

*THE FINAL REPORT OF THE  
COMMISSION OF INQUIRY INTO  
THE AFFAIRS OF  
THE MASTERBOND GROUP  
AND INVESTOR PROTECTION  
IN SOUTH AFRICA*

*CORPORATE LAW AND  
SECURITIES REGULATION  
IN SOUTH AFRICA*

*THE HONOURABLE MR JUSTICE H.C. NEL*

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# CHAPTER 1 - INTRODUCTION

**1.1** During the late eighties and early nineties the systems designed to protect investors in South Africa failed and many small investors lost their entire life-savings. The systems are still failing with disastrous effects for the victims, many of whom can never recover financially.<sup>(1)</sup>

**1.2** One of the failures during the early nineties, was the **Masterbond Group** of Companies which over a number of years had attracted approximately a billion rand by promising secured and thus seemingly safe investments. More than 90 percent of the money borrowed on short-term was used within the group and associated companies for highly speculative long-term projects, which generated little or no return. It soon degenerated into little more than a 'Ponzi' scheme.<sup>(2)</sup> The Group collapsed and thousands of investors were left destitute, many of them pensioners who specifically had been targeted and tempted with the twin carrots of security and higher than normal interest rates.

**1.3** A public outcry led to the appointment of the Commission to inquire and report on the causes of the collapse of the Masterbond Group.

**1.4** The Commission is also required to report upon

**"1.6 The question whether the common law and legislation with regard to deposit taking institutions, other financial institutions, companies, share block- and time share schemes or any other legislation, provide sufficient**

protection to investors similar to those of the Masterbond Group and the public in general, with special reference to the following matters:

1.6.1 the question whether the existing statutory or common law requirements for the conduct of agents, representatives, advisers and intermediaries, the disclosure of information and the protection of investors, are adequate;

1.6.2 the functions that an auditor of a company should fulfil in respect of the protection of the interests of investors;

1.6.3 the question whether the existing measures with regard to the personal liability of directors, officers and managers of companies are sufficient.

1.9 Any other relevant aspects.

and

2. To make recommendations, in view of the knowledge acquired from the inquiry, regarding amendments which should be effected to the above-mentioned legislation or any other legislation or the common law in order to bring about a more efficient application of legislation and the common law for the better protection of investors such as those in the Masterbond Group".<sup>(3)</sup>

1.5 In its First Report which dealt with the causes of the collapse of the Masterbond Group, the Commission stated that –

“The investigation into the Masterbond Group and its associated companies revealed serious deficiencies in the South African supervisory system and in those sections of the Companies Act which were designed to protect investors. It also revealed an astonishing degree of dishonesty, inefficiency, lack of professional integrity and lack of independence on the part of some of the auditors involved with these companies.

It became apparent that to be able to report on the adequacy of existing legislation relating to investor protection and to be able to make meaningful recommendations in regard thereto, that it would be imperative to investigate the circumstances surrounding the failures of other financial institutions.

If the circumstances which led to the losses suffered by Masterbond investors were found to be unique, drastic legislative changes would probably not be called for, but if the losses suffered as a result of the demise of the other financial institutions could be attributed to similar causes, the need for change would be apparent.

To this end extensive investigations were conducted into the demise of

- The Owen Wiggins Group of companies which was placed under curatorship by the Registrar of Financial Institutions at the end of 1994. The *modus operandi* of this Group was so similar to that of Masterbond that it necessitated an in-depth inquiry into its affairs and the reasons why supervision failed once again.
- The Cape Investment Bank Group of companies and the role played by its auditors and the Reserve Bank immediately before its liquidation.
- The Supreme Group of companies which also managed a participation bond scheme and issued debentures.

- Alpha Bank and Prima Bank with reference to the role of the auditors and the Reserve Bank.
- The Equity Brokers Clearing AG (EBC) group of companies which solicited monies for investment in South African stock mainly in Western Europe. Some of the monies were stolen in Europe and some in South Africa. Foreign investors complained about the lack of adequate investor protection”.

**1.6** With regard to the auditors of some of the entities, the Commission remarked that

“It became apparent that with a few notable exceptions the auditors involved seemed to believe that in addition to auditing the books of a company, their function was to assist and protect the management of such company as far as possible. They also seemed to believe that the end justifies the means.

Examples thereof are the following

- issuing of false certificates in respect of participation bond schemes;
- signing of unqualified reports relating to blatantly false financial statements;
- failure to comply with the requirements of section 20(5) of the Public Accountants’ and Auditors’ Act on the discovery of material irregularities;
- drafting and signing financial statements which departed so fundamentally from GAAP (Generally Accepted Accounting Practice) that no reliance could be placed thereon;
- without proper disclosure changing accounting policies to convert loss situations into profit situations;

- **failure to perform procedures designed to identify all relevant material events occurring after the balance sheet date and up to the date of the auditor's report;**
- **failure to report relevant after balance sheet date events;**
- **backdating auditors' reports, financial statements and letters of representation;**
- **failure to scrutinise minutes of relevant directors' meetings;**
- **failure to comply with the disclosure requirements in respect of debentures issued;**
- **failure to establish whether a company had issued debentures when the contrary was recorded in the notes to the financial statements;**
- **assisting in misleading the Receiver of Revenue".<sup>(4)</sup>**

**1.7** In modern economies, all members of society are actively encouraged to save some portion of their earnings and to invest it in pension funds, unit trusts, life insurance policies, securities issued by listed companies and the like. They are encouraged to do so because normally few other means exist which could enable them to achieve capital growth and to provide for their old age. Ministers of Finance also constantly exhort taxpayers to save and invest for the welfare of the economy.<sup>(5)</sup>

**1.8** Historically, governments have sought to protect investors by

- creating entities such as central banks, securities commissions, stock exchanges and registrars of companies and vesting them with powers of regulation and supervision;
- requiring persons and entities soliciting investments from the public to publish prescribed information in prospectuses and similar documents;
- requiring public companies and other financial entities to disclose their financial affairs by the periodic publication and filing of duly audited financial statements;

- creating numerous criminal offences for failure to adhere to prescriptive provisions in corporate and securities laws.

**1.9** With some notable exceptions, mainly in the United States of America, investors themselves are not adequately empowered to protect their own interests, and are not enabled to make properly informed investment decisions. They have to place their trust in the efficacy of the systems of protection put in place by others, and in the honesty, reliability, and competence of the persons involved therewith.

Unfortunately their trust is too often misplaced.

**1.10** In South Africa, as in many other jurisdictions, fuller and more timeous disclosure of the financial affairs of companies are often resisted by controlling shareholders, directors and management, and stultified by factors such as

- the lack of access to the books and records of companies and the minutes of the meetings of directors;
- the fact that disclosure of the financial affairs of public companies is often, for all practical purposes, restricted to the publication of bi-annual financial statements;
- the fact that the failure to publish such financial statements within the prescribed periods elicits very little, if any, response from regulating authorities;
- the fact that auditors' reports are only required in respect of the annual financial statements;

- the fact that when serious irregularities are discovered in the management of companies, the external auditors have no obligation to immediately bring it to the attention of shareholders or other stakeholders;
- the fact that external auditors often allow directors to publish financial statements which do not portray the true financial position of the companies;
- the fact that Gaap (Generally Accepted Accounting Practice) has no legal backing;
- the fact that in the application of Gaap very diverse results can be achieved by the use of subjective interpretations;<sup>(6)</sup>
- the fact that the duties and liabilities of directors of companies are not clearly laid down in legislation;

**1.11** In South Africa, the rights granted by the Companies Act to minority shareholders, holders of debentures and other stakeholders, are more illusionary than real. This is evident from the everyday experience of the luckless South African investor who more often than not is treated with contempt by controlling shareholders, directors, management and the external auditors,<sup>(7)</sup>

**1.12** In many respects the typical South African investor is also worse off than his counterparts in many other jurisdictions. He labours under

- the attentions of vast hordes of unregulated, unsupervised, unethical and unqualified intermediaries whose sole purpose in life seem to be to part him from his money;
- ineffective supervision by entities such as the Registrar of Companies and the JSE Securities Exchange SA, neither of whom seems to play any discernable role in the protection of investors;
- the often illusory protection entrusted to other regulatory and supervisory authorities who lack the resources or the will to carry out the functions assigned to them by the legislature;
- external auditors who are often more focussed on the protection of management than the protection of the investor;
- directors, managers, issuers of securities, intermediaries and auditors who operate with very little fear of personal repercussions in the event of fraud, negligence or incompetence;
- a criminal justice system which has broken down as a result of indifferent or ineffective investigation and prosecution;
- the absence of alternative procedures (alternative to Court procedures), and the absence of effective derivative actions, dissenter actions and class actions.

**1.13** The typical investor is thus in an invidious position. Encouraged and even compelled by circumstances to save and invest, the investor has little control over the investment and is completely at the mercy of the regulating and supervising authorities, the issuers of securities, intermediaries, auditors, and the directors and officers of corporations

and other entities. If one or more are incompetent or dishonest, financial security is at risk.

**1.14** Some of the hazards which the impotent South African investor has to endure, have been encapsulated by **Marcia Klein** in the **Business Day** of **26 November 1999**.

Under the caption "**SA corporate trend: take the money and run**", the following appeared:

"Amid a number of company failures and profit warnings, some aspirant captains of SA industry have been surprisingly fleet of foot, successfully jumping ship long before less fortunate shareholders.

A plethora of recent resignations by top managers of listed companies has been accompanied by cautionary announcements, or rumours, that their companies are in serious trouble. These executives leave unwitting shareholders to face a plummeting share price and an investment in a company with an uncertain future.

But the captain is rarely forced to help save the ship or to walk the plank. In fact, he often leaves with the only life jacket, having either cashed in his shares or pocketed a hefty restraint payment or farewell package.

With SA's history of shareholder apathy and disregard for corporate governance issues – or, in some cases, for the law – these deeds go by unquestioned.

Bryant Technology, a venture capital information technology company, announced on Wednesday that CEO Richard Bryant, financial manager Nicole Wade and non-executive director Ernest Last had resigned. It also announced that there would be a material revision of historical and forecast profits and pending litigation against certain suppliers.

This follows on the resignation of Dave King from Specialised Outsourcing in the midst of a share price collapse. Although there are no indications that the company is in trouble, poor investor sentiment is partly due to talk that King had sold out some time ago. When the company listed in 1997, he had a 71% stake. Now he is said to have less than 2%, having allegedly made a profit of more than R1bn.

When Macmed went into provisional liquidation, owing close to R1bn to 16 banks, restraint of trade agreements saw chairman Don McArthur, sales and marketing director Rob Maguire and company secretary Alan Hiscock walk away with bulging back pockets.

The three were paid R12,75m, of which more than half was paid out only months before the group went into provisional liquidation.

At New Africa Investments directors Jonty Sandler, Nthato Motlana, Swelakhe Sisulu and Dikgang Moseneke tried to pay themselves generous options and restraints packages.

They had already been the beneficiaries of large restraints, and Motlana and Sandler, who shouldered the blame, walked away from the company with packages that will ensure they can live in luxury for the rest of their lives.

At the beginning of November three Beige executives – joint MDs Dennis Heyman and Syd Rogers and chief operating officer Barry Duke – resigned before they could be dismissed.

Company secretary Barry Fink was fired following an investigation into allegations of misconduct, which saw Beige suspend its shares and issue a profit warning.

There were numerous irregularities for eight months prior to this, including alleged insider trading. Now there are allegations of an invoicing scam involving Duke, deputy chairman and adviser Peter Katz and another party.

These are just some recent examples; there are many others. They raise interesting questions about corporate governance and the involvement of management, the board, the auditors, the shareholders and the regulatory authorities. Some or all of these groups seemed to let things slip by unnoticed until they go awry".

**1.15** Against this background it is apparent that the questions posed to the Commission

**"whether the existing statutory or common law requirements for the conduct of agents, representatives, advisers and intermediaries, the disclosure of information and the protection of investors, are adequate";** (Terms of Reference 1.6.1)

**and**

**"whether the existing measures with regard to the personal liability of directors, officers and managers of companies are sufficient";** (Terms of Reference 1.6.3)

**must be answered in the negative.**

**1.16** Many of the problems which confront the South African investor are not unique. As will be seen from brief surveys of the history and evolution of the modern corporation, the compulsory disclosure of its affairs in its financial statements and the audit thereof, fraud and incompetence have always been endemic in the affairs of corporations. However, it also will be shown that in many jurisdictions effective steps have been taken to improve the protection of investors and to empower them to act when their interests are threatened or have been adversely affected.

**1.17** These surveys and brief sketches of the evolvement of the regulation of securities, of the problems associated with the traditional audit and of the difficulties experienced in the application of Gaap will also show that

- fraud, insider trading, manipulation of share prices, declaration of fictitious profits, payment of dividends out of capital or hidden reserves and publication of false or misleading or uninformative financial statements have always been part of corporate activities;
- despite ever increasing regulation and supervision and the development of generally accepted accounting practice (or 'principles') and auditing standards, the investor cannot rely upon the contents of published financial statements, even those which cannot be classified as 'false';<sup>(8)</sup>
- during the past few decades significant changes have been taking place in the regulation of financial products which have been brought about by the recognition of the necessity for innovative steps to cope with the rapidly changing faces of financial products and financial markets.

**1.18** Examination of the role of the external auditor and the widening gap which exists between the expectations of the users of financial statements and the product which auditors are prepared to deliver, will show that

- since time immemorial accounts have been audited to detect mistakes and fraud, but that during the 20<sup>th</sup> century and after having grouped themselves into self-regulating organisations, auditors began to disclaim the responsibility to detect fraud;
- despite the growth of national and multinational corporations (some of whose annual turnovers exceed the annual gross national product of many countries), the laws of many jurisdictions (including South Africa) still reflect the view of the Victorian era that corporate accounts are audited and reported upon solely for the edification of shareholders;
- disclosure in published financial statements and the traditional audit report thereon are not designed to cater for the needs of the potential users thereof. Potential users could be shareholders, holders of debentures, lenders, suppliers of goods and services, potential investors, creditors, bankers, employees, management, customers, financial analysts, financial advisers, stockbrokers, underwriters, financial journalists, taxation authorities, governments, trade unions and even the general public;
- adherence to generally accepted accounting practice and auditing standards do not necessarily result in the production of financial statements which timeously or adequately warn of impending disaster. In fact, the opposite scenarios are often portrayed therein.

**1.19** To enable the Commission to comply with its terms of reference

- oral and documentary evidence comprising some 60 000 pages was presented;

- numerous conferences both national and international were attended;
- the company laws of some 115 countries<sup>(9)</sup> and 49 states<sup>(10)</sup> of the USA have been researched;
- all reported developments of any significance in securities regulation worldwide have been monitored. In particular, the securities laws of more than 30 countries<sup>(11)</sup> and of the majority of states of the USA have been researched;
- all papers relevant to investor protection published during the last decade by international securities organisations have been studied;
- a Consultation Paper, 'The Role of the Auditor, the Elimination of the Expectation Gap and the Appointment of Auditors by all Significant Interest Groups', was issued to auditing and accounting organisations, to individual auditors and accountants, to security regulators, to universities, and to financial journals and newspapers;
- discussions were held with and the views sought of numerous regulators and supervisors of financial institutions, securities regulators, prosecuting authorities, legal practitioners, members of the audit profession and academics;
- the reports relating to class actions of the Law Revision Commissions of South Africa, Victoria (Australia), Australia, Ontario and Manitoba (Canada), the Uniform Law Conference of Canada, Lord Woolf's Review (United Kingdom) and the laws and rules of procedure in class actions in Australia, Canada, India, Israel, Sweden, the United States (Federal) and 28 States of the USA were studied and correlated.<sup>(12)</sup>

**1.20** The evidence, researches, studies and discussions have revealed some innovative approaches for the improvement of the protection of investors. Although these innovations cannot guarantee the safety of investments, their introduction would certainly enhance the protection of South African investors.

**1.21** The Commission wishes to express its gratitude to members of its staff who contributed to its investigations, deliberations and recommendations, in particular, Advocates H G Klem SC and P A Botha who were responsible for the initial investigation into the causes of the collapse of the Masterbond Group, and thereafter successfully prosecuted three of the former directors;

Adv. J de W van Vuuren who presented the bulk of the evidence and who was responsible for the inquiry into the affairs of the ECB group of companies, both in South Africa and in Europe; Mr J Esterhuizen who concentrated on the affairs of the Owen Wiggins Group of companies; the Commission's first secretary, Mr. J D Viviers who was responsible for the setting up of the infrastructure of the Commission and who worked closely with the forensic auditors, Messrs Ochse and Partners; Ms L Ruwiel who succeeded Mr Viviers as secretary and who concentrated on securities legislation and regulation and also attended a course presented by the Securities and Exchange Commission of the United States in Washington D.C.; Ms E Venter who succeeded Ms L Ruwiel; Ms A Aucamp who took over from Ms E Venter and who has made an in depth study of class actions and the form which a class action should take in South Africa; Mr A Lotriet CA (SA) who maintained and developed the IT applications used for and during investigations, including the interrogation of numerous data files the contents of which were vital for the prosecution; Mr N R Wenzelburger CA (SA) who analyzed and succinctly presented the contents of untold volumes of financial documentation, both historic and relating to innovative financial products marketed by the numerous groups of companies under investigation, and who has also kept abreast of developments in other jurisdictions; the administrative and secretarial staff who had made a major contribution towards the success of the infrastructure of the Commission, Ms E Maart and in particular the two administrative secretaries, Ms S Bryce-Borthwick and Mrs Rita Maree for their unfailing dedication and assistance in the preparation of the Reports.

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## NOTES

### 1. – **Business Day : 17 April 1998 : (Islamic Bank)**

"About 10 000 depositors in the defunct Islamic Bank who submitted claims earlier this year have been informed by Deloitte & Touche, the liquidators, that they are unable to process the claims because of the bank's 'inaccurate accounting records.'

The former chairman and directors of the bank could be sued for recklessness and negligence by the depositors.

The Islamic Bank became insolvent last year with debts estimated at between R50m and R70m. The Reserve Bank granted it funds to compensate depositors up to R50 000 a depositor, which would cover more than 80% of those affected".

### – **Business Report : 5 June 1998 : (Amalia)**

"Will people never learn? You'd think after the debacles of surrounding little mining companies – from non-existent copper mines in the Andes to dogs like Union Mines – investors would think twice about believing snake-oil statesmen who claim, 'There's gold in them hills'. This paper is aware of a large number of supposedly sophisticated investors who poured money into Amalia as though[sic] its only assets were mines that either lost money or did not exist, cross shareholdings in companies with the same thing, and an agreement with a semi-feudal state that the company did not have the ability (and perhaps the will) to carry out. Why did so many people ask themselves why Andrew Cecil, the supposed boss man, was not even a director? Even when the scrip was most obviously hitting the fan, people continued to buy Amalia's shares. We hope the liquidators' report, which shows realisable assets of roughly R1,5 million against debts of R35 million,

will give people more pause for thought. We also hope that a forensic audit reveals what happened with all the money that was raised.

Spare a thought too for the hundreds of farmers in the North West who were hoodwinked into buying the shares by sharp-tongued salesmen and lost substantial parts of their life savings. A former director, who was instrumental in persuading them to buy, is now trying to muster a rescue plan. Unfortunately the chances of any recovery are slimmer than finding gems in a jar of fish paste".

– **Saturday Argus : 13 June 1998 : (One for All Group)**

"A Cape Town-based company called the One for All Group is luring investors with promises of returns of 60 percent a year and higher.

Donovan van Nelson, managing director of the One for All Group, told Personal Finance the investment opportunity was open to a limited number of people who were all known to him.

Meanwhile the Business Practices Committee has warned that investors should expect such claims to be unrealistic.

The Business Practices Committee was faxed a copy of the quotation and responded that although it had not discussed the scheme with the company concerned or investigated the matter, the returns offered by the One for All Group 'seem to be utterly unobtainable'.

Eric Mafuna, vice chairman of the committee, said it was 'simply ridiculous' to expect a return of R405 000 on an investment of R90 000. This, he said, translated to an average annual simple interest rate of 90 percent [*sic*]. 'Consumers should be extremely cautious when parting with their money. In this case, the offer is too good to be true!.'

– **Saturday Argus : August 29, 1998: (Proplace)**

**"Elderly the hardest hit in R187-m debacle.**

Investors depending on their investments, stand to lose up to 95c in the rand when the R187 million Proplace scam is wound up, fund managers say.

Robert Cameron-Ellis of Deloitte & Touche, who has been appointed by the Registrar of Banks to wind up the scheme and pay out investors, says investors are owed R187 million but only R57 million is available to be paid out to the more than 1 050 people who invested in the scheme. Criminal charges are to be laid against the man who headed Proplace, Tony Maniachi, who has skipped the country and is thought to be living in the Lebanon.

**Investors, mostly elderly people, handed over money and Proplace promised to buy endowment policies on their behalf.** But the Deloitte & Touche accountants have found, the promised policies were not always bought; some were used to cover several investments and those who invested small amounts were not issued with policies in their own name. Cameron Ellis who, broke the bad news to investors at a packed meeting in Johannesburg this week, says these smaller investors; whose investments were not secured by policies, will be hardest hit.

Policies worth only R2 million were issued and they stand to recover only 5c for each rand they put into Proplace.

'Many people put their live savings into this scheme,' says Cameron-Ellis who has described the Proplace scam as the 'biggest debacle since Masterbond' ''.

