Traps for analysts

How brokers' research reports can run foul of the law

An analyst’s research report on a listed company can have an immediate effect on the market for its shares, with implications for stockbrokers’ responsibilities. JOHN KEEVES reviews some of the legal issues which can apply to brokers’ research reports, including the insider-trading provisions of the Corporations Law.

Investors rely on broker research, explicitly or implicitly, and the equity markets are more efficient because of the work professional analysts do in integrating and analysing information about issuers of shares.

Recent legal developments make it appropriate to focus on legal issues relevant to preparation and issue of broker research reports. The application of some provisions of the Corporations Law to broker research are not widely, or well, appreciated. Given the Corporate Law Economic Reform Program, it may be appropriate for law reform in this area to be considered.

One issue of relevance to the stockbroking community is liability for negligent mis-statement. If a research report issued by a broker, and relied on by investors, turns out to be incorrect, misleading or unreasonable, can the broker be liable under the general law?

An investor may be able to recover compensation under the tort of negligent mis-statement if the investor can establish that:

- the broker owed the investor a duty to take care in relation to the report;
- the broker failed to take reasonable care in the preparation of the report;
- the investor has suffered loss as a result of the failure of the broker to take care.

When will a broker owe an investor a “duty of care”? Unfortunately, the law in this area is derived from a series of decided cases and is not easy to express simply.

If a broker provides a research report to an investor who is a client (or potential client) with the intention that the investor will rely on it, then a duty of care will be owed to the client.

But what happens when another investor obtains a copy of the report and relies on it? Or when an investor reads about the report in the press, and relies on the report? Is a duty of care owed by the broker to everybody who may rely on the report?

One of the tests that courts have used to determine whether a duty of care exists is whether reliance was reasonably foreseeable. Clearly, the possibility that a non-client might rely on a report is foreseeable to the broker when issuing the report.

The courts have also used a test of whether reliance was reasonable in the circumstances. Would it not be reasonable for an investor to rely on a broker’s report, particularly a report by a leading analyst?

However, the recent High Court case of Esanda v. Peat Marwick may be good news for brokers. The case dealt with the analogous situation of reliance by
third parties on audited financial accounts. The case suggests that a duty of care would not arise unless a broker had at least some knowledge of the intended reliance by the investor on the research report. The mere foreseeability of reliance by a wide class of investors (of which a particular investor would be one member) would not be enough – the relationship must be sufficiently “proximate” (or close).

An appropriate disclaimer could assist in avoiding a duty of care toward investors generally. A statement that investors should not rely on the research report without seeking specific advice, having regard to their own circumstances, may make it less likely that reliance would be reasonably foreseeable, or reasonable, and that the required “proximity” could be established.

**REASONABLE RECOMMENDATIONS – SECTION 851**

The legal requirement that securities recommendations are made on a reasonable basis (section 851 of the Corporations Law) is often called the “know your client rule” but has wider implications. Section 851 applies where a securities recommendation is made to a person who may be reasonably expected to rely on it. The section does not create a criminal offence but may give rise to a right to compensation.

While in some ways a restatement of the general law position, section 851 is potentially much wider in its application – there is no explicit “proximity requirement. All that an investor needs to establish is that:

- a recommendation was made to it;
- the investor relied on the recommendation;
- it was reasonable for the investor to rely on the recommendation;
- it was reasonable to expect that the investor would rely on the recommendation; and
- the recommendation did not have a reasonable basis (for example, it was carelessly prepared).

Section 851 will apply where reports are given direct by the broker to clients and potential clients.

In recent policy statements, the Australian Securities Commission has drawn a distinction between “general securities advice” and “specific or personal securities recommendations”. It suggests in Policy Statement 122 that section 851 will apply only where there is a specific or personal recommendation. According to the ASC, general securities advice does not contain any express or implied recommendation that a particular action with respect to the securities is appropriate in light of the individual recipient’s investment objectives and financial situation. The general issue of a research report would not, on this logic, attract the operation of section 851.

Wide dissemination of a research report might carry the implication that a recommendation to act is being made to a large number of recipients. If the report is published generally by the media with the approval of the broker (as sometimes occurs) a court might consider that a recommendation is being made to a wide class of persons. Worth noting is the Corporations Law’s fairly unhelpful definition of “securities recommendation”, which expressly includes implicit recommendations, and is perhaps wide enough to catch situations other than where a report been has been given directly by the broker.

A disclaimer or warning may well be the answer to section 851, to ensure that reliance on the report is not reasonable. This is consistent with the approach taken by the ASC in Policy Statements 121 and 122.

