KEY POINTS
- There are an increasing number of Stock Drop cases.
- The calculation of damages is complex.
- The mathematical techniques employed must be case specific.
- The calculation methodology will be assisted by direction from the courts.

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FSMA s 90/90A Stock Drop damages calculation: a technical introduction

Whilst the principles of calculating damages in Stock Drop cases are clear, the calculation is complex and not helped by the dearth of precedent in most jurisdictions other than the US. The mathematical methods employed are case specific and should closely follow the legal case theory.

WHAT IS A "STOCK DROP" CASE?

The principles underlying all "Stock Drop" cases are the same. For a listed company generally two circumstances need to be considered.

A listed company is obliged to make certain information public as soon as it is aware of it as a result of its listing obligations. Similarly, it is required to provide adequate information – complete, clear and not misleading – in, for example, a prospectus, an earnings announcement, an AGM, etc. In either case, if it does not do so in circumstances where had such information been made public it would have detrimentally affected its share price, investors could rightly claim that either they would have not have bought the shares at all or the shares would have been bought at a lower price. Thus, a potential claim arises by the shareholders against the company as a result of the drop in the price of the stock.

"Stock Drop" is a generic term which includes all types of securities such as bonds, convertible bonds, American Depositary Receipts (ADRs), Global Deposit Securities (GDRs) etc not just common shares (ordinary shares in the UK). In this article, for ease, we shall refer solely to ordinary shares.

Examples of such cases include groups of shareholders versus Tesco PLC (*SL Claimants v Tesco plc* [2019] EWHC 2858 (Ch)) and Lloyds Banking Group PLC (*Sharp v Blank* [2019] EWHC 3078 (Ch)).

SOME DEFINITIONS

The date on which the disclosure should have been made is termed the Class Start Date. In general, at a future time, the full information is made public. This may occur as a result of a single announcement or the information may be released in instalments on a number of dates (Partial Disclosure Dates) culminating in complete disclosure on a particular date (Class End Date).

It should be noted that the full (partial) disclosure may be made not only by the company itself but also by a regulator, a journalist or a whistle-blower, for example.

The period between the Class Start Date and the Class End Date is defined as the Class Period.

Figure 1 below provides a schematic timeline of events.

The chart shown below in Figure 2 represents a hypothetical, schematic change in the share price as the disclosures are made. Assume that the company's share price was 100 at the Class Start Date and falls to 85 following the first partial disclosure with a further fall to 80 following the second partial disclosure. Assume also that the first and second partial disclosures together constitute full disclosure. Therefore, the Class End Date coincides with the date of the second partial disclosure. Now consider an investor who bought shares at 100 after the Class Start Date, ie before the date of the first partial

FIGURE 1: SCHEMATIC TIMELINE OF EVENTS

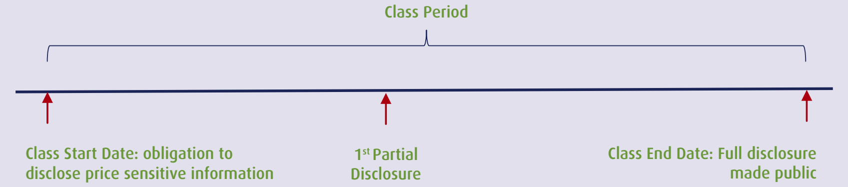
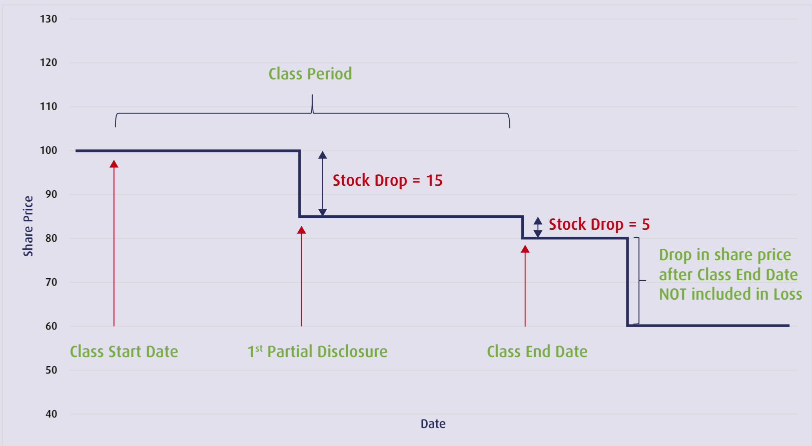


FIGURE 2: SHARE PRICE CHART



disclosure, and holds the shares until after the Class End Date. One theory of loss is that the investor would still have bought the shares had the company made full disclosure as it was obliged to do on the Class Start Date but would have done so at a lower price. In this example, the share price dropped a total of 20 directly as a result of the two disclosure announcements, therefore it can be surmised that the share price would have fallen by the same amount had the disclosures been made on the Class Start Date.[1] The loss is, therefore, calculated to be 20. Naturally, any losses suffered by investors after the Class End Date could not form part of the damages.