— **Business Day : Feb. 2 , 1999 : (New Republic Bank)**

"The importance of trust in banking has been driven home again in the New Republic Bank (NRB) saga. The Durban-based institution, which was put into curatorship last Friday, was neither insolvent nor facing a short-term liquidity crunch. Indeed, it has produced rather strong financial results in recent years and has acted decisively to broaden its customer base.

But NRB and the Reserve Bank, which regulates SA's private banks, fell short in their response to concerns raised in a report carried out by auditors KPMG, extracts of which were published by this newspaper. The report, in essence,

raised doubts about NRB's capital adequacy as reflected in its own financial statements. KPMG suggested that NRB, with at least the tacit approval of the Reserve Bank, failed to adjust its capital to allow for a large (R166m) loan which was earning no interest and was thus, in KPMG's opinion, impaired.

The bank's response was to deny that there was any problem; the regulator denied it had given its blessing to any shenanigans. In other words, the doubts raised by KPMG, which has a reputation as one of SA's most respected bank auditors, were left unallayed. Is it any wonder that many of NRB's depositors grew skittish?"

– **Cape Times Business Report: 26 August 1999:(Pension fund fraud exposed)**

"Johannesburg – The South African Local Government Association had unearthed millions of rands worth of rampant fraud and corruption in the administration of more than 30 local government pension funds with an asset base of R30 billion, Collin Matjila, the chairman, said yesterday.

Matjila said NBC Consultants and Actuaries, the first black-controlled employee benefits consultancy, would conduct the audit in the funds.

Matjila said there was a potential for conflict of interest for the non-institutional administrators of the funds – in other words, individuals who were also investment managers or employees of the fund.

He said there was also a 'lack of relevant experience and qualifications, which put such assets under undue risk'. An administrator who administered a fund worth about R9 billion and represented about 80 000 working and pensioner members billed R30 million in 1997 for work an institution would charge R10 million, he said.

– **Business Day : 7 September 1999 : (Refcorp staggers under cash problems)**

"Controversial venture capital company REF Finance and Investment Corporation (Refcorp) is staggering under major cash flow problems that could lead to its liquidation.

Former employees who did not wish to be named have said they have not been paid for more than two months and that this was just the tip of the iceberg. The company is apparently also about R4m behind on pay-as-you-earn (PAYE) tax remittances to the Receiver of Revenue.

Five directors have left the company over the past couple of months for a variety of reasons which included the nonpayment of salaries.

One employee said the problem with Refcorp was not so much the listed entity but the underlying, non-listed companies that were draining the parent's accounts, balance sheet.

The Johannesburg Stock Exchange (JSE) is believed to be investigating Refcorp and has already interrogated some former directors.

Refcorp was warned by the JSE last week for failing to submit annual financial statements within six months of the financial year-end. Refcorp deputy chairman Ivan Penny pleads that the group's financial director had to go on maternity leave three weeks sooner than expected and that results would be released soon.

– **Cape Times Business Report : 5 October 1999 : (Dorbyl fraud rings sour note for Metkor)**

"Johannesburg – Metkor Group, the steel and engineering holding company, had been forced to tear up its annual accounts and produce a fresh set of figures because of fraud and bungled bookkeeping at its Dorbyl subsidiary, the group said yesterday.

Last month Dorbyl confessed that its own annual accounts to March 31 were a sham because of fraud and accounting misstatements in two of its operations.

Inventory and accounts receivable balances were overstated for Baldwins Rosslyn, a division of Dorbyl, and for Cutmaster, a wholly-owned Dorbyl subsidiary.

As a result of this fraud and the accounting errors, Dorbyl's earnings were revised downwards by 22 percent, with headline earnings a share adjusted downwards by 24 percent".

– **Business Day : 19 October 1999 : (Bank keeps eye on Macmed)**

**Analysts say big banks can absorb knock, but smaller lenders will feel some pain**

"The Reserve Bank is scrutinising the likely liquidation, of debt-burdened Macmed Health Care for possible threats to the country's banks, financial sources said yesterday.

Macmed was placed in provisional liquidation on Friday, owing nearly R1bn to 16 banks. Company directors requested the suspension of trade in the counter on the Johannesburg Stock Exchange two weeks ago pending the results of a forensic audit.

The group issued a profit warning just before its suspension, saying 'suspected irregularities and losses' had increased the level of debt for the six months to September.

According to court papers, Macmed's debts involve SA's five biggest lenders. They are exposed to the largest chunks of the R986m owed. Three-quarters of this amount is unsecured, but is being disputed.

– **Business Report : 23 November 1999 : ("Fired Beige directors inflated reported profit")**

" 'The ostensible profit was largely arrived at in the following manner: Duke created a fiction relating to an entity known as Gapp Trading.

'This fictitious company allegedly purchased from Consultant (Beige Holdings) raw material products at highly inflated prices. A bank account styled Gapp Trading was opened and conducted by Duke.

'This created the false impression of a third party actively doing business with Consultant and the payments which, theoretically, were forthcoming from Gapp for the materials purchased were ostensibly paid for by Duke himself'.

Browde said such action 'shows a callous disregard for the interests of the company and the fiduciary duty owed by all of the miscreants to the company, not to mention it being a fraud on the public generally'."

– **Sake Burger : 22 November 1999 : (Beige)**

"Beige se voorbelaste inkomste vir die jaar tot Junie 1988 (*sic*) het R10,4 miljoen beloop, maar dit lyk nou asof meer as die helfte daarvan regstreeks verdien is van beweerde 'vervalste fakture' van Beige.

Die 'groot winste', 'n paar verkrygings en gissings oor meer wat moet kom, het die Beige aandeelprys sterk laat styg. Geen geleentheid om die aandeelprys opwaarts te manipuleer is glo misgeloop nie.

Beige se aandeelprys het van 150c kort na die notering tot 'n hoogtepunt van 1 050c in Mei verlede jaar opgeskiet. Die deelnemers aan die bedrogspul het deur 'n aandeelpeel-rekening by die makelaars Irish & Menell groot hoeveelhede aandele verkoop tydens die 'kunsmatige lopies' wat hulle self bewerkstellig het.

Die amptelike bekendstelling van Beige se resultate kan een van die skouspelagtigste bedrogsake in Suid-Afrika se korporatiewe geskiedenis inlui.

As die bewerings waar bewys word, is die vraag wat is die betrokkenheid van die ouditeurs wat 1998 se resultate goedgekeur het. Hoe kan 'n ouditeur nie agterkom dat fakture bestaan vir transaksies vir produkte wat nie verkoop is nie, maar waarop die pryse tot 100 keer meer as die markwaarde van die produkte is?"

– **Cape Times Business Report : 17 December 1999 : (Nail)**

**"Nail shareholders wait on R68,4m**

Johannesburg – New African Investments Limited (Nail) shareholders will have to wait until the release of the group's financial 1999 annual report to get details of the R68,4 million restraint of trade payments that were paid out during the year, the company said this week.

The preliminary results that were released last week revealed that restraint of trade payments of R68,4 million were paid and R28 million was paid out in the form of executive severance packages. No details were given regarding these amounts.

Dikgang Moseneke, Nail's chief executive, said this week that details of who had received payments would be disclosed in the annual report, which was due out in February".

– **Cape Times Business Report : 18 January 2000 : (Macmed)**

**KPMG finds evidence of fraud at Macmed**

Johannesburg – Certain directors of Macmed Health Care, the medical supplies business under liquidation, undertook a 'modus operadi.....to defraud creditors, shareholders and other stakeholders', according to a report released yesterday by KPMG Forensic & Investigative Accounting Group.

A number of simulated transactions had the effect of creating false profit for Macmed.

The report is the first to emerge from the investigation into the failed healthcare company, which continues this week but is closed to the public. It said one of Macmed's methods was to inflate its profit by acquiring companies at inflated prices.

Vendors of these companies – bought out over three years – were paid a higher price than the true value of the companies.

At the same time, the companies due to be bought purchased non-realizable stock from Macmed, which had little value. 'The result was that Macmed reflected realized profits on stock sold at grossly inflated values'."

— **Business Day : 28 January 2000**

### **"Bryant acknowledges big losses**

The full extent of mismanagement at Bryant Technology has begun to emerge with the company admitting to big losses after being forced to republish its financial figures.

Bryant ceased production of its main product last year, a thin-client device touted as a cheap alternative to traditional computers. Directors blamed faulty components and declined to say how badly their business has been hit. Now a statement from the company shows that accounts had been wrongly recorded and covered up a seriously deficient balance sheet.

Operating profit has been revised down R13,7m, leaving a loss of R5,6m instead of the claimed R8,1m profit. Headline earnings were slashed by 7,42c a share, leaving a loss of 4,3c instead of the claimed profit of 3,3c. The company's assets have been revalued at R14m – R12m less than the stated R27,2m".

— **Cape Times Business Report : 9 February 2000 : (Business Watch)**

### **"A splash of whitewash does the trick for DRD's board**

Johannesburg started out life as a Wild West mining town little more than 100 years ago.

And in all that time some things have hardly changed, like the quaint old custom of company directors doing exactly what they want, minority shareholders and the law be damned.

Just two weeks ago Mine Prinsloo, the chief executive of Durban Roodepoort Deep (DRD), was lamenting the fact that his company did not command the same rating as Harmony.

When it was put to him that one of the reasons for this was that the company had still not escaped the shadow of Roger Kebble, Prinsloo jumped to the defence of his friend, mentor and chairman.

'He founded this company,' was Prinsloo's response to the suggestion that DRD should actually put into practice the more independent line that he has so long professed to take.

Yesterday Prinsloo and his board showed just how independent they were when they whitewashed over serious breaches of corporate governance and breaches of the law and agreed to let the perpetrators of a share-trading scandal escape with no more than an apology.

Such actions were in no way in the interests of DRD shareholders. They only turned a profit for DRD because Harmony succeeded in its bid for Randfontein, an outcome the perpetrators could not have predicted when they attempted to foil the Harmony bid.

Prinsloo and his board had an opportunity to come clean and thereby begin to make progress towards rebuilding their rating.

Instead, they chose to wallow in the dirt".

– **Cape Times Business Report : 10 February 2000**

**"Set Points is losing points with its set misstatements**

It seems to be happening almost daily that a JSE-listed company releases a statement that it has to amend its results because of some kind of accounting error.

Yesterday it was the turn of Set Point Technology, which had to amend its audited results for the 12 months to August because of an allocation error to the tune of R21,4 million in its cash flow statement.

This money was mistakenly placed in cash flow from operating activities instead of in cash flow from financing activities – a financial oversight according to Mark Smith, the chief executive officer, as a short-term loan to purchase MTL in the UK, was posted to trade liabilities.

The net result of this oversight is that Set Points operations, according to the revised figures now only generated R6,4 million in cash during the year as opposed to its earlier recorded R27,8 million.

What amazes us is that no one noticed the error from management all the way through to Fisher Hoffman Sithole, the Set Points auditors.

This misstatement is a fairly hefty difference and of material concern to investors who bought shares on the basis of these audited results.

We are not picking on Set Point, but this latest mistake in a long litany of amended financial results should make a whole host of financial institutions sit up and take note.

It is now time for the JSE, the auditing profession and shareholders to stand up and be counted. These sort of errors should not be tolerated – especially in audited results. It is time for some sort of penalty to be imposed on all offending parties when such a glaring error is made".

– **Business Day : 11 February 2000**

**"When the ducks quack**

Cynical stockbrokers coined a phrase during the boom of the late 1960s to describe investors' indiscriminate and insatiable appetite for new listings: 'When the ducks quack', went the saying, 'feed them'. Judging by a string of unpleasant surprises recently sprung by JSE-listed companies – most of them newcomers – one can be forgiven for wondering whether the same philosophy has taken hold three decades later.

This week alone, directors at Legacy Ventures suggested that huge losses resulted from a previous board having their hands in the till. Set Point Technology disclosed that its audited 1999 financial statements had erroneously allocated R21,5m to cash flow from operations, instead of financing activities. Roadcorp, a longer-established group, was suspended amid allegations that its latest financial results were less than accurate. These cases come on the heels of irregularities at Beige Holdings, Bryant Technology and Macmed Healthcare.

It is true that the risks of investing in a venture capital or information technology outfit without a track record are higher than putting one's money in a blue chip. The JSE's job, arguably, is to provide a market, not to guarantee the quality of its listings. Furthermore, not even the most vigilant auditor or regulator can stop a determined defrauder from cooking the books.

But the growing frequency of the surprises should set alarm bells ringing. Judging by the cases that have recently come to light, some of the entrepreneurs at the helm of venture capital and IT start-ups have scant knowledge, and perhaps even scant regard, for the niceties of corporate governance. There is also the question of how thoroughly auditors and the JSE's listings committee are doing their jobs.

These shortcomings tend to be of little concern to investors so long as share prices keep rising. However, investors in the likes of Beige, Legacy and Bryant have suffered sizeable losses".

– **Business Report on Sunday : 13 February 2000**

**"Blood spills in Legacy boardroom**

Johannesburg — Bad blood in business rarely gets spilt in public and almost never in company results, but last week an extraordinary commentary on Legacy Ventures' audited results for the 10 months to December 31 seemed to be drenched in gore.

The story behind the commentary pits veteran businessman Dave King, the leader of the Virgin Island-based Rossenfeld Consortium, which took over Legacy Ventures in December, against Nick Venter, a 30 year-old tyro tycoon, who listed Legacy with R60 million raised from some 1 500 individual shareholders in March 1998. The shares, listed at R1, hit a high of R1,06 in August 1998 slumped to a low of 8c in January 1999.

'The new managers had been discomfited to uncover transactions that had led to a rapid decline in shareholders' fortunes. A large proportion of the company's funds was utilised to meet private expenses and investments, as well as investments into companies with links to former directors.

Finley Proudfoot, an executive directors of the interim Legacy ventures board, said the previous management had used the company as 'their own personal petty cash box'.

He produced sheaves of invoices that detailed bills for florists, supermarkets and bottle stores listed among office expenses to back up his claims.

'Before we took over this company there were no business ethics,' said Proudfoot.

'As far as I can see the only agenda was enrichment. We have the proof and almost every transaction you look at makes you angry.' King said he had taken the unusual action of publishing the highly critical commentary to 'clear the air'."

— **Cape Times Business Report : 18 May 2000**

**"Regal's share reels on news of accounting disagreement**

Johannesburg – Shares in Regal Treasury Bank Holdings (Regal), the niche bank and financial services business which this week reported a 38,3 percent increase in net income to R50,9 million for the year to February 29, lost 18,3 percent of their value to R4,70 yesterday as investors digested worse than expected results.

Regal's results were released a month later than had been expected and revealed that headline earnings a share had only climbed 4 percent to 50,01c, giving a maiden dividend of 13c a share.

Central to analysts' and bankers' dismay was the deferral of R30,5 million of the firm's income as a result of a passing disagreement with Ernst & Young, its auditors, over the accounting treatment of an in-house financing structure".

– **Saturday Argus : Saturday Business Report : 20 May 2000**

### **"Regal Treasury Bank**

Whatever the nature of this banking newcomer's accounting dispute with its auditors, there is no escaping the fact that its results were shocking and their presentation on the Stock Exchange News Service (SENS) and in the press lamentable.

They were released one month later than expected – without any reason being given – and came after the JSE had closed which, as we all know, is a sure sign that the company is being a little backward in coming forward.

But the worst aspect of the preliminary results announcement, other than the 3,97 percent growth in headline earning a share in a SENS release headlined 'Regal achieve (sic) five year compound earnings and eps growth of 119 percent...' was that it was written in what can only be described as technobabble.

Yes, the results may well be true, but they were so wrapped in obscurity as to reduce us and a number of clued-up readers to tears of laughter and then depression, matched only by the slump in Regal's shares this week.

We have discovered that the JSE's corporate finance department actually vets announcements before passing them on to SENS for dissemination to those lucky enough to have access to it.

So, quite how the JSE allowed a listed company – especially one with a Latin motto of 'Honor et Integritas' – to issue a release containing such technobabble beats us.

What, for example, does the following description of Regal's mysterious, so-called banking model tell you, the reader or investor?

Here goes: 'Regal has developed a futuristic financial model that transitions the group powerfully into new economy.'

Or how about: 'The leverage of our statutory framework to bridge the gap between a bank and business concern, creates a new financial instrument; and by overlaying the profile of a bank onto a business platform, the risks inherent in the created instrument are dramatically reduced.'

Ja, well, no fine. Investors have already voted with their feet by dumping Regal's shares and the savvy ones know that the safest convergent banking and information technology stock is still Nedcor".

– **Sunday Argus : 3 / 4 June 2000**

#### **"East Cape investors fear R130-m loss**

Hundreds of Eastern Cape investors could lose as much as R130-million in a sensational investment scandal involving top Port Elizabeth businessman and property speculator Danie Halgryn.

At the end of a week of drama, the once high-flying property tycoon threw in the towel on Friday and liquidated his group of 17 companies in a bid to pay back investors.

This followed a raid on Mr Halgryn's offices by lawyers who obtained a court order on behalf of anxious investors who had been attracted to his scheme by promises of more than 20% interest.

The desperate move to liquidate came after Mr Halgryn, 45, admitted in a statement to police in mid-May to taking investors' funds out of the trust account of his close corporation Sea Castle Factoring to help pay debts of his other companies".

– **Cape Times Business Report : 18 July 2000**

#### **"A taste of past promises made**

For a change and as a kind of cautionary tale, we thought it would be fun to introduce a quiz element to Business Watch.

Followers of the financial services sector over the past few years will have noticed the disproportionately high number of underperforming new entrants that managed to obtain a listing on the JSE.

Here is an advertisement dating from last July – a mere year ago – placed by one would-be contender which has proven to be no exception to the get-rich-quick listing frenzy – and has consistently destroyed value since hitting the JSE.

If you can guess the identity of the company you are probably a disgruntled shareholder. The answer will be in tomorrow's edition of Business Watch.

Here goes: 'Solidly founded on ethical values of excellence, trust and integrity and motivated by a spirit of creativity, innovation and entrepreneurship, .....is active in treasury, credit, trade finance, project and structured

finance, corporate finance, equity participation, and international banking services.

'With its sharp focus on intellectual capital and information technology and its commitment to customer service,.....intends to become a force to be reckoned with in the international arena.'

A well worn copy of a JSE Handbook is available to help readers correctly identify this financial services contender. We'll give you one clue: it is definitely not Regal Treasury Bank".

– **Business Day : 24 July 2000**

### **"Furious shareholders let rip at Faritec's bid bungling**

Hell hath no fury like a small shareholder scorned. That could be a new maxim for the stock exchange, especially after the furore surrounding the meltdown in Faritec's share price.

Faritec, the once trendy small cap information technology (IT) share, this month experienced a spectacular destruction of shareholder value as acquisitions fell through and a profit warning hit the market.

Even worse, it appears institutional investors got wind of the impending disaster, and started dumping their shares on an unsuspecting market before the formal profit warning was released on 7 July.

On that day, the share fell from 100c to under 40c without an official notice that something was wrong.

No wonder small shareholders have let rip, laying into management and the board in an outpouring of bile in a chatroom on Alec Hogg's Moneyweb internet website.

The Faritec story highlights the lack of transparency and timeous disclosure in SA's corporate world, which is fertile ground for insider trading. It also draws

attention to the role of nonexecutive directors as guardians of shareholders' wealth and the fallibility of market gurus".

2. **Ponzi scheme.** A form of pyramiding in which money paid by later investors or contributors is used to pay inflated returns to earlier investors. Named after Charles Ponzi who ran such a scheme during 1919-1920 in Boston, USA. He collected \$9 500 000 from 10 000 investors by selling promissory notes promising payment of a fifty per cent profit in forty-five days.
3. **Republic of South Africa.** Proclamation No. R.46, 1992.
4. **Republic of South Africa.** Report of the Commission of Inquiry into the Affairs of the Masterbond Group of Companies. 1997.
5. **Republic of South Africa : Minister of Finance budget speech 23 February 2000**

"These adjustments should promote a culture of savings in our country. Increasing the overall level of savings in our economy is exceedingly important if we are to generate the levels of investment required for job creation".

6. **See note 8.**
7. **Cape Times Business Report : 17 December 1999**

**"Business is living in the wild, wild west**

Johannesburg – The business community in South Africa was like the wild west, where financial cowboys reigned supreme and auditing and law enforcement was woefully inadequate, Clive Robertson, the general manager of Credit Guarantee, the domestic and foreign credit insurance firm, said this week.

He has been involved in a number of recent liquidations, and has just broken his silence to warn of the rotten underbelly of business life.

'We are paying out millions and millions of rands a month, and we have to warn credit granters to be very careful,' he said.

Robertson protested that blatant dishonesty and inept management were evident in virtually every one of the recent spate of high-profile company failures to hit the business community, and he highlighted Macmed, Beige, Oranje Sewing Thread and Infinity as cases.

'Dishonesty is evident in between 70 percent and 85 percent of all liquidations taking place in South Africa,' he said.

'This compares with a figure of 60 percent in the UK. However, the proportion of businesses failing in South Africa is far greater than in the UK.'

Robertson questioned why the danger signs were not apparent until too late in recent liquidations, and suggested that auditors had not been sufficiently rigorous.

'What is most disconcerting about the recent spate of failures is that the latest audited financial results of the listed companies gave little indication of impending financial collapse,' he said.

'You look at a company's accounts after liquidation, and compare this to the situation before liquidation, and assets have just disappeared, or stock has gone,' he said. To steal and hide assets away was the easiest thing in South Africa he said.

'This gives cold comfort to shareholders and creditors as to the effectiveness of current auditing procedures.' Robertson suggested that this situation reflected an alarming decline in both business integrity and acumen.