Policy Statement 121 does not give a form of words for a warning or disclaimer, but suggests that the warning must ensure that the investor understands that the research “advice” has not been prepared taking into account their particular circumstances, and the investor should assess the appropriateness of the “advice” having regard to their circumstances.

However sensible the approach of the ASC, it must be noted that an investor who suffers loss is not bound by the views expressed in Policy Statements 121 and 122, and could rely on the words of section 851 in seeking compensation. The type of warning suggested by the ASC may not be enough because an investor might rely on a general recommendation, despite the warning. Section 851 does not require that the recommendation is the only thing relied on. Law reform is required to make section 851 clearly consistent with the ASC’s approach.

It is interesting that section 849 – which requires disclosure of interests which might influence the recommendation – applies in the same circumstances as section 851, that is where a person may reasonably be expected to rely on a recommendation. Broker reports typically include a disclosure of interests, despite the fact that they might be regarded as “general securities advice”, not a “personal securities recommendation” (using the ASC’s approach). Strictly speaking, if a disclosure of interests is required by section 849, section 851 would also apply. Indeed, the inclusion of a disclosure of interests (without qualification) might amount to an acknowledgement that persons “may reasonably be expected to rely” on the report.

A broad interpretation of section 849 is consistent with the policy requiring disclosure of interests. However, if sections 849 and 851 are to be inter-
The report was not likely to induce anyone to trade in the securities.

Among other things, section 999 prohibits a person from making a statement or disseminating information which is materially false or misleading, and which is likely to induce a person to trade in securities where the person ought reasonably to have known that the statement or information was materially false or misleading.

The section carries a criminal penalty ($20,000 or five years' jail) and anyone who suffers loss as a result of the breach can recover compensation.

Section 999 may be coupled with section 765, which deems a representation about a future matter (for example projected earnings) to be misleading unless there are reasonable grounds for the representation, and the maker of the representation must prove that such grounds exist.

A research report could (if it were misleading) fall within the provisions of section 999.

The words “ought reasonably to have known” imply a negligence standard: the broker should have known that the report was misleading, if reasonable steps had been taken in its preparation.

What this means is that section 999 imposes criminal liability for negligent conduct; that is, where there is a failure to take due care. Civil liability is also imposed, without any need for a duty of care to be established and without the need for an investor to prove that the recommendation was made to it. All that is necessary is that the report is seen as likely to induce trading in the relevant securities.

The broker would need to argue that the report was not likely to induce anyone to trade in the securities concerned. Use of a disclaimer might assist here.

Nonetheless, many would consider it inappropriate that criminal liability, as well as civil liability of an “indeterminate amount” to an “indeterminate class” (in the words of Chief Justice Cardozo of the New York Supreme Court in the 1930s audit case of Ultramares v. Touche) should be imposed for merely careless statements. Law reform is needed.

MISLEADING OR DECEPTIVE CONDUCT – SECTION 995

If section 999 were not bad enough, we should not overlook section 995 and its equivalents in the Trade Practices Act and state fair-trading legislation.

Section 995 imposes civil liability for misleading or deceptive conduct. No intention to mislead is required. Even negligence is not required. All that is needed is conduct that will lead someone to make a mistake.

The person affected by the conduct is not an “average” or “reasonable” member of the class to which the conduct is directed. The entire class is to be considered, excluding the particularly stupid. We cannot assume the recipient of the conduct will be sophisticated.

There are no considerations of whether a duty of care is owed. Moreover, section 765, noted earlier, also applies to section 995: forecasts, predictions or projections will be misleading unless based on reasonable grounds.

The good news is that a breach of section 995 is not a criminal offence. However, any person who suffers loss as a result of the conduct can recover compensation.

There is little a broker can do about a breach of section 995. Civil liability is “strict” and there are no defences. The only protection is to avoid breaching the section by seeing that all reasonable steps are taken to ensure that a research report is not misleading.

Preparation of reports should include compliance procedures to ensure that all relevant information has been taken into account, that all material information has been verified and that reasonable grounds can be established for all statements about future matters. What happens if new information comes to light shortly before a report is to be issued? “I don’t want to know” is not an appropriate response, however attractive it may seem at the time.

Liability can extend to persons “knowingly involved” in a breach, as well as the broking house itself. All that is required is involvement in the offence with knowledge of the relevant facts.

Disclaimers cannot avoid the statutory liability under section 995, but may assist in demonstrating that any loss suffered by an investor was not caused by the report, or that in all the circumstances the conduct of the broker was not misleading. However, no great confidence can be placed in these arguments. Law reform is also required here.