However, a number of simplifying assumptions have been made in arriving at the loss.

LOSS INDEXED TO MARKET CHANGE

The mechanism for calculating the loss in the US is well established. It is less well tested, if at all, in courts in other jurisdictions including under English law.

The share price chart shown overleaf at Figure 2 is, of course, idealised. A company's actual share price is volatile, in the sense that it is not static. A company's share price may vary for any number of reasons. It can vary either because of company specific information, such as a results announcement, or information affecting the stock market as a whole, such as changes in interest rates announced by a central bank.

Figure 3 below shows the movement of the share price of a stock and the representative stock market index (such as the FTSE100, S&P500, etc relevant to the company) (the Index) between the Class Start Date and *immediately prior to* the Class End Date. During this period, say, there was no company specific information that was made public. Given the high correlation between the stock and the Index, it can be concluded, therefore, that the share price in this period was affected solely by market related information. The straight, green line is the line of "best-fit".[2] In other words, this line can be taken to represent the relationship between the share price and the Index, calculated from the observed daily data, if the two tracked each other perfectly. In this case, the Index was 4,250 on the Class End Date. The share price would have been 428 according to the best-fit analysis.

Figure 4 below shows a similar chart immediately after the disclosure.

It can be seen that post-disclosure the share price also correlates highly with the Index. In this case, with the Index at 4,250, the line of best fit implies a share price of 403.

Figure 5 (opposite) shows both pre- and post-disclosure share price and Index on the same chart.

Two observations can be readily made. First, it can be seen that the share price relative to the Index is lower post-disclosure when compared to pre-disclosure. Second, it takes four days from the disclosure date for the share price to reach its new share price level relative to the Index.[3] The red point denotes the disclosure date and the blue points the days when the share price reacted to the disclosure and moved down.

We can calculate that the effect of the disclosure was to reduce the share price from 428 to 403, ie 25. This is not the only method of estimating the loss.

CALCULATING LOSS

Example 1: Continuing with the example above, assume that the actual share price immediately prior to the disclosure was 425

FIGURE 3: PRE-DISCLOSURE SHARE PRICE AND STOCK MARKET INDEX

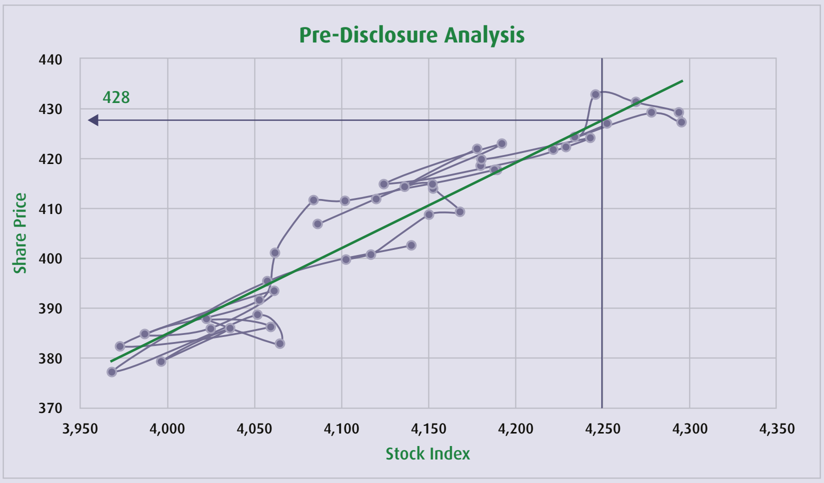
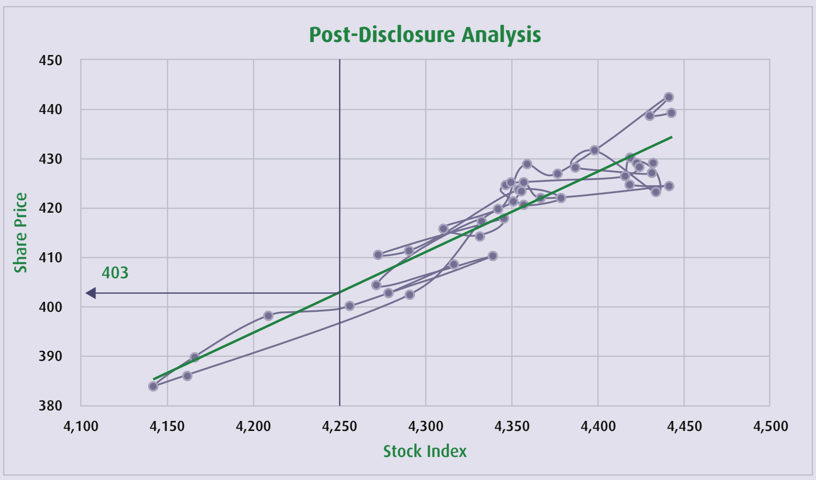