Robertson argued that the patent inability of the policing and justice systems to deal effectively with what he described as 'rampant' white collar crime was encouraging a wild west syndrome amongst potentially dishonest

businessmen, for whom the rewards of unlawful business practise far outweighed the risks".

8. **Central** to some of the Recommendations to be made by the Commission is the fact that financial statements drafted in accordance with GAAP are not necessarily accurate or reliable. The mistaken belief that financial statements drafted in accordance with GAAP are accurate and reliable is generally held by legislators and the public. To correct this belief at the outset, reference is made to the publication 'Corporate Governance' by Robert A G Monks and Nell Minow (Blackwell Publishers Inc., Cambridge, Massachusetts) 1995 at p. 48-50:

"We begin, of course, with the Generally Accepted Accounting Principles (GAAP). Readers should note that the operative term here is 'generally accepted', not 'certifiably accurate'.

GAAP is a language by which the assets and liabilities of corporations are recorded in balance sheets and their functioning is stated in income statements. Accounting purports to present performance in numbers; by the consistent use of a fixed set of quantitative techniques, accountants can accurately depict the course of a business over long periods of time.

Accounting rules are important because the Securities & Exchange Commission (SEC), the New York Stock Exchange (NYSE), and other regulatory bodies require that companies have 'certified financial statements'. The purpose of these rules is to assure a consistent (if minimal) level of disclosure. What they measure, they [should] measure consistently over time and between companies, and that has some utility. But it is crucial to remember that there is enough flexibility and room for interpretation in the GAAP to permit accounting firms to compete with each other by offering more creative approaches, and there are many clients out there who will hire the firm whose creativity is most in its own favour. Accountancy is a business, indeed, a competitive business, and one of its characteristics is the willingness to find solutions to a client's problems. One accounting firm's charges against earnings are another's 'charge offs' to surplus, for example.

For this reason, the numbers may not be as 'apples and apples' as an outsider evaluating them would wish for.

It is best to view accounting as an invented foreign language like Esperanto – useful enough for communicating across cultures, but really not particularly helpful in day-to-day business dealings. For example, accounting has always had a hard time dealing with inflation. The 'nominal' or stated value of an asset departs widely from its market value. And many items that are vitally connected to the profitability of the enterprise are not carried as assets on a balance sheet: the value of a concession to drill for oil, the value of brand names, the 'goodwill' associated with a new venture launched by a household name. Accounting standards are based on a time when real property, like machinery, was the most important asset. They do not reflect the value of 'human capital'.

But the real problem with accounting standards is that through their general acceptance, appearance becomes reality. New forms of measurement are rarely conceptualized or applied. And existing standards are too often seen as far more objective and meaningful than they are. For example, 'earnings' are one of the critical components of value in the market place, yet essentially, earnings are what accountants say they are. Earnings are subject to manipulation. Much of it is legal and some is even appropriate, but some goes far beyond what should be acceptable. In recent years, there has been an increasing tendency towards what has been called 'big bath' accounting. This is the practice when a company decides at the end of the year that it must make a one-time only 'restructuring charge'. This charge is not assessed against current earnings, it is levied against the accumulated earnings of the venture.

There is an *Alice in Wonderland* character to this. Imagine a company that has reported over the past five years earnings of \$10 a share each year; then in year six, the company decides on a restructuring charge of \$75 a share. During all of the six year period, the company is deemed to be operating profitably from an accounting point of view. Each year has its \$10 earnings; the retroactive 'restructuring charge' cannot affect the five years of perceptions that have passed. Furthermore, because it is a restructuring charge, it does not

alter the reported 'earnings from ongoing operations' in year six, which are, let's say, \$10 a share. Thus, the company has lost money over a six-year period, and yet each annual component shows a profit at the time of reporting. This trick is especially popular for new CEOs, as it enables them to start with, if not a clean slate, a cleaner one.

The numbers make more sense if you keep in mind that accounting earnings are not economic earnings. Accounting standards are like a maze through which to work one's way. A concept as simple as 'costs' can be interpreted a dozen different ways. If the CEO is a veteran who wants to show steady progress, costs may be reported one way. If she is a restructurer to be compensated according to new reported earnings, costs may be calculated another way. And if she is top gun of a defense firm that is paid only 'cost plus' a percentage, costs will be calculated another way.

Consider the situation of Westinghouse Corporation, which by 1993 had taken six restructuring charges over the previous seven years. It got to the point that the 'operating earnings' figures were meaningless, most analysts disregarded the company's figures and developed their own understanding of Westinghouse operations.

In many instances, the accounting conventions have material impact on the company's decisions. For example, in the late 1980s, Westinghouse decided to expand its real estate financing business very substantially. In order to motivate the executives, they devised a compensation package that provided incentive for an improved return on the equity invested (ROE). The executives were so motivated that they dramatically improved the ROE by the fastest method available – they borrowed. This leverage brought increased earning (and, hence, compensation) to the bottom line. Everyone was happy, until Westinghouse became overwhelmed by its new debts. When the real estate commitments proved to have been carelessly assumed, the entire company (not just the real estate division) almost went bankrupt – and all because of an accounting formula to create incentives for salespersons".

9. Anguilla, Antigua, Argentina, Australia, Bahama Islands, Bahrain, Barbados, Belgium, Belize, Bermuda, Bolivia, Botswana, Brazil, British Virgin Is., Brunei,

Burma, Canada, Cayman Islands, Chile, Colombia, Costa Rica, Cuba, Cyprus, Denmark, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Ethiopia, Fiji, Finland, France, Gambia, Germany, Ghana, Gibraltar, Greece, Grenada, Guatemala, Guernsey, Guyana, Honduras, Hong Kong, India, Iran, Iraq, Ireland, Isle of Man, Italy, Jamaica, Japan, Jersey, Jordan, Kenya, Korea, Kuwait, Lebanon, Lesotho, Liberia, Libya, Luxembourg, Malawi, Malaysia, Malta, Mauritius, Mexico, Nauru, Nepal, Netherlands, Netherlands Antilles, New Zealand, Nicaragua, Nigeria, Norway, Oman, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Portugal, Puerto Rico, Qatar, Romania, St Christopher & Nevis, St Lucia, St Vincent & Grenadines, Saudi Arabia, Seychelles, Sierra Leone, Singapore, Spain, Sri Lanka, Sudan, Swaziland, Sweden, Switzerland, Syria, Taiwan, Tanzania, Thailand, Trinidad & Tobago, Turkey, Turks & Caicos Islands, Uganda, United Arab Emirates, United Kingdom, Uruguay, Venezuela, Western Samoa, Yugoslavia, Zambia, Zimbabwe.

10. Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York State, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.
11. Argentina, Australia, Bangladesh, Belgium, Brazil, Bulgaria, Canada, China, Finland, Germany, Hong Kong, India, Indonesia, Israel, Italy, Japan, Korea, Latvia, Lithuania, Malaysia, Mexico, Netherlands, New Zealand, Pakistan, Philippines, Russian Federation, Singapore, Sweden, Switzerland, Taiwan, Thailand, United Kingdom, United States, Vietnam.
12. Alabama, Arkansas, California, Colorado, Connecticut, Georgia, Hawaii, Idaho, Illinois, Iowa, Louisiana, Maryland, Minnesota, Missouri, Montana, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, West Virginia, Wisconsin, Wyoming, Utah.



# CHAPTER 2 - THE HISTORY AND EVOLVEMENT OF THE MODERN COMPANY

**2.1** Many definitions of the concept of a company have been attempted. The late **Professor Gower** defined it (as usually understood) as an association of a number of persons for a common object, the object (usually) being the economic gain of its members.<sup>(1)</sup>

A somewhat more cynical definition appears in **Ambrose Bierce's The Devil's Dictionary** —

"An ingenious device for obtaining individual profit without individual responsibility."<sup>(2)</sup>

**Monks and Minnow** describe it as

".....a mechanism established to allow different parties to contribute capital, expertise, and labor, for the maximum benefit of all of them. The investor gets the chance to participate in the profits of the enterprise without taking responsibility for the operations. The management gets the chance to run the company without taking the responsibility of personally providing the funds. In order to make both of these possible, the shareholders have limited liability and limited involvement in the company's affairs. That involvement includes, at least in theory, the right to elect directors and the fiduciary obligation of directors and management to protect their interests".<sup>(3)</sup>

**2.2** It should be noted that the definition of **Monks and Minnow** is correct in that (in the traditionally English-speaking countries)

— normally only those parties who own shares, whether or not they have contributed to the working capital of the company, have the right to appoint directors,

- the fiduciary duties of the directors and management only extend to the protection of the interests of the company, and rarely to its shareholders and the interests of creditors or employees;
- parties who contribute their expertise, labour or credit for the welfare of the company have no say in its management.

**2.3** A modern public company has, amongst others, usually the following features

- it has an artificial legal personality with the right to own property and to carry on business in its own name;
- it has perpetual succession;
- its assets and profits belong to itself and not to its members;
- the liability of its members is limited;
- the interests of its members are freely transferable;
- its affairs are managed by directors appointed by its members;
- in many jurisdictions, its directors periodically have to prepare and publish duly audited financial statements.

**2.4** The company evolved from associations of persons who shared resources for common objects. Such associations were known to the ancient Greeks and were not uncommon during Roman times<sup>(4)</sup>.

In his '**New Pandect of the Roman Civil Law**' **John Ayliff** stated that

“A **Corporation**, or **Community**, is a Collection or an Assembly of several individual Persons united and formed into one Mystical Body, called a **Body Politick**, by the Permission and Grant of the Prince.....

There were several of these **perpetual** Corporations or Communities at **Rome**, which were either confirm'd by the Decrees of the Senate, or else by **Imperial** Constitutions.....

The first sort of Corporations has a respect unto such Persons, whose principal business regards Religion, as Chapters of Cathedral or Collegiate Churches, Monasteries, and the like: and these are stiled **Ecclesiastical** Corporations. The second sort of Communities extends itself to those Persons who have to do with Temporal Affairs only, as the Civil Government of Cities, Towns, **etc.** which are stiled the Corporation of such a City, Town, and the like; and inferior unto these we may reckon the Colleges and Corporations of Merchants, Tradesmen, and Artificers, usually called **Companies**. This second sort of Corporations we term **Secular** Corporations".

One of the texts referred to by the author, (**Digest of Justinian 3.4.1.1.**), reads —

“When persons are allowed to form associations under the title of a corporation, guild or any other body of this kind, they are, like a municipality, entitled to have common property, a common treasure chest, and an agent or a syndic, and, as in the case of a municipality, whatever is transacted and done by him is considered to be transacted and done by all”.

**2.5** The South African Companies Acts followed closely in the footsteps of the Companies Acts of England. Prior to colonisation by Great Britain, South Africa and most of the other countries of the British Commonwealth had little, if any, experience of companies, save for the often oppressive rule by large trading entities such as the VOC and the East India Company. It is only to be expected that the English Companies Acts which served the purposes of a wealthy commercial and industrial nation, would have served as models for its colonies. The history of the companies act of the United Kingdom is therefore largely also the history of the South African Companies Act.

**2.6** In England, before the Norman Conquest during the 11<sup>th</sup> century, the power to confer corporate privilege was exercised by the nobles. Corporate privilege usually included perpetual succession and limited liability.

"there grew up in England of preconquest days several classes of organizations embodying many of the elements of corporations. The first of these, according to Kyd, were those peculiar to the church, and grew out of the

necessity of providing means for holding property. It was out of this situation that there developed the corporation sole, an offshoot of the corporate concept and subsequently applied, by analogy, to municipal affairs and to the state.

Contemporaneously with these ecclesiastical corporations, if not antedating them, as some authorities say, there existed in England certain forms of temporal corporations known first as peace guilds, the members of which were pledged to stand together for mutual protection. These, it seems, were of two classes, one including neighborhood groups, the other embracing those exercising similar occupations. Both of these, in time, developed into an approximation of the modern municipal corporation, each exercising minute supervision over those under its jurisdiction, the one dealing with all persons living within a certain territory, and the other with all of those of like occupation residing within a certain district".<sup>(5)</sup>

**2.7** After the Conquest corporate privilege was conferred by the Sovereign and later also by Parliament.

**2.8** From the 11<sup>th</sup> century numerous corporations were created by Royal Charter for ecclesiastical and educational purposes. Corporate privilege was also granted to some of the trade and merchant guilds which had started to emerge, such as the 'Goldsmiths', the 'Mercers' and the 'Haberdashers' during the 14<sup>th</sup> and 15<sup>th</sup> centuries.<sup>(6)</sup>

**2.9** Guilds controlled, regulated and protected their members, and ensured product quality. The individual members, however, usually traded on their own behalf.

**2.10** Partnerships were formed but suffered from disadvantages such as the lack of perpetual succession, the (usual) personal liability of the partners for all partnership debts and the limitation on the free transferability of the interests of partners. In England, as opposed to Scotland, it also suffered from the reluctance of the Courts to recognise a partnership as a legal personality.<sup>(7)</sup>

**2.11** The lack of financial means or the lack of the necessary influence to obtain incorporation by Royal Charter or by Act of Parliament contributed to the emergence of unincorporated companies and the use of trust deeds. Unincorporated companies were formed with deeds of settlement wherein the subscribers agreed to be associated in enterprises with prescribed joint stock divided into specified numbers of shares, with management delegated to

committees of directors and with property vesting in separate bodies of trustees. Members were also allowed to withdraw by transferring their interests to other persons.<sup>(8)</sup>

**2.12** During the sixteenth and seventeenth centuries, and when the need for large scale trading enterprises emerged, incorporation of trading companies became popular in Europe.<sup>(9)</sup> Companies such as the **East India Company (1600)** and the **Vereenigde Oost Indische Compagnie (V.O.C.) (1602)** were incorporated by Royal Charter or by Acts of Parliament (or the Staten-Generaal). Both these companies were granted sole trading rights from East of the Cape of Good Hope to the Straits of Magellan.

**2.13** The development of the capital structure of corporations during the 17<sup>th</sup> century is illustrated by the history of the **East India Company**.

“(It) evolved in just sixty years from a system of speculative voyages with terminable stocks to a continuing corporation with permanently invested capital. Between **1600** and **1617** the company sponsored **113** voyages, each supplied with newly subscribed capital and treated as a separate venture. This made liquidation necessary after each voyage so that those who wished to drop out might do so and new ‘adventurers’ might be admitted. It also meant the stock was not readily negotiable, since there was no way to enter a venture in progress other than by buying unissued stock or a fraction of a share held by a present member. At the end of each voyage assets as well as earnings were subject to ‘divisions’ among the shareholders. Profit was easily measured by the individual investor: he gained to the extent that he got back more than he had paid in.

But ships, trading posts and other long-lived resources had a bothersome way of carrying over from one venture to the next, until finally the company’s accounts became a jumble of successive voyages. As unliquidated balances or ‘remains’ of earlier voyages were merged with later ones, it became necessary to juggle assets and profits of many distinct ventures in various stages of completion. Also, during the seventeenth century trading abroad had developed into a fairly continuous process requiring permanent capital. It now became more useful to view the business as a going concern.

In **1613** the East India Company stopped issuing stocks for each venture and began selling four-year subscriptions, with a fourth of the stock price to be paid each year and used to finance that year’s voyages. A new charter in **1657** established the principle of permanently invested capital and extended the right to transfer individual shares before liquidation. Stock was to be priced by the company, first at the end of

seven years, then every three years thereafter. Any shareholder could at any time sell his stock at these prices. This not only simplified the problem of transferring shares but, from the company's view, made it easier to attract new capital. In 1661, following out the logic of permanently invested capital, the company's Governor announced that future distributions would consist of 'dividends' paid from profits rather than the familiar 'divisions' of profits and assets".<sup>(10)</sup>

**2.14** One of the first attempts to deny stockholders access to the records of their company occurred during 1633. After a decline in the fortunes of the East India Company, some stockholders moved for the appointment of a committee of inspectors. The Governor (Chairman) refused to put the motion to the meeting and the governing committee decided that no-one should be permitted to read or copy, or to 'ravel and dive' into the accounts without its consent. This was decided on the grounds of the allegedly 'ill use' of transcripts to divulge secrets of the company.<sup>(11)</sup>

**2.15** During the 17<sup>th</sup> and 18<sup>th</sup> centuries, companies, incorporated and unincorporated, proliferated. There were no regulating authorities and fraud, corruption, insider trading and manipulation of stock prices were commonplace.

**2.16** Conditions in England during the last decade of the 17<sup>th</sup> century are described by **Edward Chancellor** as follows;

"In the stock market of the 1690s, the line between commendable self-interest and arrant fraud was frequently crossed: sham companies were launched for the enrichment of projectors, share prices were manipulated, and false rumours were circulated. In *The Volunteers*, Thomas Shadwell described the stock market as a world of sharpers and cheats, where men 'bubbled' each other for profit (at this date, 'to bubble' meant to perpetrate a fraud). Charles Davenant describes the moneyed men as practising a variety of 'Cheats, Extortions, Frauds, Bribery and Corruption' in their pursuit of wealth. The term *stockjobbing* – synonymous with speculation as well as the trade in shares – also described the act of blowing up shares above their true value while simultaneously running down a company's real prospects. In a world where credit notes and lottery tickets circulated as money, company shares became the currency of corruption".<sup>(12)</sup>

**2.17** During 1696 money became scarce (due to the costly war with France and hoarding of coinage) and credit even scarcer.

"The 'bell whether' East India Company share price fell from 200 in 1692 to 37 in 1697.....Of 140 English and Scottish companies operating in 1693, only 40 survived the crisis to 1697 – a failure rate of 70 per cent".<sup>(13)</sup>

**2.18** The activities of the directors of the legendary **South Seas Company**, incorporated during 1711 as ‘**The Governor and Company of Merchants of Great Britain trading to the South Seas and other Parts of America and for the encouragement of the Fishing**’<sup>(14)</sup>, are prime examples of the activities of the mendacious swindlers who appear on the company stage from time to time.

**2.19** During a period of inflation, high interest rates and frenetic speculation in stocks and shares in Paris, Amsterdam and London, the directors of the South Seas Company successfully bribed a number of British parliamentarians. This resulted in the enactment in 1720 of **Act VI George I Cap 4** whereby the **South Seas Company** acquired the right to the greater portion of the then national debt on favourable terms.

**2.20** Payment was to have been financed by the issue of stock. To make successive issues appealing to the public, the price of stock previously issued had to be kept at an attractive level. The directors manipulated the price by

- selling stock on margin;
- creating a scarcity of stock by delaying the issue of new scrip subscribed for;
- advancing money to-would-be subscribers on the security of existing stock of the company pledged to it;
- lending money received from subscribers to other would-be subscribers for purposes of subscription;
- borrowing money from the ‘**Sword Blade Company**’<sup>(15)</sup> (a company with a number of common directors), to advance to would-be subscribers;
- personally using money issued by and borrowed from the ‘**Sword Blade Company**’ to buy stock at inflated prices in an attempt to corner the market;

**2.21** To generate additional income for the company and for themselves, the directors

- sold stock pledged to the company, hoping to repurchase it at lower prices;
- bought stock in advance of the declaration of abnormally high dividends.<sup>(16)</sup>

**2.22** The **South Seas Company** competed for capital with many other companies and (some say) in an attempt to assist it,<sup>(17)</sup> and as from 24 June 1720, the British Parliament outlawed virtually all unincorporated companies. Brokers ('stock jobbers') were also prohibited from dealing in stock of such companies. The effects of this Act (**VI George I Cap 18**) were so disastrous that it became known as the '**Bubble Act**' ('the Act which burst the bubbles').<sup>(18)</sup>

**2.23** Although the price of the South Seas stock was initially supported by the effect of the '**Bubble Act**', the losses suffered by investors in other companies (many who were also investors in the **South Seas Company**) and the general down-turn in public confidence, hastened the collapse of the **South Seas Company**. The price of its stock fell from 1050 pounds during August 1720 to 124 pounds during December 1720, when Parliament stepped in with a scheme to assist the investors.<sup>(19)</sup>

**2.24** In 1734 and in another attempt to avert similar crises, Parliament passed "**An Act to prevent the infamous Practice of Stock-jobbing**" which outlawed the trade in futures and options and made short sales illegal.

It provided —

"That all Contracts and Agreements whatsoever, which fall, from and after the first Day of *June* One thousand seven hundred and thirty four, be made or entered into, by or between any Person or Persons whatsoever, upon which any Premium or Consideration in the Nature of a Premium shall be given or paid for Liberty to put upon or to deliver, receive, accept or refuse any Public or Joint Stock, or other Public Securities whatsoever, or any Part, Share or Interest therein, and also all Wagers and Contracts in the Nature of Wagers, and all Contracts in the Nature of Putts and Refusals, relating to the then present or future Price or Value of any such Stock or Securities as aforesaid, shall be null and void to all Intents and Purposes whatsoever...."

"VII And whereas it is a frequent and mischievous Practice for Persons to sell and dispose of Stocks or other Securities, of which they are not possessed : Be it therefore further enacted by the Authority aforesaid, That all Contracts and Agreements whatsoever, which shall, from and after the said first Day of *June* One thousand seven hundred and thirty four, be made or entred into for the buying, selling, assigning or

transferring of any Public or Joint Stock or Stocks, or other Public Securities whatsoever, or of any Part, Share, or interest therein, whereof the Person or Persons contracting or agreeing, or on whose Behalf the Contract or Agreement shall be made, to sell, assign and transfer the same, shall not, at the Time of making such Contract or Agreement, be actually possessed of, or intitled unto, in his, her or their own Right, or in his, her or their own Name or Names, or in the Name or Names of a Trustee or Trustees to their Use, shall be null and void to all Intents and Purposes whatsoever;"<sup>(20)</sup>

**2.25** The losses suffered by the public and the effects of the '**Bubble**' Act retarded the development of companies in England for decades. Eventually, from the latter part of the **18<sup>th</sup> century** and partly as a result of the industrial revolution, numerous associations, some with hundreds of members, were again formed for purposes such as banking and insurance. Not being incorporated, they were in substance partnerships, but the Courts, especially Chancery, started to relax some of its rules, notably by allowing one or more members to sue 'on behalf of' the general body of members.

