, value-relevant information and stock price movement can be established. Thus, event study analysis often plays a prominent role in establishing market efficiency. Moreover, the U.S. Supreme Court's more recent ruling in *Halliburton II* established that defendants can rebut claims of indirect reliance if they can establish that the misrepresentations did not affect the price of the security at issue (i.e., that the misrepresentations had no "price impact"). Halliburton Co. v. Erica P. John Fund Inc., 573 U.S. (2014). Event study analysis may be employed to establish price impact or lack thereof. See Kristin Feitzinger and Amir Rozen, "*Halliburton II* and the Importance of Economic Analysis Prior to Class Certification," Cornerstone Research, 2014, https://www.cornerstone.com/Publications/Articles/Halliburton-Price-Impact-Analysis.pdf.

[13] For example, a study by Patell and Wolfson found that when a firm publishes its latest earnings or announces a dividend change, the major part of the adjustment in price occurs within five to ten minutes of the announcement. James M. Patell and Mark A. Wolfson, "Good News, Bad News, and the Intraday Timing of Corporate Disclosures," *Accounting Review* 57, no. 3 (1982): 509–527.

[14] The 95 per cent confidence interval, or a range that contains 95 per cent of the observations, is frequently used in academic literature and by U.S. courts. See, e.g., *Reference Manual on Scientific Evidence*, 2nd ed., Federal Judicial Center (2000), p. 124, internal citations omitted ("In practice, statistical analysts often use certain preset significance levels—typically .05 or .01. The .05 level is the most common in social science, and an analyst who speaks of 'significant' results without specifying the threshold probably is using this figure.").

[15] Financial Services and Markets Act 2000, Section 90, Subsection (1).

[16] "The Securities Litigation Review," *Law Business Research*, June 2015.

[17] Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005).

[18] For example, the court in *Imperial Credit Industries* discusses the "importance and centrality of the event study methodology in determining damages" and cites a long list of cases in support of its statement that "[b]ecause of the need 'to distinguish between the fraud-related and non-fraud related influences of the stock's price behavior,' . . . a number of courts have rejected or refused to admit into evidence damages reports or testimony by damages experts in securities cases which fail to include event studies or something similar." In Re Imperial Credit Industries, Inc. Securities Litigation, 252 F. Supp. 2d 1005 (C.D. Cal. 2003).

[19] Plaintiffs may also implement adjustments attempting to deal with additional loss causation considerations, such are eliminating damages for any shares that were not held over an alleged corrective disclosure.

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