FIGURE 4: POST-DISCLOSURE SHARE PRICE AND STOCK MARKET INDEX



Biog box

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with a stock drop of 25 and a shareholder owned 1,000 shares at the start of the Class Period. If there had been no further trading during the Class Period then the loss suffered by the investor is simply 25,000 (25 x 1,000).

OTHER ISSUES

Intra-Class Period Trading

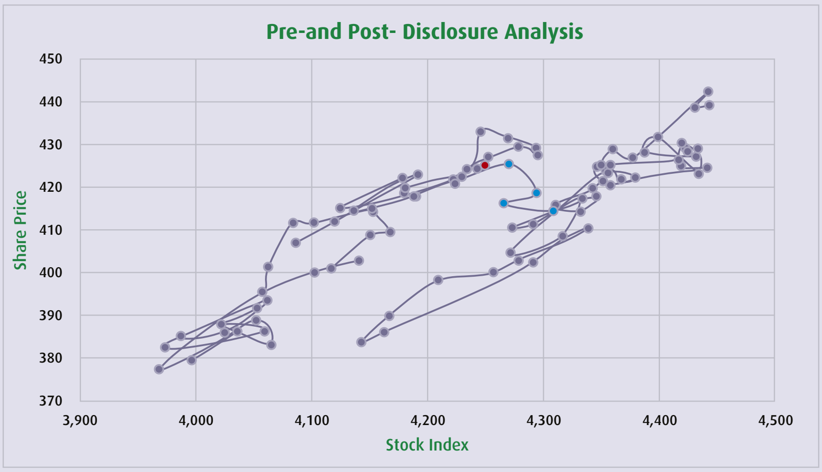
Depending on the nature of the case it may be that shares transacted during the Class Period are excluded from the calculation of damages, ie only the shares held at the start of the Class Period are deemed to be relevant.

Example 2: In addition to owning 1,000 shares at the Class Start Date (as in Example 1), the investor buys a further 250 shares at a price of 425 and thereafter sells 250 shares also at a price of 425 with both transactions occurring during the Class Period. If the 250 shares sold are considered to be the ones bought immediately beforehand[4] then the number of original shares held at the end of the Class Period remains at 1,000 and the loss is 25,000. On the other hand, if the 250 shares sold are deemed to be the original, pre-Class Period shares,[5] then at the end of the Class Period though the investor owns 1,000 shares in total only 750 of these are deemed to be shares owned at the start of the Class Period. Accordingly, the loss is calculated to be 18,750 (25 x 750). No damages claim is accorded to shares bought within the Class period.

Content of disclosure

Often negative partial disclosure statements when made by a company are accompanied by other information such as a trading update, announcement of a share buy-back scheme, etc. The question then becomes to what extent the fall in the share price was solely as a result of the disclosure. Perhaps a negative trading update also contributed to the fall, therefore the fall related solely to the disclosure was not as great as initially calculated. Conversely, a positive trading statement is likely to have had the effect of supporting the share price, therefore arguably the fall in the share price would have been greater absent the trading statement.

FIGURE 5: PRE- AND POST-DISCLOSURE SHARE PRICE AND STOCK MARKET INDEX



CONCLUSION

The calculation of damages in "Stock Drop" cases is complex and case specific. It is made more difficult by a lack of precedent in most jurisdictions outside of the US. A number of calculation mechanisms such as the appropriate allocation of traded shares (LIFO/FIFO) need to be established by the courts. Nor is it necessarily the case that the methodology followed in the US will be the standard for other jurisdictions. ■

1 There may be variations to this formulation dependent upon the specific circumstances of a case.

2 A line of best-fit is calculated by minimising the difference between it and all the observed data.

3 This is relevant to the debate about the *Efficient Market Hypothesis* and its use in calculating damages, however it is beyond the scope of this article.

4 Allocation of shares sold to be the ones last purchased is termed LIFO – "Last In First Out".

5 Allocation of shares sold to be the ones first purchased is termed FIFO – "First In First Out".

Further Reading:

- Claims under s 90A of FSMA for dishonest statements made to the market: an underutilised remedy? (2019) 3 JIBFL 154.
- Collective proceedings and financial markets claims (2017) 4 JIBFL 241.
- LexisPSL: Banking & Finance Practice note: Misleading statements, misleading impressions and market manipulation.