**2.26** These associations were formed despite the losses suffered by the public during the 'canal mania' in the 1790's and again during the 1820's by the speculation in South American bonds which were backed by spurious claims of fabulous gold resources.

**2.27** In 1767 the first canal was completed in England. Financially it was a success and was soon followed by others. Initially the canal companies paid large dividends and share prices soared. However, in the early 1790's over fifty parliamentary acts for new canals were passed, more than double the number passed during the preceding fifty years. The proliferation of 'canal' companies and the commercial crisis brought about by the outbreak of the French revolutionary wars in 1793, caused the collapse of the so-called 'canal mania'.

**2.28** In the beginning of the 19<sup>th</sup> century, successful speculation in bonds issued by the British Government during the Napoleonic Wars whetted the appetite of the public and when newly liberated South American countries such as Colombia, Chile and Peru launched loans during the 1820's, the loans were over-subscribed and frantic speculation followed. The speculative fever was such that in 1821 a fraudster successfully floated a loan on the London Stock Exchange in the name of a fictitious South American country (Poyias).

**2.29** The circumstances in which the South American bonds were floated are described by Chancellor:

"As well as appealing to liberal sentiments, the foreign loans were designed to be attractive to investors. Their interest payments were set so high that the South American bonds had to be contracted in Paris to avoid British usury laws which limited interest charges to a maximum of 5 percent (an early example of 'offshore' finance being used to evade government regulations). The market yield of the bonds was even higher since they were issued at steep discounts to their nominal value. Moreover, only small initial deposits were required, with further payments stretched over a lengthy period. Thus, a small percentage rise in the market value of the bonds brought far greater returns to the holders of scrip. A large percentage of the money raised by the loans was retained by British contractors to pay dividends, while the proceeds from later loan issues were used to repay earlier debts. The payment of interest from capital, otherwise known as 'Ponzi finance', created the illusion of viability although no money was ever actually sent from South America to service the loans (to which it must be added that the borrowing countries received only a tiny fraction of the total sums for which they contracted)".<sup>(21)</sup>

**2.30** The speculative fever extended not only to foreign bonds but once again to domestic ventures such as

"to drain the Red Sea, in search of the gold and jewels left by the Egyptians, in their passage after the Israelites"

and to companies such as the Resurrection Metal Company which announced its intention to raise tons of cannon balls that lay on the seabed near Trafalgar and other scenes of British naval victories.<sup>(22)</sup>

**2.31** The provisions of the 1734 Act which had outlawed trading in futures and options and had made short sales illegal, were also circumvented or totally ignored.

This speculative fever is described by Chancellor as follows:

"As in earlier speculative periods, most companies were established for no purpose other than to benefit their promoters. 'All we have to do,' claimed the fictional promoter in a contemporary novel, 'is to puff up shares to a premium, humbug the public into buying them, and then let the whole concern go to ruin'. A variety of means were employed to advance this 'humbug' : Only a small deposit was required on

new issues; rumours of speculators' fortunes were circulated in order to entice new players into the market; brokers were employed to manipulate share prices; and journalists were paid to puff companies in the 'money market' columns that had recently appeared in the papers. The editor of the *Morning Chronicle* accused his fellow editors of undermining their journalistic integrity by taking shares in many of the new schemes (editorial indifference to the exposure of fraud was also influenced by a court case involving the *Chronicle* itself, which had concluded with the trial judge opining that 'the conductors of newspapers had no recognised vocation to enlighten the public with regard to abuses')".<sup>(23)</sup>

**2.32** In the King's speech at the opening of Parliament in February 1825, it was stated that

"there was never a period in the history of the country when all the great interests of the nation were at the same time in so thriving a condition".

Within a year of this speech, share prices fell by up to 80 percent, numerous banks failed, and, with the sole exception of Brazil, every South American state defaulted on its debt.<sup>(24)</sup>

**2.33** During this period of euphoria and as a result of the increase in numbers and importance of the unincorporated companies, the **Bubble Act** was repealed on 25 July 1825 (6 Geo IV C. x C1). This is heralded as the start of modern company law in England. The repeal was followed by acts such as the **Trading Companies Act 1934** and the **Chartered Companies Act 1937**.

**2.34** During **1841** a Select Committee (later under the chairmanship of **Gladstone**) was requested—

“to inquire into the State of the Laws respecting Joint Stock Companies.....with a view to the greater Security of the Public”.

**2.35** It published its **First Report** during **1844**. Companies where investments were at risk ('**bubble**' companies) were classified into three groups:

“**1st**, Those which, being faulty in their nature, inasmuch as they are founded on unsound calculations, cannot succeed by any possibility;

**2dly**, Those which, let their objects be good or bad, are so ill constituted as to render it probable that the miscarriages or failures incident to mismanagement will attend them; and —

**3rdly**, Those which are faulty, or fraudulent in their object, being started for no other purpose than to create shares for the purpose of jobbing in them, or to create, under pretence of carrying on a legitimate business, the opportunity and means of raising funds to be shared by the adventurers who start the Company."

**2.36** The companies in the first group ('faulty in their nature, inasmuch as they are founded on unsound calculations') were declared to be 'beyond certain cure by the Legislature'.

However, the hope was expressed that early publication of their prospectuses would be useful for purposes of control.

**2.37** The Committee acknowledged that it would not be so 'easy' to find a remedy for the companies in the second group ('so ill constituted as to render it probable that the miscarriages or failures incident to mismanagement will attend them) and expressed itself as follows:

".....the character and credit of the persons engaged in Companies of this second class lull suspicion. The Directors themselves are often indifferent and careless, trusting too much to their officers; shareholders purchase on the strength of their names, without due inquiry, and thus confer factitious support; so that one set of persons relying upon another set, the delusion is sustained for a longer space of time.

Publications of the Directors and shareholders, of Deeds of Settlement and of the Capital, will not meet this class of cases; but it may be met by the periodical holding of meetings, by the periodical balancing, audit and publication of accounts, and by making the Directors and officers more immediately responsible to the shareholders, which may probably be accomplished by facilitating and improving the remedies available to the Joint Stock Companies and their shareholders inter se. Periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud and illegality".

**2.38** More than 150 years later and despite the emergence of national and international standards of accounting and auditing, regulators, supervisors, shareholders and other stakeholders on the one hand and the directors and auditors of corporations on the other hand still argue whether particular accounts have been 'honestly made and fairly audited'.

**2.39** The fraudulent activities of the companies in the third group (those which are faulty or fraudulent in their object) were described as follows:

“All the Companies of the last class of course adopt, as far as possible, the outward characteristics common to those of the best kind. They exhibit an array of Directors and officers, — announce a large capital, — adopt the style and title of a company, — issue plausible statements, intimating excellent purposes, — declare that they are sanctioned or empowered by Act of Parliament, — use come conspicuous place of business, in a respectable situation, — and employ throughout the country respectable agents and bankers.

But many of these characteristics are fictitious. The Directors have either not sanctioned the use of their names, or they are not the persons they are supposed to be. Not only is there no capital, but neither subscribers nor deed of settlement. The style of the Company may be true, because any Company may adopt such style; but their purposes, though plausible, are often founded on calculations which do not admit of success, and they have not only not received the sanction of authority of Parliament, or of the Crown, but the very statutes which are cited as conferring the authority will be found to have a very different object”.

**2.40** Some of the ‘**Modes of Deception Adopted**’ by these companies recorded in the Report (many with a familiar ring) were

“By the use of the names of such persons (distinguished persons and persons of respectability and wealth) as patrons and honorary directors, with their consent, while such persons have been ignorant of the nature of the concern and of its transactions, and have exercised no control over its management:

By the issue of prospectuses and advertisements containing false statements as to the authority under which it exists, as to the amount of capital of the Company, or as to the period of its establishment, as well as to the Directors, &c. above mentioned:

By the employment throughout the country, on very tempting rates of commission, of respectable agents, whose character has cloaked the want of respectability of the Company. In one or two remarkable cases this appears to have been the most efficient means of success; it has procured business at a distance, where inquiries could not be readily made as to the character of the concern:

By opening banking accounts with the Bank of England and other respectable banks:

By the selection of offices in respectable situations, and fitted up in a respectable manner:

By the concoctors and managers living at great expense, entertaining their neighbours, and thereby endeavouring to fortify themselves against suspicion:

By the making up of fraudulent accounts, so as to deceive the Directors and the Shareholders, which has been facilitated sometimes by the accounts not being audited, or by the Accountant being a near kinsman of the Managing Director, the only party taking an active part in the concern:

By declaring dividends out of capital, on false representations of profits realized:

By the use of the names of respectable solicitors and counsel attached to the prospectuses and circulars of the Company, by which mercantile men and others are deceived into a belief of the bona fide character of the undertaking”.

**2.41** The Select Committee expressed the view that this situation could easily be remedied by the –

“.....publication of the Directors, of the Shareholders, of the Deed of Settlement, of the amount of the Capital, and whether subscribed or not subscribed, nominal or real, would baffle every case of fraud which has come under the notice of Your Committee. The public would have the means of knowing with whom they deal; and agents and bankers would be enabled to avoid participating in the discredit of such concerns, by giving the sanction of their names to questionable undertakings”.

**2.42** Unfortunately the disclosures advocated by the Select Committee did not ‘baffle’ the frauds which were going to be committed during the next 150 years and will not 'baffle' those which will be committed in the future.

**2.43** The Select Committee also recommended

"7. That in order to prevent jobbing in shares of non-registered Companies and other Companies in an immature state, no allotment of shares have any legal effect till the Company be provisionally registered: and all sales or transfers of shares be prohibited till the Company be completely registered.

That it is expedient that the accounts of every such Company be open to the inspection of the shareholders: and that the annual balance-sheet, together with the reports of the auditors thereon, be registered.

17. That if it thereon appear that any acts have been illegally or fraudulently committed in the management of such Company, it is expedient to make provision for prosecuting the directors or officers in respect thereof.

18. That in order to prevent the use of false designations of Companies, and of the names of fictitious directors and officers, it is expedient to subject offenders in that respect to penalties recoverable in a summary way".

**2.44** The **1844 Report** was followed by the first general Companies Act, the **Joint Stock Companies Act 1844** which provided for

— the institution of the Office of the Registrar of Joint Stock Companies where prescribed documentary information relating to companies had to be kept for public inspection;

— the formation of companies with unlimited liability by the lodging of prescribed documentation at the Office of the Registrar followed by the issue of a certificate of incorporation;

— the preparation and delivery of 'full and fair' audited balance sheets and the auditors' reports thereon to all shareholders, the reading thereof and of the report of the directors at the annual meetings of companies, and the filing of the balance sheets and auditors' reports at the Office of the Registrar;

— the right of shareholders to inspect the books of account of their companies.

**2.45** Limited liability was introduced by the **Limited Liability Act 1855** subject to certain provisions, such as the adoption of the word 'limited' as the last word of the name of the company, a minimum membership of 25 and minimum subscribed and paid-up capital.

The Act also provided for the winding-up of the company in the event of three-fourths of the capital being lost and for the personal liability of the directors in the event of the payment of a dividend when the company was insolvent or if loans had been made to members.

**2.46** The **Joint Stock Companies Act of 1856** consolidated the two former acts and made provision for two kinds of companies, the unlimited company and the limited company with a fixed capital structure. It introduced the memorandum and articles of association, abolished the compulsory audit of balance sheets and also introduced a system of winding up under the Companies Act.

**2.47** It was followed by an amending Act in **1857** and then by the consolidating **Companies Act 1862** which served as the model for most of the Commonwealth countries. It

- prohibited the association of more than 10 persons for the purpose of carrying on banking and the association of more than 20 persons for the purpose of carrying on any other business for gain unless registered as a company;
- allowed seven or more persons to form an incorporated company with or without limited liability, but if limited, that word had to be added to the name of the company;
- empowered the Board of Trade to appoint inspectors to inspect the affairs of a company;
- contained schedules for the optional use by companies dealing with such matters as the payment of dividends, accounts and the audit of the accounts.

**2.48** During the 1860s so many companies were liquidated and so many frauds perpetrated on the public that an official inquiry followed, and the '**Report on the Limited Liability Acts**', **1867**, was published.

**2.49 Keynes and MacGregor** ascribed the numerous liquidations to special conditions which existed at the time, namely the activities of 'wreckers' of companies, the crash of the seemingly respectable financial firm of Overend, Gurney and Company, and the repercussions of the railway scandals.

"For the benefit of promoters and their professional allies, the lawyers and accountants, many companies were deliberately set up in order that after a short fictitious existence they might pass into the winding-up process, with birth and burial expenses accruing to their creators. It would be arranged that the first charge on the capital received from investors should be the preliminary promoting and vendor charges, which satisfied the first of the trio, and a preferential charge on the assets in winding up was (and is) the legal expenses, which satisfied the other two. Companies, it must be remembered, were then free from having to state either promoting expenses or vendor contracts or to state the minimum capital on which business could be commenced; therefore, when capital sufficient to pay the above expenses had been collected, the company would pretend to start business, fulfil its promoting agreements – and fail or, with inauspicious future, wind up voluntarily or compulsorily.

Or where the company had been established, and its shareholders thinking they were on an easy golden road to fortune, a pit would be dug and the company pushed into it. A dissatisfied creditor or shareholder could petition the Court of Chancery for a winding up, and seven days *after* public advertisement, his case could be heard. A creditor might present, or threaten to present, a petition as a form of blackmail to hasten payment, for its advertisement was fairly sure to ruin the company's credit before the truth could be found out.

Speculators might present a petition to make a 'bear' market for shares. And attorneys' clerks became shareholders to bring grist to their masters' mills. There was a 'system of 'wrecking' going on'.

Competitive races to the Judges frequently occurred for the first place in pushing the company into the pit. The appointment of the liquidator was by 'a sort of rule of thumb', the Judge appointing the nominee he thought most suitable. The liquidator always appointed a solicitor and the vicious circle was complete.

Two other causes contributed to the high early figures of compulsory and voluntary dissolutions and, perhaps, to those of the more shady 'unknowns': the Overend Gurney crash and the railway scandals.

In July 1865 the old respectable financial firm of Overend, Gurney and Company, then liable for unsecured deposits of some £7-£8,000,000 and also *then* 'insolvent by at least four millions sterling', sold itself to the unsuspecting public and charged £500,000 for the goodwill. In May 1866 the new company closed its doors in open and hopeless insolvency. Panic reigned in the City: the Bank Act was suspended; the Rate went up to 10 per cent, and stayed there for three months; the Foreign Secretary circularised all European governments that there was 'no general want of soundness in the ordinary trade of the country'. As the shock spread from its epicentre, more and more companies tottered and crashed and the circle of misery widened.

After finance came transport. As early as 1863 the West Hartlepool Railway had exceeded its authorised limit to debenture issues and had taken the public's money for (legally) worthless paper. In 1865 the Great Eastern had done the same thing. In 1866 the greater misdoings of the London, Chatham and Dover were revealed.

All confidence vanished and business was paralysed. By August 1866 over 150 companies were in process of compulsory liquidation and another 50 in other forms. By March 1867, when over 260 companies were in Chancery, Newmarch could say, 'the constitution of the country consisted of four parts: the Queen, Lords, Commons and the liquidators of public companies'.

The official inquiry which followed in 1867 'into the operation of the Limited Liability Acts' was largely 'City' in personnel and in witnesses. Ultramontane

*laissez-faire* had doughty champions in Lowe as a member and in Newmarch as a witness : the Committee recommended additional privileges for limited companies, especially the power to reduce capital, and rejected a measure of additional publicity approved by even the *Economist* and the Stock Exchange. If investors will be foolish, they must suffer – that was the prevailing sentiment; no attention was paid to the saner and more realistic view of Lord Romilly, who thought that 'it was the duty of the Government and of legislation .....to protect people who are ignorant and foolish; it is not sufficient to say that because a man is a foolish person, therefore he must be allowed to ruin himself in his own way'. To *laissez-faire* doctrinaires, people were either wise or quick learners; to promoters, they were neither. Serious legal reform had to wait until the 'nineties".(25)

**2.50** Numerous amendments and related statutory enactments followed during the ensuing years which culminated in the **Companies (Consolidation) Act 1908**.

**2.51** During this period

- the **Directors' Liability Act 1890** provided for the liability of directors to pay compensation to persons who had been induced to take shares on the strength of false statements in a prospectus;
- the **Companies Act 1900** re-introduced provisions relating to the compulsory audit of the accounts of companies;
- the **Companies Act 1907** (following upon the report of the **Loreburne Committee** [1906]) provided for the establishment of private (as opposed to public) companies but exempted them from the inclusion of balance sheets in their annual returns.

**2.52** Numerous amending and consolidating acts followed, some of them as a result of reports of the **Wrenbury Committee** (1918), the **Greene Committee** (1926), the **Cohen Committee** (1945) and the

**Jenkins Committee (1962)** and more recently as a result of **European Union Directives**.

**2.53** Some of the matters dealt with during this period related to

- the alteration of objects;
- matters required to be stated in a prospectus;
- the prohibition of financial assistance by a company to buy its own shares;
- redeemable preference shares;
- the publication of the balance sheets of companies whose shares are held by public companies;
- the recognition of principles of accountancy by prescriptive provisions;
- the production of group accounts for inter-connected companies;
- the demanding of professional standing for auditors of company accounts;
- the protection of minority shareholders;
- the extension of the powers of the Board of Trade to order an investigations into the affairs of companies;

**2.54** The development of company law in England during the past 150 years has been summarised as follows by the Department of Trade and Industry:

“2.3 Many of the principles of key importance (such as limited liability, registration on a public register, and disclosure of information about the financial state of the business) were put in place in the middle of the last century, and some mention of the historical background is helpful for an understanding of the present arrangements. Two reforms were especially significant:

The Joint Stock Companies Act of 1844. This required all new businesses with more than 25 participants to be ‘incorporated’ that is, to be set up as companies with a legal status and personality of their own, rather than as conventional partnerships. Second, the Act said that such companies should be set up by the simple process of registration (rather than by Act of Parliament or royal charter), and created the post of Registrar of Companies which continues to this day. Third, it provided for ‘publicity’ – or, as we would say today, *disclosure – in particular through companies’ constitutions and annual accounts being filed with the Registrar of Companies.*

The Limited Liability Act of 1855. This introduced the concept of general limited liability for shareholders – ie their liability for the company’s debts, if it became bankrupt, was limited to the amount of share capital which they had invested. It was felt important that the company’s creditors should be aware of the limited liability status of the company, and the requirement for companies to have ‘limited’ or ‘Ltd’ in their name dates from this time. It was the 1855 Act which, in the words of the later Professor Gower, ‘finally established companies as the major instrument in economic development’.

2.4 After this legislation, businesses mostly fell into two categories: incorporated companies and conventional partnerships. The numbers of incorporated companies increased steadily, in particular towards the end of the nineteenth century. By 1914 around 65,000 were registered; by 1945 about 200,000. Since the war the number has increased greatly to the present level. The principal rules for partnerships were brought together in the Partnership Act 1890 and continue to govern partnerships to this day.

2.5 Development of company law in this century comes mostly from reactions to scandals and mischiefs arising from the wild scope allowed by the Victorian

legislation, which in general had only a light regulatory touch. The pattern was that the Board of Trade appointed a Committee at intervals of around 20 years to review company law. The resulting recommendations were introduced in an amending Companies Act. The old and the new law were then ‘consolidated’ into a new comprehensive Companies Act. Such consolidations took place in 1908, 1929 and 1948. The most recent major review was that of the Company Law Committee — the ‘Jenkins Committee’ — which was appointed in 1960 and reported in 1962. A number of its recommendations were enacted piecemeal in the companies legislation of 1967, 1980 and 1981. As already pointed out, these reviews concentrated on current scandals and perceived deficiencies in protecting investors or preventing fraud. The net result was a constant addition of new laws and regulations to companies legislation without any re-examination of its fundamental principles. Company law thus grew in bulk and complexity, but there was no attempt to slim down the basic structure and remove sections designed to deal with practices and situations which, often, no longer happened.

2.6 The complexity grew even more rapidly from 1972 as a result of the need to reflect in UK companies legislation EC Directives adopted under the EC company law harmonisation programme. This left the legislation, in the view of the late Professor Gower, ‘in a worse state than at any time this century’.

2.7 As noted in paragraph 2.2, the legislation up to 1985 was consolidated in the form of the Companies Act 1985. This was quickly followed by the Insolvency Acts of 1985 and 1986, and by the Financial Services Act 1986. These latter acts represented a major structural change in the legislation by removing insolvency law and securities regulation from companies legislation and establishing them as distinct areas of law. This may be said to be the only major simplification, if that is the correct word, of companies legislation this century.

2.8 A further Companies Act was passed in 1989. Its main aim was to implement the 7<sup>th</sup> EC Company Law Directive on Consolidated Accounts, and the 8<sup>th</sup> on Audits; but it also included some domestic reforms. The 1989 Act is the most recent Act in company law, though a number of parts of this Act and the 1985 Act have since been modified by the use of Order-making powers (ie powers to make minor changes without a new Act of Parliament). In addition the DTI has in recent years reviewed a number of those areas of current legislation which frequently give rise to difficulty, and has developed proposals to amend the present law when there is an opportunity.