INSIDER-TRADING ISSUES – SECTION 1002G

The Corporations Law prohibits a person from trading in securities, or procuring others to trade, where the person is in possession of non-public information which might have a material effect on the price or value of the securities. There is little doubt that a broker issuing a report with a “buy” or “sell” recommendation would be procuring investors to trade, particularly given the expanded definition of “procure” in the Corporations Law.

In the context of the provisions, “non-public information” means information not generally available — that which is not readily observable or made known in a manner that would bring it to the attention of investors.

The potential application of these provisions to broker research is obvious: an analyst might seek information not available to the market, to give the report an edge. For example, when preparing an earnings forecast, if a broker obtained information from the company which was non-public, then the insider-trading provisions could apply.

A similar point can be made for issuers. Giving material non-public information to analysts could be a breach of the insider-trading provisions, because it is also an offence to communicate information to a person (the analyst) who would be likely to procure a third person (the investor) to trade in the securities.
These implications of the insider-trading provisions may seem impractical, but are consistent with the policy of the provisions to encourage equal access to price-sensitive information.

OTHER ISSUER QUESTIONS

Issuer rights of action
Could an issuer have a right to claim compensation where it suffers loss as a result of a negligent research report?

It is unlikely that a general-law remedy would be available for a merely careless report, but there seems to be no reason in principle why an issuer could not sue under section 995 for misleading or deceptive conduct. Indeed, an application for an injunction to restrain further publication of a misleading research report would be a use of section 995 entirely consistent in principle with a number of the cases under section 52 of the Trade Practices Act.

Issuer’s liability for “approving” reports
Can an issuer be liable to an investor or the broker, if the issuer approves the form or content of a report?

The issuer could be responsible under one or more of the provisions discussed above if it approves contents of the report which turn out to be incorrect. An example might be the issuer’s “approval” of an unreasonable earnings forecast.

Moreover, the issuer must ensure that no non-public material information is disclosed to the analyst when commenting on the report. This could have insider-trading implications, as well as implications in relation to the issuer’s continuous disclosure obligations to the ASX under Listing Rule 3.1 and section 1001A of the Corporations Law.

An issuer must take great care in considering a report, and in considering how to respond, if at all, to a broker’s request for comments and approval.

Issuer’s obligations to respond to reports
Does an issuer have any duty to respond to statements or forecasts made in a research report?

This is related to a wider question as to whether listed companies must respond to press or market speculation under the continuous disclosure obligations.

The ASX’s attitude might be that a listed company may well have a duty to respond to ensure that the market is not operating on incorrect or misleading information – for example, on the company’s expected earnings. If a research report suggested a substantial adverse change in earnings outlook, the issuer may well need to consider whether a “profit downgrade” response was necessary.

CONCLUSION

While the general law may not impose a wide duty of care on brokers when issuing research reports, and the operation of section 851 may be limited by the inclusion in reports of warnings or disclaimers, the possible application of sections 999 and 995 may have unexpected consequences.

Brokers need to keep these risks in mind when preparing and issuing reports. The insider-trading rules also need to be considered, as do some of the implications of research reports for issuers.

It may be that the Corporate Law Economic Reform Program can address some of these issues, so that broker analysis and research is encouraged for the benefit of the more efficient operation of Australian securities markets and not discouraged by imposition of liability to the “indeterminate class” for an “indeterminate amount”.

The author gratefully acknowledges comments from Phillip Laity (partner, Johnson Winter & Slattery) and David White (executive director, Australian Stock Exchange Limited) but takes sole responsibility for errors, omissions and opinions. He points out that some statements are generalisations and that the article should not be relied on as legal advice.

Switching on the ASC

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- illegal offerings of securities or prescribed interests;
- prospectuses and associated marketing material being placed on the Internet without relevant approval;
- “hot tips” about particular securities; and
- investment advice offered by unlicensed persons.

The types of misconduct or mischief by individuals are familiar enough; only the medium has changed. In most cases of contravention of the law that the ASC has encountered it has issued warnings and/or ordered the withdrawal of the material.

Investor education
It is not our role to prevent investors from taking risks in terms of the products they purchase or their dealings with service-providers. However, investor education is of particular importance to the ASC, which believes one of the most successful ways of preventing fraudulent activities is by “fighting information with information”.

Investor education initiatives of the ASC have included warnings though information releases, the media and the Internet itself to warn investors and market participants about unlicensed advisers on the Internet, false or misleading information and rumours by persons attempting to influence the price of securities or create a false market.

The ASC has also held a number of public forums to warn investors of the pitfalls of investing in illegal schemes offered on the Internet, in particular foreign-based schemes which are not regulated by the ASC. In February 1996, the ASC launched its own Internet site to provide investors, creditors, company directors, lawyers and the general public with better access to ASC information.