2.9 The history of company law since the great reforms of the last century can thus be seen as a series of additions to the existing legal framework resulting from the need to tackle perceived deficiencies and shortcomings. For long periods this process may be enough. But recent years have seen increasing concern that the framework is becoming obsolescent; and it is clear that piecemeal reform cannot significantly reduce the amount and complexity of current arrangements”.

**2.55** The development of corporation law in the United States (where each state has its own corporation law) is described as follows by **Dr Amir Licht**:

“In the United States, the classification of company law has taken the shape of classifying the business corporation as ‘public’ or ‘private’”. Initially, business corporations were considered public entities. However, during the nineteenth century business corporations were perceived as private entities despite several waves of academic and political attacks. The following paragraphs recount this transformation and argue that the persistence of the ‘private’ character of the corporation is due largely to the rise of securities regulation as the ‘public’ companion of corporate law.

Until the eighteenth century, incorporated companies were relatively rare and were incorporated by a special charter (also called ‘grant’ or ‘concession’) from the sovereign. As such, they were analogous to extensions of the state and had an unmistakable public character. The economic activities they pursued often had a public nature such as public utilities, transportation, and water works. These corporations also enjoyed powers and privileges characteristic to public entities. This situation changed dramatically with the 1819 *Dartmouth College* case, which held that the state grant of a charter created an enforceable contract under the Contracts Clause of the United States Constitution. Such corporations, therefore, had a private nature, distinct from municipal corporations that remained governed by public law. Once freed from the grip of regulatory public law, corporations and corporate law retained their private characters to this day.

The remainder of the nineteenth century witnessed great changes in the legal theory of the corporation. Corporations became more commonplace with the enactment of general incorporation laws. Two competing theories replaced the charter theory. One saw the corporation as a free contract among individual shareholders, akin to a partnership. ‘In this conception, the corporation was not a creature of the state but of individual initiative and enterprise. It was ‘private’, not ‘public’ ‘.

The competing theory, which started to gain influence in the United States during the turn of the century, was drawing on the academic discourse in continental Europe about 'corporate personality'. This theory elevated the corporation from its constituent individual shareholders and claimed that as a group it had a 'natural' and 'real personality'. That theory also sought to represent the corporation as private by identifying it as a private association. Since individuals and not the state supplied the creative force that brought the group into existence, respect for individuals counseled against regulation.

While companies were solidifying their status as private entities during the late nineteenth century, they were also growing to non-human dimensions (first the railroad companies and later the mass production firms). A major effort to regulate both corporate conduct and corporate structure was launched in 1890 with the enactment of the Sherman Anti-Trust Act and continued with the enactment of the Clayton Act in 1914. It took a considerable amount of time for this early antitrust regulation to mature and achieve real force, but for our purposes it was the harbinger of a more general strategy: If corporations and corporate law could not be penetrated and regulated from within, then regulation could come from other legal fields, external to corporate law".<sup>(26)</sup>

**2.56 Fletcher** sketches the development of corporations in the United States as follows:

"In America some of the colonies were themselves essentially public corporations, albeit they were chartered companies, and others existed under crown governors or proprietors, neither of which, without specially delegated power, probably could have created or authorized the formation of private business corporations, such power remaining otherwise in the English government.

The trading corporation and the range of its activities was a known and accepted fact at the time of the formation of the constitution of the United States, entering into the meaning of that instrument, and necessarily of other constitutions and laws and decisions then and since made and enacted. Historically it lies at the base of all American corporation law in greater or less measure.

There was a distrust or disfavour of private corporations. Some of the states ratified the Constitution with misgiving of the power of congress to form corporations, which in fact created but few, and those for purposes related to national interests, leaving it to the states, and but few were created or formed, and those by special act, until the early years of the nineteenth century. During the colonial period of American history there

were but six purely native-born business corporations, although English trading corporations operated on this continent. To this list were added but twenty during the thirteen-year period preceding the adoption of the Federal Constitution of which one was created by the Confederacy itself, entitled 'The President, Directors and Company of the Bank of North America'.

The cloud of disfavour under which corporations laboured in America was not dissipated until near the end of the eighteenth century, and during the last eleven years of that period the total number of charters granted did not exceed two hundred, most of the business of that period being transacted by unincorporated joint stock companies more in the nature of limited partnerships. The chief cause for the changed popular attitude towards business corporations that marked the opening of the nineteenth century was the elimination of their inherent monopolistic character. This was accomplished primarily by an extension of the principle of free incorporation under general laws. The way for this innovation was paved by North Carolina, which in 1795 enacted a law of this nature, although limited at the time, to canal companies.

The new idea did not become well established, however, until after the supreme court had given sanction to the doctrine that a corporation, instead of having the right to do all things that a natural person could do, unless prohibited from it by its charter, had such powers only as were expressly granted to it by its enabling act. With this obstacle removed, and with a vast territory open for commercial development, business corporations multiplied rapidly in number and importance.

In order clearly to understand the successive stage of development of corporations in America, it is necessary to bear in mind that the corporate idea came to this continent stamped with the salient features of the English corporation of that time. These were, first, that a corporation could be created only by the will of Parliament or of the Crown; second, that this creative act was symbolized by the granting of a charter of powers, and third, that at least insofar as the trading corporations were concerned, these charter rights and powers were exclusive and monopolistic in a high degree".<sup>(27)</sup>

**2.57** At the **Cape** and prior to the 1800s, the **V O C** did not brook opposition to its commercial activities, and privately owned companies, whether the 'deed of settlement' unincorporated or those incorporated by legislation, only started to emerge during the 1830's. (For more details see the well researched articles by **Dr E de la Rey** in the **1986 Codicillus**.)

**2.58** The evolvement of the South African Companies Act is summarised in the excellent contribution by **Professor M S Blackman** in *Lawsa*, 3rd ed. Vol. 4.

“The first general Act providing for the incorporation of companies was the **Cape Joint Stock Companies Limited Act of 1861**, which was based on the then already repealed **English Acts of 1844 and 1855**. This Act, which required a membership of 25 and consisted of only 19 sections, formed the model for the companies Acts subsequently enacted in Natal, the South African Republic and the Republic of the Orange Free State. ....<sup>(28)</sup>

It was only in **1892** that a fully-fledged Companies Act was enacted in the Cape, which Act was based on the **English 1862 Act**; and it was only with the passing of the **Transvaal Companies Act of 1909** — a fairly faithful rendition of the **English (Consolidated) Act 1908** — that legislation incorporating current English statutory provisions was introduced.

Thus at the time of Union each of the provinces had its own Companies Act, and these Acts remained in force after Union until the first **South African Companies Act** was enacted in **1926**. The **1926 Act** was modelled on the **Transvaal Act**, and hence on the **English 1908 Act**. But even at this stage there were differences. Unlike English legislation, the **1926 Act** provided for the system of judicial management and contained a section regulating pre-incorporation contracts. The Act was destined to remain on the statute books for nearly 50 years. ....

After **1926** the legislature was content to follow English legislative developments closely; and the two comprehensive amendments to the **1926 Act** followed upon slightly earlier major English legislative changes and adopted most of these, although again there were exceptions.

In 1963, shortly after the Jenkins Committee had reported on English company law, the Van Wyk de Vries Commission was appointed. Its report resulted in the present **Companies Act of 1973**, which marked something of a departure from the earlier legislative pattern. ....

Most of its recommendations are reflected in the present Act. Some of these amendments represented major changes. Many were based on recommendations of the Jenkins Committee that had not as yet been enacted by the legislature in England. Thus the ultra vires doctrine was in effect abolished, no par value shares were introduced, insider trading was made a criminal offence, and the section on fraudulent trading was extended to cover reckless trading. Other amendments were derived from, but were not identical to, legislative innovations in other jurisdictions, for example the

introduction of a **statutory derivative action**, and **provisions regulating take-overs**.

.....

In **1980** the **Share Blocks Control Act** was passed, which applies to every 'share block' company. A share block company is defined as a company the activities of which comprise or include the operation of a 'share block scheme', which in turn is defined as 'any scheme in terms of which a share, in any manner whatsoever, confers a right to or interest in the use of immovable property.

An important innovation introduced in the **1973 Companies Act** on the recommendation of the Van Wyk de Vries Commission was **the appointment** of a **standing advisory committee on company law**. .....

Of fundamental importance for company law was the enactment in **1984** of the **Close Corporations Act**, which introduced, alongside companies incorporated under the Companies Act, a new form of business enterprise, namely, the close corporation. The Act was introduced to provide separate provisions for the incorporation of the typically smaller business entity. ....

While leaving unaffected the existence or availability of the private company, the **Close Corporations Act** provides a simple, inexpensive, fully-fledged juristic person for an enterprise with no more than ten members who, generally, must be natural persons. Membership is restricted to ten to enable the close corporation to be structured for a membership that both puts up the capital and manages the business; and corporate membership is excluded to prevent large companies from creating close corporations as subsidiaries, and to render unnecessary cumbersome provisions for disclosure and abuse of control. ....

There is no separation of ownership and control: unless otherwise agreed, every member can participate in the management and representation of the company. The ultra vires and constructive notice doctrines do not apply, and the capital maintenance rule has been abandoned in favour of a solvency plus liquidity test. ....

In 1989 a new chapter, entitled '**Regulation of Securities**', was added to the **Companies Act**. ....

Of immediate effect in **1989** was the provision establishing a **Securities Regulation Panel**. The panel ..... is empowered to regulate all 'affected transactions' (which are defined to include not only transactions that involve a change of control, but also

the acquisition by a controller of further securities in excess of prescribed limits) and to supervise all dealings in securities contemplated by the chapter. In pursuance of its power to regulate such transactions, the panel has formulated the **Securities Regulation Code on Takeovers and Mergers**, modelled on the City Code. The panel is empowered to make rulings on the applicability of the provisions of the code, to hear appeals from such rulings, and to enforce the provisions of the code by application to court for the necessary order.

The chapter was amended in **1990**, and all its provisions are now in force. The original provisions of the **1973 Act** governing insider trading were replaced by more extensive provisions prohibiting trading on inside information and making provision for a civil law action. The chapter also contains a provision empowering the panel to obtain information concerning the beneficial ownership of equity dealt with on a stock exchange.

In **1992** a new definition of 'subsidiary' company was **introduced**; and the **controlling and controlled company definition was deleted**. Various amendments in regard to auditors were also introduced consequential upon changes to the legislation governing the profession. ....

In the same year a new **Schedule 4** to the Act was introduced, which Schedule sets out the requirements for the company's annual financial statements".

**2.59** Since the publication of this work a number of amendments to the Companies Act were introduced.

Some amendments redefined 'offers of shares not being offers to the public' (Acts 35 and 125 of 1998), and Act 60 of 1998 inserted a section 91A to make provision for uncertificated securities.

Act 37 of 1999 provided for the acquisition by a company of its own shares, substituted section 86 dealing with the liability of directors and shareholders under certain circumstances, and also provided for the disclosure of directors' emoluments and the appointment of secretaries for public companies.

**2.60** The various types of companies recognized by the South African Companies Act are dealt with in the well-known publication 'Corporate Law' as follows:

#### **"Formal classification of companies**

**3.02** Although the ordinary private and public companies are encountered most often in practice, there are also various other types of companies which should be noted. Only two basic *types* of companies can be formed in terms of the Act: a company having a share capital and a company not having a share capital with the liability of its members limited by the memorandum of association. The latter type is termed 'a company limited by guarantee' in the Act. A special kind of company obliged to utilise this company type is the so-called section 21 company or the incorporated association not for gain. The company having a share capital may take one or two *forms*: a public or a private company. Further variants of these forms with different characteristic features may be distinguished. Thus a share block company may be seen as a particular kind of public or private company, whereas section 53(b) makes provision for a particular kind of private company with unlimited joint and several liability of its directors, which is mainly aimed at the needs of the professions. In addition the Act provides for the registration of an external company as well as that an unlimited company registered in terms of the Companies Act of 1926 may continue to exist.

#### **A company having a share capital**

**3.03** By far the more important of the two types of companies which may be formed and incorporated under the Act is the company having a share capital. It obtains its capital by issuing shares and normally its members stand to lose no more than the amount paid by them for their shares. A fundamental difference between this type of company and one limited by guarantee is precisely that it has a share capital, that is that the law assumes that its funds will be, to some extent at any rate, contributed by the members. Its share capital may consist of shares having par value or of shares having no par value. This type of company may take one of two forms: a public or private company.

#### **The public company**

**3.04** At least seven persons associated for a lawful purpose are required for the formation, incorporation and existence of a public company. Its name ends with the word 'Limited' and it can raise capital from the general public. The transferability of shares and interests in the company enables its members to dispose of their investments freely without withdrawing such investments from the company. In general, the company is therefore 'open' or 'public' in the sense that members of the public are or may become substantially interested in the company. Normally the articles of a public company do not contain provisions restricting the number of its members or excluding generally the offer or transfer of its shares or debentures to the public. So also comprehensive provisions apply as far as the compulsory disclosure of

information concerning the company to the public is concerned. Thus the publication of annual financial statements, interim reports and provisional financial statements, *inter alia* by lodging copies with the Registrar where they are available for public inspection serves to round off the disclosure requirements of the Act.

**3.05** Shares and debentures of a public company may be *listed* and dealt in on a stock exchange if permission thereto is obtained from the committee of the stock exchange. Obviously many advantages flow from obtaining a listing on a stock exchange. The *listed public company*, especially, has the capacity as 'capital pump' to mobilise substantial amounts of capital from a large number of investors and to put it at the disposal of specialists who employ it in economic ventures for the benefit of the investors. As a consequence of the widely spread shareholding in the large listed company an impersonal relationship exists between the mass of small shareholders *inter se* and between them and the management. The typical shareholder is in economic reality, if not in the eyes of the law, merely an investor who obtained his shares with a view primarily to capital growth.

#### **The private company**

**3.06** For the formation and incorporation of a private company at least two persons associated for a lawful purpose are required. However, if the company to be formed is to be a private company with a single member, only one person for any lawful purpose is required. The name of a private company ends with the words '(Proprietary) Limited'. A private company is a company with a share capital which is subject to certain restrictions: it must restrict the right to transfer its shares, it must limit its membership to 50 and it must prohibit any offer of its shares or debentures to the public.

The private company with a *single member* was introduced by the Act because it appeared that many private companies were in reality so-called *one-man companies* in that the second member was no more than the nominee of the first. Thus the necessity of making use of a nominee merely to comply formally with legal requirements no longer exists.

The private company is discussed in greater detail in 4.01 *et seq.*

**3.07** During 1968 a special kind of private company with *unlimited concurrent joint and several liability of the directors* was introduced to make it possible for acknowledged professions practising in partnership to become incorporated under the Companies Act of 1926. At present section 53(b) of the Act makes specific provisions

for a private company wishing to effect unlimited liability of its directors (although in principle nothing prevents a public company from making the same provisions). This provision permits a private company to incorporate a provision in its memorandum that directors and former directors shall be liable jointly and severally for the debts of the company which are or were contracted during their periods of office. The directors and the company are then liable *singuli in solidum* for the debts of the company. The last word in the name of such a company shall be 'Incorporated'.

The provision creating joint and several liability may be included in the memorandum at any time by way of special resolution and with the written consent of the directors concerned but it may only be amended or removed by special resolution if the court is satisfied that it is just and equitable.

Such a private company is mainly intended for professional association. However, this does not mean that only members of professions may make use of this special kind of private company. Members of professions permitting such incorporation (such as attorneys, stockbrokers, quantity surveyors and architects) find this an acceptable form in which to be associated, notably for the advantages of corporate existence and perpetual succession. This so-called 'professional company' sometimes displays so many particular characteristics that it may also be referred to as a special kind of private company.

#### **A company limited by guarantee**

**3.08** At least seven persons associated for a lawful purpose are required for the formation and incorporation of a company limited by guarantee. The last word in its name is 'Limited'. The statement '(Limited by Guarantee)' must be subjoined to its name to distinguish it from the ordinary public company. The company does not have a share capital but the liability of its members is limited by the memorandum to the amount (not being less than R1 per member) which the members undertake to contribute in the event of the company being wound up.

Any provision in the memorandum or articles or in any resolution of the company purporting to give any person a right to participate in the divisible profits of the company other than as a member shall be void as well as any provision purporting to divide the undertaking of the company into shares or interests.

Previously this type of company could have been a public or private company. In terms of section 19(3), however, all companies limited by guarantee, including those incorporated before the commencement of the Act, are deemed to be public companies

for the purposes of the Act. Such a company is therefore obliged to lodge its annual financial statements with the Registrar although it is exempted from the obligation to send and lodge interim reports and provisional annual financial statements.

Since the company may not have a share capital it does not obtain its initial working capital from its members. This type of company is therefore only suitable if no initial working funds are required or those funds are obtained from other sources, for example endowments, fees, charges, donations, subscriptions or loans. Therefore this company type is hardly suitable for business purposes and is used almost exclusively in cases where the object is not one for gain, for example mutual benefit societies or research associations.

**3.09** A special kind of company not for profit and which may, under the Act, only be incorporated as a company limited by guarantee, is the so-called *section 21 company* or *association not for gain*. Unlike the ordinary company limited by guarantee the last word of the company's name need not be 'Limited' but the statement 'Association incorporated under section 21' must be subjoined to its name, or if incorporated before 25 June 1980 it may instead subjoin to its name the statement 'Incorporated association not for gain'. Essentially this kind of company is suitable for an association with the main object of promoting religion, arts, sciences, education, charity, recreation, or any other cultural or social activity or communal or group interests. As such an association may not be one for gain it must apply its profits in promoting its main object and it may not divide its profits or assets amongst its members.

The section 21 company is discussed in greater detail in 4.08 *et seq.*

#### **Unlimited company**

**3.10** This type of company can no longer be registered but the small number which were registered in terms of the Companies Act of 1926 may continue to exist. Most of them have come into being as a result of the formation of consortiums of professional persons connected with large engineering projects. If such a company does not convert itself into another type of company the provisions of the Companies Act of 1926 continue to apply to it.

#### **External company**

**3.11** The provisions of the Act in respect of external companies become operative as soon as such a company establishes a place of business in the Republic. An external company must register its memorandum within 21 days after it has

established a place of business in the Republic. After registration the external company is a juristic person in the Republic subject to the applicable provisions of the Act".<sup>(29)</sup>

## NOTES

**Gower, L. C. B.** Gower's Principles of Modern Company Law, 5<sup>th</sup> Ed., p.3.  
(Sweet & Maxwell, London, 1992).

2. [www.literature-web.net/dictionary/](http://www.literature-web.net/dictionary/)

**Monks, Robert A. G. and Minow, Nell :** 'Corporate Governance', p. 8.  
(Blackwell Publishers Inc., Cambridge, Massachusetts).

4. **Fletcher Cyclopedia of the Law of Private Corporations.** Vol. 1 (Perm Ed) 1990.  
par. 1. (Callaghan & Company).

"There is authority for the statement that the concept of collective entity antedates that of the individual; that 'groups of men united by the reality of fiction of blood relationship' into families, clans or tribes were recognized units of primitive society even before the individual was so regarded. Maine, Ancient Law (4<sup>th</sup> Ed) 183."

"Some students, committed to the imitative theory of jural development, disregard these faint foreshadowings of the modern corporation and trace its genesis to the Greece of Solon (638-559 B.C.), citing the Commentaries of Gaius on Roman law and passages from the Pandects of Justinian as authority for the assertion that laws fathered by the great Hellenic jurist permitted the formation of private corporations for certain purposes, upon condition that they did not operate in violation of other laws of the state. Ayliffe, Treatise on Civil Law 197.

Blackstone, on the other hand, ascribes the birth of the corporation to the political necessities of Numa Pompilius (715-672 B.C.), who, upon his accession to power in Rome, desiring to end the disrupting influence of the private war being waged between Sabine and the Roman factions, thought it a prudent and politic measure to subdivide these two into many smaller ones, by instituting separate societies of every manual trade and profession.

1 Bl Comm 468".

5. **Ibid** : par 1.
6. **Lloyd, Dennis** : 'The Law relating to Unincorporated Associations', p.29.  
(Sweet & Maxwell, London, 1938).
7. **Story, Joseph** : Commentaries on the Law of Partnership. p. 357.  
(Little, Brown & Company, Boston, 1859).  
**Clark, Francis William** : A Treatise on the Law of Partnership and Joint Stock  
Companies : Vol. 1, p. 5-6. (T & T Clark, Edinburgh, 1866).
8. **Gower, L. C B.** : **ob. cit.** : p. 32.  
**Pennington, Robert P.** : Company Law 3<sup>rd</sup> Ed. p. 6 (Butterworths, London, 1973).
9. **Preceded** by the 'Merchant Adventures of England' in 1359.
10. **Chatfield, Michael** : 'A History of Accounting Thought', p.79-80.  
(Dryden Press, Illinois, 1974) .
11. **Scott, W.R.** : Constitution and Finance of English, Scottish and Irish Joint Stock  
Companies to 1720. Part 1, p. 229.
12. **Chancellor, Edward** : 'Devil Take the Hindmost – A History of Financial  
Speculation', p. 48. (Macmillan Publishers Limited, 1999).
13. **Ibid** : p. 52.
14. **11 & 12 W 3 : C 13.**
15. The **Sword Blade Company** was incorporated with a monopoly to manufacture a  
certain type of sword blade. The venture was unsuccessful and the company  
eventually began operating as a bank, issuing its own bank-notes, the face value  
whereof far exceeded its assets.
16. **Scott, W.R.,** : **ob. cit.** Part 1, p. 423 and Part 3, Section V.
17. **Pennington,** : **ob. cit..** : p. 7.  
**Chancellor** : **ob. cit.** : p. 82.
18. **Lloyd** : **ob. cit.** : p. 40.

"A similar statute was passed in the North American Colony in 1741. The immediate cause was the issue in 1740 by one of the greatest voluntary joint-stock companies, the Land Bank of Massachusetts, of circulating bills to the amount of nearly £50,000, notwithstanding the protest of the royal governor. The Act forbade any future American grants of corporate privileges for business purposes, and rendered unlawful any unincorporated joint-stock company of more than six persons. This was the law in the American Colonies until the Revolution, when the old practice of doing business by unincorporated joint-stock companies was resumed. Thus Alexander Hamilton organised the Bank of New York in this manner, and the Bank carried on an extensive business without receiving a charter until 1791".

19. **Scott, W.R.** : **ob cit.** : Part 3, Section V.
20. **Anno 7 Georgii II C.8.**
21. **Chancellor, E.** : **ob. cit.** p. 100.
22. **Ibid.** : p. 105.
23. **Ibid.** : p. 106.
24. **Ibid.** : p. 107.
25. **Keynes, I. M. and MacGregor, D.H.** : 'Economic History - The First Five Thousand Limited Companies and Their Duration', p. 414 - 418. (The Royal Economic Society, London, MacMillan & Co. Ltd. 1933).
26. **Licht, Amir N.** : 'International Diversity in Securities Regulation : Roadblocks on the Way to Convergence', p. 258-260.(Cardozo Law Review, 1998, Vol. 20).
27. **Fletcher, W.M.** : **ob. cit.** : Vol. 1, par. 2.
28. See also 'The Joint-stock Companies Liability Ordinance, 1864' of the Territories of British Kaffraria.
29. **Cilliers H.S., Benade M.L., Henning J.J., Du Plessis J.J., Delpont P.A.** : 'Corporate Law', 2<sup>nd</sup> Ed, p. 27 – 32. (Butterworths, Durban, 1992).



# **CHAPTER 3 - THE HISTORY OF CORPORATE ACCOUNTS AND THE DISCLOSURE OF FINANCIAL INFORMATION**

**3.1** The keeping of records of commercial transactions is an activity as ancient as the recording of the history of civilisation itself. From the outset the primary purposes of the keeping of such records were to ensure the reliability of information and to detect losses caused by fraud or inefficiency. However, for thousands of years the development of accountancy and the proper audit of accounting records were retarded by general illiteracy, by the lack of commonly accepted values (currencies) and by the problems encountered with arithmetic. The last was only overcome in Western Europe during the 12<sup>th</sup> century by the adoption of the Arabic system of numerals.

**3.2** Generally speaking, in England the extent of financial disclosure in corporate accounts was dictated by the legislature. In the United States it developed as a result of the requirements of financial institutions, by the listing requirements of the Securities and Exchange Commission and as a consequence of the quest for generally accepted accounting principles. As will be seen, the present requirements for fairly comprehensive financial disclosure are of recent origin.

**3.3** In both countries, as elsewhere in the world, public pressure for more informative and timely disclosure has been and is still being fuelled and driven by the disastrous collapses of seemingly healthy companies.

These collapses, often shortly after the publication of glowing financial results, have been occurring with monotonous regularity for centuries. There is no reason to believe that similar disasters will be averted in future by the present-day disclosure requirements or by the present-day system of auditing of financial statements. This system has shown little change during the past century, and, as will be shown, nowadays, in some respects, audit reports have less value than they had a hundred years ago.

**3.4** Since time immemorial, governments such as those in Mesopotamia, Egypt and China had to keep records of tax receipts and disbursements. Private individuals who had accumulated wealth and entrusted it to the management of others, also required some form of verification of honesty and reliability.

When governments became accountable to the public, financial disclosure became an important concept. Thus, in Athens, in the 5<sup>th</sup> century B.C., certain accounts were engraved in stone and placed on public view.

In Rome, citizens were required to regularly submit statements of assets and liabilities which were used as a basis for taxation and even for the determination of civil rights. Public accounts were regularly examined by an audit staff and the use of an annual budget was introduced.

**3.5** The **Association of Chartered Accountants in the United States (ACAUS)** published the following brief history of accounting in the Ancient World:

“Five thousand years before the appearance of double entry, the Assyrian, Chaldaean-Babylonian and Sumerian civilizations were flourishing in the Mesopotamian Valley, producing some of the oldest known records of commerce.

As farmers prospered, service businesses and small industries developed in the communities in and around the Mesopotamian Valley. The cities of Babylon and Ninevah became the centers for regional commerce, and Babylonian became the language of business and politics throughout the Near East. There was more than one banking firm in **Mesopotamia**, employing standard measures of gold and silver, and extending credit in some transactions.

During this era (which lasted until 500 BC), Sumeria was a theocracy whose rulers held most land and animals in trust for their gods, giving impetus to their record-keeping efforts. Moreover, the legal codes which emerged penalized the failure to memorialize transactions.

Governmental accounting in ancient Egypt developed in a fashion similar to the Mesopotamians. The use of papyrus rather than clay tablets allowed more detailed records to be made more easily. And extensive records were kept, particularly for the network of royal storehouses within which the ‘in kind’ tax payments were kept.

Egyptian bookkeepers attached to each storehouse kept meticulous records, checked by an elaborate internal verification system. These early accountants had good reason

to be honest and accurate, because irregularities disclosed by royal audits were punishable by fine, mutilation or death.

Although such records were important, ancient Egyptian accounting never progressed beyond simple list-making in its thousands of years of existence. Perhaps more than any other factors, illiteracy and the lack of coined money appears to have stymied its development.

While the Egyptians tracked movements of commodities, they treated gold and silver not as units of fungible value, but rather as mere articles of exchange. The inability to describe all goods in terms of a single valuation measure made cumulation and summation difficult and development of a cohesive accounting system all but impossible.

Pre-Christian China used accounting chiefly as a means of evaluating the efficiency of governmental programs and the civil servants who administered them. A level of sophistication was achieved during the Chao Dynasty (1122-256 BC) which was not surpassed in China until after the introduction of double entry processes in the nineteenth century.

Greece in the fifth century BC used 'public accountants' to allow its citizenry to maintain real authority and control over their government's finances. Members of the Athens popular assembly legislated on financial matters and controlled receipt and expenditure of public monies through the oversight of ten state accountants, chosen by lot.

Perhaps the most important Greek contribution to accountancy was its introduction of coined money about 600 BC. Widespread use of coinage took time, as did its impact on the evolution of accounting. Banking in **ancient** Greece appears to have been more developed than in prior societies. Bankers kept account books, changed and loaned money and even arranged for cash transfers for citizens through affiliate banks in distant cities.

Government and banking accounts in ancient Rome evolved from records traditionally kept by the heads of families, wherein daily entry of household receipts and payments were kept in an *adversaria* or daybook and monthly postings to a cashbook known as a *codex accepti et expensi*. These household expenses were important in Rome because citizens were required to submit regular statements of assets and liabilities, used as a basis for taxation and even determination of civil rights.

An elaborate system of checks and balances was maintained in Rome for governmental receipts and disbursements by the *quaestors*, who managed the treasury, paid the army and supervised governmental books. Public accounts were regularly examined by an audit staff, and quaestors were required to account to their successors and the Roman senate upon leaving office.

The transition from republic to empire was at least in part to control Roman **fiscal** operations and to raise more revenues for the ongoing wars of conquest. While the facade of republicanism was maintained, the empire concentrated real fiscal and political power in the emperor. Julius Caesar personally supervised the Roman treasury, and Augustus completely overhauled treasury operations during his reign.

Among Roman accounting innovations was the use of an annual budget, which attempted to coordinate the Empire's diverse financial enterprises, limited expenditures to the amount of estimated revenues and levied taxes in a manner which considered its citizens' ability to pay".<sup>(1)</sup>

**3.6** The thousand years which followed the fall of the Roman Empire are often viewed as a period during which accounting stagnated. However, **Michael Chatfield** believes that during this period accountancy

“laid the foundation for the doctrines of stewardship and conservation and the medieval era created the conditions for the rapid advance in accounting technology that occurred during the Renaissance”.<sup>(2)</sup>

**3.7** During this period, literacy in England, as elsewhere, was so rare that oral communication and verification of financial data was the norm. Improvements in the technique of arithmetic and a new interest in the written language led to a system of written records. One of the oldest surviving records is the ‘Great Roll of the Exchequer’, or the ‘Pipe Roll’ which, beginning in 1130 AD, is a 700-year old narrative of monies due to the monarch with a summary of payments made and expenses incurred in the collection thereof.

**3.8** The rise of commerce in the Mediterranean during and after the Crusades (1096 - 1291) necessitated more sophisticated bookkeeping methods. The methods suitable for small concerns failed when merchants started trading through a network of factors and formed international partnerships.

The merchants were literate, paper was invented, the Arabic system of numerals was adopted and a sophisticated money economy with a stable coinage developed.

These and other factors led to the development of double-entry bookkeeping during the 14th century in Italy when the seven 'Key Ingredients', described by **Littleton**, presented themselves 'together in a form and strength necessary to push man to the innovation of double-entry'.

"In *Accounting Evolution to 1900*, A.C. Littleton lists seven preconditions for the emergence of systematic bookkeeping:

'The *Art of Writing*, since bookkeeping is first of all a record; *Arithmetic*, since the mechanical aspect of bookkeeping consists of a sequence of simple computations; *Private Property*, since bookkeeping is concerned only with recording the facts about property and property rights; *Money* (i.e., a money economy), since bookkeeping is unnecessary except as it reduces all transactions in properties or property rights to this common denominator; *Credit* (i.e., incompleting transactions), since there would be little impulse to make any record whatever if all exchanges were completed on the spot; *Commerce*, since a merely local trade would never have created enough pressure (volume of business) to stimulate men to coordinate diverse ideas into a system; *Capital*, since without capital commerce would be trivial and credit would be inconceivable'.

Each of these prerequisites to bookkeeping was present in some form in the ancient world, yet even the most advanced of those civilizations failed to produce a double entry system or anything like it. The potentialities of a written language were always diluted by mass illiteracy. A money economy never fully existed. Greece and Rome were in this sense transitional societies in which monetary assets were usually accounted for in monetary terms, while inventories and other resources were often recorded in physical units. Every ancient society had arithmetic, but none developed a simple way of making calculations. A basic reason for the backwardness of Greco-Roman accounting can be found in their system of numerical notation. These were inferior partly because of the large variety of symbols used for numbers (the Greeks had twenty-eight), and partly because the Greeks and Romans never learned to express a number's value merely by its position in relation to other numbers. This lack of place value meant that there was little incentive to arrange figures in columns, since they could not be added down like Arabic numerals. And without a columnar separation of receipts and payments, giving rise to the notions of debit and credit, there could of course be no double entry bookkeeping".<sup>(3)</sup>

**3.9 Chatfield** describes the developments from the advent of the double-entry bookkeeping system to the 19<sup>th</sup> century as follows:

Double entry bookkeeping came into being with the rise of Mediterranean commerce during and just after the Crusades (1096-1291). Besides requiring ships and provisions, the crusaders brought back silks, spices, and other eastern products, stimulating demand for such items and for the production of European exchange goods. New trade contacts gave impetus to a 300-year commercial revolution which foreshadowed the Industrial Revolution of the eighteenth century. Genoa and Venice quickly established themselves as intermediaries in trade relations between Europe and the Near East. Italians not only became the leading merchants of the Middle Ages but nearly monopolized international banking. They regularly put trade competitors out of business and limited others, such as the English, to a local sphere of influence.

Their success resulted particularly from superior business organization. Besides double entry bookkeeping, they invented the bill of exchange in draft form, experimented with marine insurance, mastered the techniques of creating credit money and evolved a body of codified mercantile law which forms the basis of commercial law today. Operating on a scale never before known, they found that bookkeeping methods which worked in a small company broke down when a merchant began trading through a network of factors and international partnerships. Unsystematic records limited the size of such businesses, and beyond a certain point of growth and dispersion caused so much disorder that owners lost control of distant operations.

The Italians had always paid attention to accounting and their tendency to standardize and codify the better practices was an important factor in the development of double entry bookkeeping. As early as the eleventh century Genoese maritime law required scribes to render an account of goods shipped. Milanese accountants compiled registers of taxable land revised the accounts kept in building a cathedral. Members of the Florentine banker's guild were required to keep accounts and open them to surprise audits by guild agents. Genoese bank bookkeepers had to be licensed notaries and their records had the same formal status as deeds. The first society of accountants was formed in Venice in 1581 and, gaining a virtual monopoly over practice, prescribed a six-year apprenticeship and an oral examination for candidates.

In thirteenth century Italy Littleton's seven 'antecedents' for systematic bookkeeping were present in dynamic form. Literacy was widespread among the Italian commercial class and writing was facilitated by the invention of paper. Through their North

African trade contacts the Italians became the first Europeans to acquire Arabic numerals which, within a generation after their exposition by Leonardo of Pisa (1202), were widely used by Italian merchants. The existence of a sophisticated money economy and the most stable coinage since Roman times allowed transactions to be reduced to the common denominator necessary for double entry bookkeeping. ....

The commercial life of Tudor England was much like that of Renaissance Venice, and the British were fortunate that the Venetian style of double entry, with its venture accounts and irregular balancing, set the pattern for Italian bookkeeping throughout Europe. English businesses were small, trading tended to be sporadic, and profits were calculated separately for individual voyages or commodities. Most firms kept single entry records which amounted to little more than lists of payments and receipts. ....

The striking difference between seventeenth century and modern bookkeeping technique was the failure to balance and close books regularly. The closing process was tied to random events: the end of a voyage, the filling of a ledger, the sale of a business, the dissolving of a partnership, a merchant's bankruptcy or death. There was no concept of periodic reckoning,. Many early texts recommended closing ledgers only when they were full, and eighteenth century authors who demonstrated annual balancing implied that it was optional. ....

More than most accounting tools, financial statements are the result of cumulative historical influences. Before the Industrial Revolution they were usually prepared as arithmetic checks of ledger balances. Afterward the roles were reversed and it was account books which were reorganized to facilitate statement preparation. As statements became communication devices rather than simple bookkeeping summaries, the journal and ledger evolved from narratives to tabulations of figures from which balances could easily be taken. Beginning in the nineteenth century periodic financial reporting, first to creditors and later mainly to stockholders, led to the subdivision of accounts into current and fixed categories, to refinements of ledger data through accruals and deferrals, and to government regulation of published statements. ....

Once statement preparation became the main purpose of bookkeeping, ledger figures began to be refined to more closely approximate current market prices. The need for periodic reporting made asset valuation a major issue for the first time and stimulated interest in percentage depreciation. Techniques for accruing rent and interest had been

used in practice since the fourteenth century, but there had never before been urgent reason to apply them widely or systematically. Similarly with inventory valuation. **Jacques Savary** in 1712 had shown understanding of lower of cost or market, obsolescence write-downs, and net realizable value, but it was not until the late nineteenth century and the wide use of financial statements that standardized inventory pricing began to develop. Before then there had existed a great variety of acceptable valuation methods, with little or no tendency toward uniformity. The new importance of financial reporting created a need for consistency and comparability of data, which in turn strengthened arguments in favour of historical cost accounting and realization at the point of sale”.<sup>(4)</sup>

**3.10** In England the watershed between the preparation of accounts for own purposes and their preparation for own purposes as well as for the purposes of other stakeholders, was the enactment of the Joint Stock Companies Act of 1844 which provided for the general incorporation of companies, the preparation of ‘full and fair’ balance sheets and the audit thereof.

**3.11** As pointed out,<sup>(5)</sup> the Joint Stock Companies Act of 1844 followed upon the First Report of the Select Committee which was set up in 1841 as a result of the unsatisfactory state of the law relating to unregistered joint stock companies and the frauds perpetrated by them, to

—  
“inquire into the State of the Laws respecting Joint Stock Companies  
with a view to the greater Security of the Public”

and in its First Report (1844) expressed the view that –

“Periodical accounts, if honestly made and fairly audited, cannot fail to excite the attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud and illegality”.

This view was expressed against the background of some of the ‘modes of deception’ which the Select Committee found to have been used in a number of frauds which included

".....the use of the names of such persons as patrons and honorary directors, with their consent, while such persons have been ignorant of the nature of the concern and of its transactions, and have exercised no control over its management;

.....the employment throughout the country, on very tempting rates of commission, of respectable agents, whose character has cloaked the want of respectability of the Company. In one or two remarkable cases this appears to have been the most efficient means of success; it has procured business at a distance, where inquiries could not be readily made as to the character of the concern;

.....the making up of fraudulent accounts, so as to deceive the Directors and the Shareholders, which has been facilitated sometimes by the accounts not being audited, or the Accountant being a near kinsman of the Managing Director, the only party taking an active part in the concern.

.....declaring dividends out of capital, on false representations of profits realized”.

**3.12** The Committee realised that adoption of its recommendations including ‘honestly made and fairly audited’ accounts would not eliminate fraud but was nevertheless convinced that proper disclosure would in some measure counteract the “susceptibility of ignorant persons”. However, the provision of more accurate information to share-brokers and professional investors was regarded as potentially the most important benefit of disclosure.

“But probably the greatest benefit in this direction will be produced by enabling the share-brokers and other persons professionally employed in making investments of this kind to learn more easily and more accurately the real nature of these Companies; so that, at least, the ignorant may not be so much misled by the example of persons of weight and intelligence, who have sometimes, with extraordinary recklessness, connected themselves with Companies which, whether the objects of the promoters, the nature of the enterprise, or the constitution of the Company be considered, must be regarded as of a questionable character”.

**3.13** This Report heralded the beginning of the never ending attempts to enforce proper disclosure of the affairs of corporations, the birth of the modern accountancy and audit professions and the eventual supervision by entities such as Stock Exchanges, Central Banks and Securities Commissions.

**3.14** The first attempt in England to enforce proper disclosure of the financial affairs of corporations, the Joint Stock Companies Act of 1844, provided for

— the entering of the accounts of a company in books provided for that purpose;

- the balancing of the books and the preparation of a ‘full and fair’ balance sheet signed by three directors and the chairman of the company, and the delivery thereof to the auditors appointed at the annual general meeting;
- the right (subject to the deed of settlement or by-laws) of shareholders to inspect the books of account during periods before and after ordinary meetings;
- the furnishing of the balance sheet and the auditors’ report to shareholders and the reading thereof and of the directors’ report at the shareholders’ meeting;
- the filing of the balance sheet and auditors’ report at the Office of the Registrar.

**3.15** During the following year, the Companies Clauses Consolidation Act of 1845 (8 VICTORIÆ, Cap.16) was enacted. It provided as follows:

“And with respect to the keeping of Accounts, and the Right of Inspection thereof by the Shareholders, be it enacted as follows:

CXV. The Directors shall cause full and true Accounts to be kept of all Sums of Money received or expended on account of the Company by the Directors and all Persons employed by or under them, and of the Matters and Things for which such Sums of Money shall have been received or disbursed and paid.

CXVI. The Books of the Company shall be balanced at the prescribed Periods, and, if no Periods be prescribed, Fourteen Days at least before each Ordinary Meeting; and forthwith on the Books being so balanced an exact Balance Sheet shall be made up, which shall exhibit a true Statement of the Capital Stock, Credits, and Property of every Description belonging to the Company, and the Debts due by the Company at the Date of making such Balance Sheet, and a distinct View of the Profit or Loss which shall have arisen on the Transactions of the Company in the course of the preceding Half Year; and previously to each Ordinary Meeting such Balance Sheet shall be examined by the Directors, or any Three of their Number, and shall be signed by the Chairman or Deputy Chairman of the Directors.

CXVII. The Books so balanced, together with such Balance Sheet as aforesaid, shall for the prescribed Periods, and if no Periods be prescribed for Fourteen Days previous to each Ordinary Meeting, and for One Month thereafter, be open for the Inspection of the Shareholders at the principal Office or Place of Business of the Company; but the

Shareholders shall not be entitled at any Time, except during the Periods aforesaid, to demand the Inspection of such Books, unless in virtue of a written Order signed by Three of the Directors.

CXVIII. The Directors shall produce to the Shareholders assembled at such Ordinary Meeting the said Balance Sheet, applicable to the Period immediately preceding such Meeting, together with the Report of the Auditors thereon, as herein-before provided.

CXIX. The Directors shall appoint a Book-keeper to enter the Accounts aforesaid in Books to be provided for the Purpose; and every such Book-keeper shall permit any Shareholder to inspect such Books, and to take Copies or Extracts therefrom, at any reasonable Time during the prescribed Periods, and if no Periods be prescribed during One Fortnight before and One Month after every Ordinary Meeting ; and if he fail to permit any such Shareholder to inspect such Books, or take Copies or Extracts therefrom, during the Periods aforesaid, he shall forfeit to such Shareholder for every such Offence a Sum not exceeding Five Pounds.

And with respect to the making of Dividends, be it enacted as follows:

CXX. Previously to every Ordinary Meeting at which a Dividend is intended to be declared the Directors shall cause a Scheme to be prepared, showing the Profits, if any, of the Company for the Period current since the preceding Ordinary Meeting at which a Dividend was declared, and apportioning the same, or so much thereof as they may consider applicable to the Purposes of Dividend, among the Shareholders, according to the Shares held by them respectively, the Amount paid thereon, and the Periods during which the same may have been paid, and shall exhibit such Scheme at such Ordinary Meeting, and at such Meeting a Dividend may be declared according to such Scheme.

CXXI. The Company shall not make any dividend whereby their Capital Stock will be in any degree reduced”.

**3.16** These first attempts to enforce disclosure did not provide for enforcement machinery and the Registrar had no authority to reject balance sheets submitted to him.

Reputedly, directors found it easy to file misleading or uninformative balance sheets.<sup>(6)</sup>

**3.17** The Joint Stock Companies Act of 1856 consolidated the two former acts and made provision for two kinds of companies, the unlimited company and the limited company with a fixed capital structure. It abolished the compulsory audit of balance sheets (eventually reintroduced by the Companies Act of 1900).

“In place of statutory requirements, the 1855-56 Acts included a model balance sheet and model corporate articles of association (bylaws). These were permissive. Any registered company which chose to adopt its own articles could ignore the model set, which was compulsory only for firms which did not bother to register articles of their own. The model balance sheet was extremely progressive. Assets and liabilities were classified by type, bad debts were provided for, depreciation was shown for both plant and inventories, and retained earnings was divided into portions reserved for contingencies and available dividends. The model articles included nearly all the audit and accounting provisions of the 1845 Act plus others even more advanced. Books were kept in doubly entry form. No dividend was to be paid which reduced capital. An income statement was not required but different sources of revenue were to be distinguished. By specifying that auditors no longer had to be shareholders in the company, the model articles simplified the employment of outside professionals. As additional protection the new law provided that, even if no auditor was appointed, a petition by 20 percent of the stockholders required the Board of Trade to name an inspector who would investigate the company's affairs”.

**3.18** The 1856 Act was followed by an amending Act in 1857 and then by the consolidating Companies Act 1862 which served as the model for the companies acts of most of the Commonwealth countries.

The 1862 Companies Act reproduced the model balance sheet and articles of association with only a few important changes. The auditor's examination was described in greater detail, and a standard form audit certificate was presented for the first time. It was stated explicitly that dividends could only be paid from accumulated income. This act completed the conceptual framework of English company law.<sup>(7)</sup>

**3.19** Edey and Panitpakdi summarised the developments during the period 1844 – 1900 as follows:

“In 1844 another Act made provision for the incorporation and regulation of joint stock banks (which, as already noted, were not covered by the 1844 Joint Stock Companies Act}. This Act required the company’s regulations to provide for the supply to shareholders of an annual balance sheet, in this case with a profit and loss account as well. Provision was also to be made for the appointment of auditors and for an annual audit of the accounts of the company. In addition, a monthly statement of assets and liabilities was to be published by the bank.

Thus the accounting requirements of the first Joint Stock Companies Act did not represent an isolated phenomenon. The main aims of the contemporary legislators in framing accounting requirements seem to have been: (a) to provide the creditors and shareholders of companies with statements of assets and liabilities that would give indications of the solvency of the companies, and (b) in the case of some classes of companies to prevent actual and potential shareholders or creditors from being misled as the result of dividend distributions made out of capital – which, in effect, means made at the expense, in some sense, of the future of the company without this fact being known. In the case of the Joint Stock Companies Act of 1844, the main consideration was solvency, and no direct attention was paid to the second point. ....

Again, though the legislators (or their advisers) believed, if we may take their words and actions at their face value, in the merits of accounting disclosure, they omitted to define in any clear way the form or content of the accounts that were to be prepared, or the valuation principles that were to be adopted. Nor were the duties of auditors laid down in any detail. This lack of precision was probably attributable to the combination of: (a) a desire not to interfere too closely in matters of private enterprise; (b) an undeveloped state of accounting techniques with respect to the presentation of information and to rules of procedure for the valuation of assets and liabilities and the measurement of profit (or at least a lack of a widespread knowledge of those that had been developed); and (c) the absence of an established code of auditing rules built on professional practice and legal precedent.

There seems little doubt that it was an easy matter for the unscrupulous to violate the spirit of the legislation. We learn, for example, that balance sheets filed with the registrar under the 1844 Act might be 'manufactured for the very purpose of the return' or 'unexplainable'. Similar defects existed in the other legislation we have mentioned. Railway accounts could be uninformative, failing to comply even with the limited requirements of the 1845 Companies Clauses Act, and the audit could be ineffective. Bank audits also, it seems, might be purely formal.

No action was taken to remedy the defects of the 1844 Act. The tendency was indeed in the opposite direction. In 1855 when general registration with limited liability was introduced for the first time, no attempt was made to strengthen the 1844 accounting or auditing provisions, although support was not lacking for the proposition that the privilege of incorporation with limited liability demanded in return the obligation of providing publicly information on the state of the company's capital. In the Joint Stock Companies Act that replaced, in 1856, the 1844 and 1855 Acts, compulsory accounting requirements and compulsory audit for registered companies were abandoned. The resultant state of affairs was to endure until 1900 for all such companies except banking and insurance companies, and deposit, provident or benefit societies. ....

Although the 1856 Act contained no compulsory accounting or audit provisions, it did include, unlike the Act of 1844, a model set of articles, which were to apply to all companies registered under the Act who did not register their own particular articles. These model articles, whose adoption was therefore not mandatory, were in Table B of the 1856 Act (later to become Table A of the 1862 Act and, in amended form, of the later consolidating Acts up to and including that of 1948). Table B included accounting and auditing clauses considerably more advanced than those written into the 1844 legislation. ....

The failure in 1856 of the Royal British Bank (which has been incorporated under the Joint Stock Banking Act of 1844), following substantial falsification of balance sheets by the directors coupled with the payment of dividends in the absence of profits and the issue of new shares to the public, did not

convince prevailing contemporary opinion that compulsory accounting provisions and compulsory audit were desirable. On the contrary, it was suggested that these, while having the effect of causing people to relax their vigilance, would, at the same time, be avoided by the unscrupulous.

In the event the main accounting provisions of the 1844 Joint Stock Banking Act were abandoned when, in 1857, the special incorporation law for banks disappeared and these businesses were added to those that could be incorporated under the general company law. Nevertheless, certain minimum requirements were reintroduced for banking companies in the following year when the right to register with limited liability (other than in respect of any note issue) was extended to them. Every such company had to display half-yearly in its registered office and in every branch office a statement of assets and liabilities, together with a summary of the nominal capital, authorised and issued, and calls made and received. ....

While the law makers of the period were not prepared to impose compulsory publicity on the general body of corporate business they did not hesitate to strengthen the sanctions of the law against fraud. The Punishment of Frauds Act of 1857 made it a specific offence for any director, officer or manager of a company to falsify or tamper in any way with the company's books and accounts for fraudulent purposes or to circulate or publish any written statement or account knowing it to be false in any material particular with intent to defraud any member or creditor of the company or to induce any person to invest money in the company either as a shareholder or a creditor. These provisions were later embodied in the Larceny Act, 1861. It was under section 84 of that Act (formerly section 8 of the 1857 Act) that, seventy-five years later, Lord Kylsant was to be successfully prosecuted in the *Royal Mail* case.

A few years later the general company law was consolidated in the Companies Act, 1862; this was to remain the main Companies Act until 1908. Apart from points already noted, the 1862 Act made no material change in the part of the law with which we are concerned. The model articles were not included in Table A; the accounting and auditing clauses which had appeared in Table B of the 1856 Act were substantially the same and the model form of

balance sheet was again reproduced, an interesting minor change was the omission of the requirement that the books of account should be kept in double-entry form.

After 1862 a number of attempts were made to reintroduce compulsory accounting and auditing provisions into the company law, at first without success. The usual accounting features of the Bills introduced into Parliament between 1862 and 1900 were provisions for the keeping of proper books of account, for the publication (by way of distribution to shareholders, deposition at the company's office or by registration with the Registrar of Companies) of balance sheets and profit and loss accounts in prescribed forms, and for audit. ....

A Bill which provided for publication of balance sheets was rejected in 1867; the Select Committee on Limited Liability Acts of the same year made no recommendations on accounts and audit. Ten years later the 1877 Bill already mentioned was examined by another Select Committee on the Companies Acts, with a similar result. *The Economist* was among those who were then of the opinion that it was desirable to impose a form of account on companies. ....

An event that must have contributed to the change in outlook was the catastrophic failure in 1878, in a setting of directorial mismanagement and falsification of accounts, of the City of Glasgow Bank, which had been registered – but without limited liability – under the Companies Act, 1862. By over-valuing assets, undervaluing liabilities and – particularly significant in a bank – misdescription of balance sheet items with the object of maintaining the company's credit standing, directors had for a number of years successfully concealed its insolvency while continuing to pay dividends, a fraud for which they received in due course terms of imprisonment.

This fraud was followed by the Companies Act, 1879, which made it possible for unlimited companies to re-register as limited and introduced a compulsory annual audit for all banking companies registered thereafter with limited liability. The provisions relating to the appointment, duties and powers of the auditors were in general similar to those contained in the model clauses of

Table B of the 1856 Act and Table A of the 1862 Act. No provision was made, however, as in 1856 and 1862, for the employment of accountants by the auditors at the company's expense. This suggests that the appointment of professional auditors was becoming more usual.

The original 1879 Bill required the submission of an annual balance sheet to the company in general meeting and contained a simple form of balance sheet, but all this disappeared in the process of enactment. ....

The Act specifically called upon the auditors to report whether the balance sheet was 'full and fair'. That this required active verification of the company's position, going beyond what was merely recorded in the books, was given judicial recognition in 1895.

Special treatment in accounting matters was not confined to banking companies. Under the Life Assurance Companies Act, 1870, every company carrying on life assurance business was required to prepare, file with the Board of Trade, and make available to shareholders and policy holders annual revenue accounts and balance sheets in prescribed forms. The statutory quinquennial actuarial valuation was introduced at the same time. No special auditing provisions were imposed, however, on these companies.

Public utility companies, too, continued to receive special treatment. The Regulation of Railways Act, 1868, provided for the publication and filing with the Board of Trade of detailed accounting statements including a revenue account and balance sheet in prescribed forms.

Similar arrangements for the preparation and publication of accounts in prescribed forms were made for other public utilities, for example, in the Gas Works Clauses Act, 1871, and the Electric Lighting Act, 1882.

Thus by about 1880 the principle of compulsory publication of accounts in uniform style, and (except for life assurance companies) compulsory audit by auditors elected annually by shareholders had been accepted for these 'special' types of company.

The extension of the compulsory annual audit to all registered companies followed an extensive inquiry conducted by the Company Law Amendment Committee of 1895. The Committee's report, which included a draft Bill, was followed by the submission of the Companies Bill of 1896 to a House of Lords Select Committee, which sat during the following three years. Finally, in 1900, an amended Bill became law as the Companies Act, 1900. This Act contained no explicit provisions for the regulation of company accounting, but it did, for the first time since 1856, make an annual audit obligatory for all companies registered under the Companies Acts, and thereby imposed, by inference, an obligation to prepare an annual balance sheet.

The auditing requirements of the 1900 Act followed the same general lines as those for banking companies under the 1879 Act, and as those of Table A of the 1862 Act, though the wording of the auditors' report to the shareholders differed in some respects...;

The phrase 'full and fair' relating to the balance sheet was omitted. It still had to show a 'true and correct view of the state of the company's affairs'. It is of interest to note that in addition to the report the auditors were required to append to the balance sheet a certificate stating whether or not their requirements as auditors had been complied with. The present-day equivalent is now included in the form of the report. ....

The **Davey Committee**, while recommending that the directors should be required to make provision for proper books of account and to submit annually to shareholders (or deposit at the company's registered office) a balance sheet containing certain minimum information, were nevertheless opposed to public registration of accounts. As we have seen, this view was accepted by Parliament. It is interesting to note, however, that the original 1896 Bill included a clause whereby the annual balance sheet was not only to be submitted to the shareholders but was also to be filed with the Registrar of Companies (where it would be open to public inspection). Speaking on the Bill in the House of Lords, Lord Dudley, Secretary to the Board of Trade, said that the principle upon which the Bill was based was that of publicity in the interests of the shareholders and the creditors. It was impossible to protect people against the consequences of their own folly, but it was possible to place

prudent people in a position to determine whether they could safely invest their money in these concerns. ....

Although the 1896 Bill, by requiring the disclosure of the basis on which assets had been valued, would (had this clause become law) necessarily have provided some information on the method of profit calculation used, the Bill – and here again the Parliamentary draftsmen were in accord with what appears to have been the prevailing climate of opinion – did not call for either the publication or the supply to shareholders of a detailed profit and loss account.

On one subject – the desirability of audit – there was a substantial measure of agreement including a good deal of support for the inclusion among the auditors of at least one professional accountant. The compulsory audit recommended by the Davey Committee was written into the Bill, but, also following the Committee's Report, without the proviso that professional accountants should be employed. As we have seen, the auditing proposals became law in 1900. ....

Two auditing requirements that were in the 1896 Bill and are now part of the law, but which failed to reach the Statute-book in 1900, would have imposed upon auditors the duty of ascertaining whether the books of the company had been properly kept and likewise of reporting whether the balance sheet had been drawn up in accordance with the provisions of the Act. These requirements, *inter alia*, were criticised by the Council of the Institute of Chartered Accountants on the grounds that the auditors' work would thereby be made unduly onerous (*The Accountant*, XXII [1896], pp. 418-419). Another interesting suggestion of the Davey Committee which failed to reach the Statute-book was that the directors should, for the purpose of the audit, supply the auditors with a 'private balance sheet', giving the full details upon which the balance sheet to be issued to the shareholders was founded, and which would be signed on behalf of the Board. The object of this proposal, said the Committee, was to secure increased care and attention on the part of the directors, and to bring home to their minds their responsibility with respect to the issued balance sheet so that more care would be taken in seeing that the summary results exhibited to the shareholders were founded upon

sufficient and trustworthy materials, and at the same time to preserve evidence of the manner in which the directors and auditors had performed their duty (The Report, para.55). The Council of the Institute took the view that this provision was redundant”.<sup>(8)</sup>

**3.20** At the end of the 19<sup>th</sup> Century, calls for more statutory regulation and for better disclosure of financial information were defeated on the grounds of

- confidentiality;
- the belief that public disclosure would harm the company because competitors could benefit by it;
- the fear that if the real profitability of the company was known, it would lead to increased wage demands by employees.

**3.21** The **Davey Committee** (1896) recommended that —

“true financial position of the company should be honestly disclosed to shareholders not less than once a year but not for public use”.

**Troberg and Ekholm** state —

“One argument against public disclosure in the nineteenth century was the fear that it could harm the company because competitors would unreasonably benefit from the information disclosed. In addition, information for public use, it was argued, could raise the danger that the labor force would present pay demands to the management of highly profitable companies. If information was to be made public, the profit should be understated (potentially overstated in unprofitable companies) so that it would not harm the company. The 'real picture' could, however, be given to the shareholders at the shareholders' meeting. The point of view held by the Davey Committee can be seen as a strong support for a rather extreme form of the proprietary theory view”.<sup>(9)</sup>

**3.22** As will be seen, these views, expressed during the **1890's**, prevailed for the next 50 years until the **Cohen Committee (1945)** recommended the introduction of minimum requirements regarding the contents of the profit and loss account.

**3.23** The **Wrenbury Committee (1918)** was appointed to report upon possible amendments to the Companies Act arising out of some practical problems which followed upon the conclusion of the 1914–1918 War.

The Committee reiterated the view that public disclosure of a profit and loss account would be prejudicial to the commercial interests of the company.

“60. Section 26(3) of the Act of 1908 provides that the annual summary required of every company other than a private company must include a statement in the form of a balance sheet, but the balance sheet need not include a statement of profit and loss. We have made enquiry whether a profit and loss account ought to be included. We do not recommend that it be required. As a commercial matter publication of profit and loss ought not to be required in the absence of very strong reason, and we do not find that such reason exists. To require from a corporation a public disclosure of profit and loss which is not required from a firm or an individual, gives an unfair advantage to a competitor in trade and does not commend itself to our judgment. But we think that it may reasonably and without public mischief be required that the statement in the form of a balance sheet to be included in the annual summary shall state the amounts or rates of dividend which have been paid since the last balance sheet or are proposed for payment as the result of the trading.. And we recommend an amendment of the law to that effect”.

**3.24** The **Greene Committee (1925)** reported that

67. Under the present law there is no direct statutory obligation on a company to keep proper accounts. We consider that the law should be altered so as to make the keeping of such accounts compulsory.

68. We consider that the present facilities given to shareholders for obtaining copies of the balance-sheet and directors’ and auditors’ reports are insufficient.

69. With regard to the form of accounts, although in general we consider that shareholders and others concerned have little ground for complaint, cases occur where the information given by the accounts is of a scanty nature, particularly where assets are so grouped together under one heading that the true position of the company cannot readily be ascertained.

We think it most undesirable to attempt to lay down hard and fast rules as to the form which a balance-sheet should take, but we consider that the recommendations set out below will help to remove some of these grounds for complaint. The matter of accounts is one in which we are satisfied upon the evidence before us that within reasonable limits companies should be left a free hand.

70. With regard to the filing of published accounts, section 26 (3) has not worked well in practice. The form of statement required by that sub-section is not satisfactory and it is permissible to file the same statement year after year. We consider that in lieu of the present statement the last audited balance-sheet of the company should be filed. As the sub-section only applies to public companies we are of the opinion that there can be no objection to this course. One result of this recommendation, if adopted, will be to enable the registrar to tell, in cases where he cannot easily do so at present, whether a company is defunct or not. We have considered the question whether private companies should be compelled to file accounts and, in our opinion, the present exemption enjoyed by these companies should be continued.

71. The position of holding companies with particular reference to the form of their accounts has been much discussed before us and the evidence discloses a considerable divergence of views on the subject among both commercial men and accountants. Complaints have undoubtedly been heard from shareholders in such companies that the information given to them by the accounts of the holding companies is unintelligible without fuller details as to the position of the subsidiary and associated companies. Some witnesses take the view that the publication of a consolidated or combined balance-sheet for the whole group of companies should be made compulsory. We do not agree with this. Many holding companies have adopted the practice already and we consider that the matter should be left to the shareholders to make such requirements as to the form of their company's accounts as they may think proper. It is often forgotten that it may be in the best interests of the shareholders themselves that the accounts should be in a certain form, and we consider that undue interference by the legislature in the internal affairs of companies is to be avoided, even if some risk of hardship in individual cases is involved".

**3.25** The **Cohen Committee (1945)** reported as follows:

"We have included a number of proposals to ensure that as much information as is reasonably required shall be made available both to the shareholders and creditors of the company concerned and to the general public.

.....

7. Since the Companies Act, 1929, came into force, public attention has been drawn particularly to the following aspects of company law:

.....

d) Accounts

The present legal requirements as to the contents of the accounts to be presented to shareholders are too meagre. The practice of showing a number of diverse items in one lump sum and thereby obscuring the real position as to the assets and liabilities, and as to the results of trading, makes it difficult and often impossible for a shareholder to form a true view of the financial position and earnings of the company in which he is interested. While auditors have tended to press for standards in advance of the requirements of the present law, it has been suggested that their hands would be strengthened if the law were to accord more nearly with what they regard as the best practice.

(e) Control

The illusory nature of the control theoretically exercised by shareholders over directors has been accentuated by the dispersion of capital among an increasing number of small shareholders who pay little attention to their investments so long as satisfactory dividends are forthcoming, who lack sufficient time, money and experience to make full use of their rights as occasion arises and who are, in many cases, too numerous and too widely dispersed to be able to organise themselves".

Paragraphs 96, 97 and 103 of the Report read as follows:

"96. General.—The history of company legislation shows the increasing importance attached to publicity in connection with accounts. The Act of 1862 contained no compulsory provisions with regard to audit or accounts, though Table A to that Act did include certain clauses dealing with both matters. In 1879 provision was made for the audit of the accounts of banking companies but it was not until 1900 that any such provision was made generally applicable. It was only on 1<sup>st</sup> July, 1908, when the Companies Act, 1907, came into force, that provision was made for including a statement in the form of a balance sheet in the annual return to the Registrar of Companies, and that provision exempted private companies from this requirement. The Act now in force requires directors to produce a balance sheet and a profit and loss account in every calendar year and to lay them before the company in general meeting. The Act lays down some requirements as to the contents of the

balance sheet; we refer to them in greater detail in paragraph 99. But there are no requirements as to the form of the profit and loss, or income and expenditure, account, nor does the Act in terms make the auditors' report cover the profit and loss account, though, since the balance on that account is necessarily carried into the balance sheet, an auditor cannot discharge his duties without examining it. We consider that the profit and loss account is as important as, if not more important than, the balance sheet, since the trend of profits is the best indication of the prosperity of the company and the value of the assets depends largely on the maintenance of the business as a going concern.

97. Present practice.—The amount of information disclosed in the accounts of companies varies widely. The recent tendency has been to give more information and this tendency has been fortified by the valuable recommendations published from time to time by the responsible accountancy bodies as to the form in which accounts should be drawn up and the information which they should contain. The directors of many, but by no means all, companies now give shareholders as much information as they consider practicable and the accounts which they present contain much more detail than is required by law. Auditors use their influence to persuade directors to present their accounts in accordance with the principles laid down by the professional bodies to which they belong, but in the absence of statutory requirements they cannot override the directors and in some cases may be deterred from pressing their views by fear of losing their position as auditors. The professional bodies representing the accountants who gave evidence before us all agreed that the position of auditors would be strengthened if the law were to prescribe a minimum amount of information to be disclosed in all balance sheets and profit and loss accounts. We accept this view and have considered whether, as in the case of societies operating under the Friendly Societies Acts, Industrial Assurance Acts, Building Societies Acts and Industrial and Provident Societies Acts, there should not be prescribed forms of accounts with which all companies registered under the Companies Acts would be required to comply. In our view the diversity of companies is such that it is doubtful whether standard forms of accounts would be practicable and in any event we fear that standard forms might restrict further progress in the technique of conveying information through the published accounts. We have also considered suggestions that, to assist those responsible for framing general economic policy, companies should be required to disclose in their accounts details of sales, expenses of production, selling and distribution, administration and management, and other like details. In our view, however, such information could not be given in sufficient detail to achieve the object in view without loading the published accounts, of which the primary purpose is to convey financial information in a form that can be assimilated by shareholders and

creditors, with so much detail as to fail in that purpose. We consider that information required for general economic purposes would be more appropriately and conveniently obtained through some such machinery as the Census of Production Act, under which information could be required in greater detail than would be practicable in published accounts.

.....

103. Profit and Loss Account.—We have already referred in paragraph 96 to the absence of statutory requirements as to the contents of the profit and loss, or income and expenditure, account and to the importance of the trend of profits as the best indication of the prosperity of a company. We consider that the law should lay down minimum requirements as to the contents of the profit and loss, or income and expenditure, account calculated to ensure that it gives a fair indication of the earnings of the period covered by the accounts and that the auditor should be under specific responsibility to report on its contents. The account should be drawn up in accordance with accepted accountancy principles consistently maintained and if for any reason any change of a material nature, e.g. a change in the basis of stock valuation, is adopted, specific attention should be called to the change and to the effect thereof".

**3.26** The **Jenkins Committee (1962)** again expressed the view that the publication of some information might be detrimental to the business of the company:

- “11. It is no doubt necessary for the protection of shareholders, creditors and intending investors that the activities of companies and those responsible for their management should be subject to a considerable degree of statutory regulation and control. But controls and regulations carried to excess may defeat their own object; and we share the views expressed by the Greene and Cohen Committees as to the undesirability of imposing restrictions which would seriously hamper the activities of honest men in order to defeat an occasional wrongdoer, and the importance of not placing unreasonable fetters upon business which is conducted in an efficient and honest manner.
- 12. Accordingly, in our consideration of proposals to impose further statutory restrictions and requirements on companies or their directors, we have asked ourselves whether the new restriction or duty proposed would, if it was made law, improve to an extent worthy of legislation the position of the investors or creditors it was designed to protect; and if so whether its implementation would to any significant extent hamper or impede the company in the efficient conduct of its legitimate business, thus perhaps operating to the detriment of those very persons.

- 13. Thus, while (for example) we share the views of the Cohen Committee as to the importance of ensuring that companies should make available to shareholders, creditors and the general public as much information as is reasonably required, we also recognise the importance, where the desirability of some proposed new statutory obligation to provide information is in question, of considering whether the additional information would be of any real value to the persons receiving it, and if so whether its ascertainment would involve an amount of work disproportionate to its value, or its publication might be detrimental to the company's business, and thus indirectly to its shareholders and creditors.
- 14. Another instance of conflicting considerations is to be found in proposals for giving shareholders closer control over their directors. It may be theoretically desirable that shareholders should have a more effective voice in the management of their company's business, of which they are ultimate proprietors. As against this, no company's affairs can be managed properly, or indeed managed at all, otherwise than through a board of directors with a reasonably free hand to do what they think best in the interests of the company. The risk (which must not be exaggerated) that dishonest directors may abuse the trust reposed in them must be accepted if business is to go on".

**Chatfield** commented as follows —

"The 1967 Companies Act, following the report of the Jenkins Committee, set additional disclosure requirements. Like the AICPA's Accounting Research Study No. 9, it required the all-inclusive income statement. Balance sheets now had to show: (1) the basis of inventory valuation; (2) totals of fixed assets acquired, disposed of, or destroyed during the year; (3) capital authorized by directors but not contracted for; (5) a subdivision of land into freehold, long leasehold, and short leasehold categories; (6) the total of loans other than bank loans and overdrafts, which are not repayable within five years, and including terms of repayment and interest rates; (7) the name of each subsidiary of a holding company, with details of the nature of the stock investment; (8) or, in the case of a subsidiary, the name and country of incorporation of its ultimate holding company".<sup>(10)</sup>

**3.27** In the United States, by the end of the 19<sup>th</sup> century, corporate disclosure to the public lagged far behind the even meagre disclosure required in England.

Management decided what and how financial data should be revealed. Disclosure was generally not considered to be a good policy and the fear of providing competitors with information led to the suppression of sales and profit figures.

**3.28** Before the formation of large industrial corporations, capital was usually sought from banks and not from the general public, but when short-term lending by banks outgrew its local origins based on personal acquaintanceship with borrowers and their businesses, bankers began to ask for signed balance sheets. They wanted the assurance that their loans would be repaid, were interested in the relationship between current assets and current liabilities, favoured the writedown of inventories to the lower of cost or market price and encouraged the use of depreciation reserves and bad debt allowances.<sup>(11)</sup>

During the 1920s many corporations still kept sales figures secret, some did not depreciate assets, failed to treat non-operating income consistently, did not separate retained earnings from paid-in capital and did not disclose asset write-ups.

**3.29** Today, the financial statements published by the listed American corporations are the most detailed and comprehensive in the world.

The prime causes were the requirements of financial institutions, changes in public attitudes after the stock market crash in 1929, the depression which followed, the federal intervention in the form of the Securities Acts of 1933 and 1934 and the quest for generally accepted accounting principles.

**3.30** **Dr Amir Licht** summarised the early development of securities regulation towards full disclosure as follows:

While companies were solidifying their status as private entities during the late nineteenth century, they were also growing to non-human dimensions (first the railroad companies and later the mass production firms). A major effort to regulate both corporate conduct and corporate structure was launched in 1890 with the enactment of the Sherman Anti-Trust Act and continued with the enactment of the Clayton Act in 1914. It took a considerable amount of time for this early antitrust regulation to mature and achieve real force, but for our purposes it was the harbinger of a more general strategy: If corporations and corporate law could not be penetrated and regulated from within, then regulation could come from other legal fields, external to corporate law.

.....

Loss and Seligman trace the historical origins of the disclosure and anti-fraud components of modern securities regulation in the United States to the English Companies Act of 1844. In that Act, Parliament enacted the first modern prospectus requirement. A later version of that Act, the English Companies Act of 1929 ('1929 Act'), served as the foundation for Felix Frankfurter and his team in drafting the Securities Act of 1933. Importantly, the 1929 Act was the source of two major components of the current American securities regulation regime, the concept of full disclosure and the civil liabilities of the registrant, its officers, directors, and experts.

The importance of the legislative history goes beyond the mere anecdotal interest. After all, the 1929 Act's drafters were not the only ones to perceive the value of full disclosure; Frankfurter's team was indeed implementing President Roosevelt's policy, which championed full disclosure as the preferable remedy to the malaise of American financial markets at the time. Roosevelt often referred to Louis Brandeis's famous maxim: 'Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman'. The significant point here is that the very principle that constitutes the central pillar of the securities regulation regime in one country was located, at virtually the same point in time, at the heart of another country's corporate law".<sup>(12)</sup>

**3.31** During 1932 the New York Stock Exchange expressed concern about the wide variety of accounting and reporting methods used by companies whose securities it listed. A committee of the American Institute of Accountants under the chairmanship of George May was appointed to formulate improved accounting standards which could then be enforced through listing requirements.

The Committee's final report contained five recommendations:

1. To promote consistency, corporations listing their stock on the exchanges were asked to adhere to certain broad accounting principles, within this framework, each firm could adopt the accounting methods it preferred.
2. Each listed company would prepare a summary of accounting methods used in its statements. This summary would be formally approved by the firm's board of directors, would be filed with the Exchange, and would be available on request to any stockholder.

3. The procedures listed in this summary would be consistently followed from year to year and would not be changed without prior notice to the Stock Exchange and to the company's investors.
4. Financial statements were to be the representations of management. The auditor's task was to inform stockholders whether the methods adopted by each company were actually being used, whether they were compatible with 'generally accepted' principles of accounting, and whether they were being applied consistently.
5. The Committee suggested that a qualified group of accountants, lawyers, and corporate officials draw up an authoritative list of accounting principles to help corporations in preparing their own lists of procedures".<sup>(13)</sup>

The developments are described by **Chatfield** —

"The first important effort to codify accounting principles as made in 1932 by the American Institute's Special Committee on Cooperation with Stock Exchanges, chaired by George O. May. The New York Stock Exchange had expressed concern about the wide variety of accounting and reporting methods used by companies whose securities it listed. On the Institute's side there was uncertainty over the precise wording of the audit certificate and the responsibility it imposed on CPAs. The Committee was appointed to formulate improved accounting standards which might then be enforced through the Stock Exchange's listing requirements.

In May's view, the Committee had two specific tasks: to educate the public as to why a variety of accounting methods was necessary, and to suggest ways to curtail this variety and gradually make the better methods universal:

In considering ways of improving the existing situation two alternatives suggest themselves. The first is the selection by competent authority out of the body of acceptable methods in vogue today a detailed set of rules which would become binding on all corporations of a given class.....The arguments against any attempt to apply this alternative to industrial corporations are, however, overwhelming.

The more practical alternative would be to leave every corporation free to choose its own methods of accounting within the very broad limits to which reference has been made, but require disclosure of the methods employed and consistency in their application from year to year.

.....

In proposing an extension of English practice to fit American situation, May could expect no statutory assistance. Aside from the Exchange's listing rules, success would depend on the integrity and cooperation of company officials and on the competence of the CPAs. He believed most business managers were honest, most financial statements adequate, and most accountants capable. So it was all to be done without disturbing managerial prerogatives, 'and with no compulsion except that of educated opinion'.

However, the American Institute's Committee of Accounting Procedure (also headed by George O May) accepted only two of these recommendations. It retained the provision that, subject only to the restraint imposed by accounting principles, each company might choose the methods most suitable for its own operations. The Committee also specified that an auditor was responsible only for his opinion, not for the contents of financial statements. To help make these decisions operative, in 1933 the standard audit certificate was revised to include the phrase 'accepted principles of accounting', which later was changed to 'generally accepted accounting principles'.

But the recommendation that corporations be required to disclose their accounting procedure was never put into effect. Almost no summaries of methods were filed with the stock exchange or sent to shareholders. Nor was a statement of accepted accounting principles forthcoming. Instead, the Institute opted for a case-by-case treatment of accounting issues as they arose.

.....

The Securities Act of 1933 and the Securities and Exchange Act of 1934 transferred to the SEC much of the listing authority formerly held by the stock exchanges. Ironically, the SEC took up several of the recommendations so recently rejected by the American Institute. Like the British companies acts, the SEC's intention was to protect investors by enforcing disclosure and consistency and by requiring the periodic filing of audited financial statements. Its ultimate goal was to remedy a situation in which insiders knew much more than ordinary stockholders about the details of corporate activities. To achieve this the SEC could either prescribe accounting rules for every situation — which it had the power to do — or work through and reinforce the accounting profession's principles program. In 1938 it chose the latter policy. Since then its influence on accounting theory has depended largely on accountants' knowledge that they could limit the extension of SEC regulation by improving the effectiveness of accounting principles, with the implied threat that if they did not, the government would.

There remained the task of defining those principles under which the Institute's program was to operate. In 1936 the American Accounting Association published 'A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements'. Its list of twenty 'principles' was really a mixture of rules and standards, including definitions of particular account titles, instructions concerning the form of financial statements and the correct handling of asset writeups and depreciation, attempts to distinguish precisely between paid in capital and retained earnings, and between normal and extraordinary income, and a series of preferred methods in other areas where abuses had occurred. As a comprehensive statement of accounting concepts it had two major faults: it mixed broad principles with procedural rules, and it had no single derivation, either in logic or in practice.

.....

In 1938 the Haskins and Sells Foundation commissioned three educators, T H Sanders (Harvard), H R Hatfield (Berkeley), and Underhill Moore (Yale Law School) 'to formulate a code of accounting principles which would be useful in the clarification and improvement of corporate accounting and of financial reports issued to the public'. In preparing A Statement of Accounting Principles they interviewed both makers and users of accounting data, reviewed the periodical literature, and studied laws, court decisions, and current corporate reports.

.....

The next step was the application of principles to discipline rules, and this also was aided by a fresh approach. In 1938 A C Littleton published two articles on the development of accounting concepts. Like Gilman he began with the terminology problem. 'Each book usually contains a mixture of axioms, conventions, generalizations, methods, rules, postulates, practices, procedures, principles and standards. These terms cannot all be synonymous. So his first task was 'to distinguish unchanging truths from variably practices. Rules are a basis of conformity, whereas principles are gauges to measure departures from the norm. He accepted Byrne's thesis that principles embody a 'coercive or compelling force which carries a penalty for violation', and Gilman's idea that, whereas rules are influenced by the diversity of business conditions, accounting principles express fundamental truths. It follows that principles derived wholly from experience are inadequate. Generalizing from practice to improve practice is in effect asking the profession to lift itself by its own bootstraps. A successful approach must combine inductive reasoning with deductive logic. Setting standards above the level of current practice need not embarrass the

profession. The problem is not simply to formulate principles but also to apply them, associating particular accounting goals with specific means of attainment.

These ideas permeated Paton and Littleton's *An Introduction to Corporate Accounting Standards* (1940), the most coherent statement of principles to emerge from this period, and still probably the best exposition of cost-based accounting theory. It was the first codification of accounting principles to be developed mainly deductively rather than from practice. It emphasized theory at a higher level than previous statements and subordinated operative rules to concepts. Doctrines such as conservatism and the lower of cost or market rule were either not supported or not even discussed. This was the first codification which not only elaborated a list of principles but showed their specific interactions with accounting methods. It foreshadowed the development of a complete framework of accounting doctrine from which preferred practices might be deduced before problems became acute.

All the codifications of the 1930s were harshly criticized. None achieved wide professional acceptance or noticeably influenced accounting practice at the time. Yet never before or since have the ablest academic accountants had such influence on the accounting societies' official pronouncements. At no other time during this century has the discussion of accounting theory combined a comparable range and intensity. In 'The Search for Accounting Principles' **Reed Storey** summarizes this remarkable era:

'Accounting, as it is practiced today, probably owes more to the decade of the thirties than to any other period after the development of double-entry bookkeeping. During this period both the American Institute of CPAs and the American Accounting Association formalized their respective machinery for the promulgation of accounting principles. ....The basic form of financial accounting as a process of cost allocation based on the matching of revenues and expenses crystalized during this period. The concept of accounting principles developed in the late thirties has dominated accounting thinking for more than twenty years. So have the prevailing ideas as to how principles are formulated'.<sup>(14)</sup>

**3.32** Nearly a century after the **Gladstone Report** in England, the **Lansdowne Report** on the South African Company Law (1936) recognised the inadequacies in the then existing South African company legislation in regard to financial disclosure and the necessity to make more information available to shareholders and persons who might be disposed to become creditors of the company.

“12. ....The trend of amending company legislation in recent years has been towards the devising of additional or improved means for the protection of the investor and the creditor. In this, as in many other matters, the developments of practice demand a periodical revision of the law with a view to its better adaptation to changed conditions. The marked advance of company activity in recent years has brought in its train increased attraction of public subscription, new methods of dealing with companies’ funds, and other matters which were not apprehended or adequately provided for in existing legislation...

13. Publicity is a powerful safeguard against unconscionable profits out of proportion to the value of services rendered or property sold, and against financial schemes for the unscrupulous exploiting of the public.....By means of annual balance-sheet and of profit and loss or revenue and expenditure account, shareholders should be fully and fairly informed of the progress of their concern, and of the manner in which it has been conducted by those representing their interests. By means of the annual balance-sheet persons who might be disposed to become creditors of a company should be in a position to judge of its financial stability. In the course of the following pages we shall have occasion to show that in all these respects the existing company legislation is inadequate”.

**3.33** The pious views expressed in the Lansdowne Report are little more than a regurgitation of the findings of the Gladstone Committee in England in 1844, and the maxim of **Judge Brandeis** 'publicity is justly commended as a remedy for social and industrial diseases' expressed in 1933.<sup>(15)</sup>

**3.34** Chapter XI of the South African Companies Act (sections 284 – 309) deals with the accounting of and disclosure by companies.

Some of the requirements are

— the duty to keep such accounting records as are necessary fairly to present the state of affairs and business of the company and to explain the transactions and financial position of the trade or business of the company (sec. 284);

- the duty of the directors to cause to be made out annual financial statements consisting of a balance sheet, an income statement, a cash flow statement, a directors' report and an auditor's report (sec. 286 (1) and (2));
- that the annual financial statements shall, in conformity with generally accepted accounting practice, fairly present the state of affairs of the company and its business as at the end of the financial year concerned and the profit or loss of the company for that financial year and shall for that purpose be in accordance with and include at least the matters prescribed by schedule 4, in so far as they are applicable, and comply with any other requirements of the act;
- the approval of the annual financial statements by the directors of the company and the signing thereof on their behalf by two of the directors, or if there is only one director, by that director (sec. 298);
- the laying before the annual general meeting of a report by the directors with respect to the state of affairs, the business and the profit or loss of the company or of the company and its subsidiaries, if any, and which must deal with every matter which is material for the appreciation by the members of the company of such state of affairs, business and profit or loss (sec 199(1) and (2));
- the duty of the auditor of the company to examine the annual financial statements and to satisfy himself that proper accounting records have been kept, and to examine them to satisfy himself that the annual financial statements present the financial position of the company and the results of its operations in conformity with generally accepted accounting practice applied on a basis consistent with that of the preceding year and that the statement made by the directors does not conflict with a fair interpretation or distort the meaning of the annual financial statements and accompanying notes (sec. 300);
- that after having carried out the audit as prescribed, the auditor has to make a report to the members of the company to the effect that he has examined the annual financial statements and that in his opinion they fairly present the financial position of the company and the result of its operations, and in the event of being unable to make such a report or to make it without qualification, he has to include in the report a statement to that effect setting forth the relevant facts or circumstances (sec. 301(1) and (2));

- the duty of the company to send copies of the annual financial statements to members, holders of debentures and the Registrar of companies not less than 21 days before the date of the annual general meeting (sec. 302);
- the duty to send half-yearly interim reports fairly presenting the business and operations of the company to all members and holders of debentures within 3 months after the expiration of the first period of 6 months of its financial year (sec. 303);
- the duty to send provisional annual financial statements to all members and holders of debentures within 3 months after the end of its financial year in the event of the annual financial statements not having been issued during this period (sec. 304).

**3.35** As experience in South Africa and elsewhere in the world has shown , the publication of balance sheets and profit and loss accounts is not a safeguard at all.

Without access to records and without proper regulation, supervision and powers of inspection, investor protection cannot be achieved.

## NOTES

1. **Association of Chartered Accountants in the US.** 'Accounting History'. ([www.acaus.org/history/index/html](http://www.acaus.org/history/index/html)).
2. **Chatfield, Michael** : 'A History of Accounting Thought', p. 19. (The Dryden Press, Illinois, 1974).
3. **Ibid.**, p. 15.
4. **Ibid.**, p. 32-33, 58-59, 64, 72.
5. **Chapter 2.**
6. **Chatfield, ob. cit.**, 114.
7. **Ibid.**, p. 114-115.

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**Chatfield. ob. cit.**, p. 119.

**Ibid.**, p. 127, 270-271.

**Licht, Amir N.** : 'International Diversity in Securities Regulation : Roadblocks on the Way to Convergence', p.246–247. (Cardozo Law Review, 1998, Vol. 20)

13. **Chatfield, ob. cit.**, p. 286..
14. **Ibid.**, p. 284 – 290.

**15.** See par. 3.11, 3.12 and 3.30. above.

# CHAPTER 4 - THE HISTORY OF THE AUDIT OF CORPORATE ACCOUNTS

**4.1** Verification by others of the stewardship of those who were entrusted with the receipt or disbursement of property originated when the transactions became too voluminous for individual scrutiny, even for those who were literate.

Before the 19<sup>th</sup> century and the advent of the Industrial Revolution, literacy was such a scarce commodity that the auditing of accounts had to be carried out by the reading thereof in the presence of interested persons.

This practice led to the descriptive name of the process, namely 'audit' which is derived from the Latin *audire* (to hear).

**4.2** As late as 1602 the Charter of the VOC (section 14) provided

“.....ende de generale rekeninge (sal doen) nae thien jaren, sal geschieden in topenbaer, mits datter alvorens billetten sullen worden aangeslagen om elcken een te waerschowen, die over d' auditie derselver sal begeren commen”.

“.....and the general accounts (produced) after ten years, shall be presented in public, provided that prior notice thereof must be sent to inform every person who might wish to attend the audit thereof”. (Translation)

and its Charter of 1622 stipulated that the process had to be conducted

“niet alleen met opene deuren maar ook met opene vensteren”  
“not only with open doors but also with open windows”.(Translation)

**4.3** The origin of auditing is described by **Spicer and Pegler** as follows —

“The practice of Auditing had its origin in the necessity for the institution of some system of check upon persons whose business it was to record the receipt and disbursement of moneys on behalf of others. In the early stages of civilisation the methods of account were so crude, and the number of transactions to be recorded so small, that each individual was no doubt able to check for himself all his transactions; but, as soon as the ancient States and Empires acquired any coherent organisation, records are found of systems of check being applied to their public accounts : the Ancient Egyptians, the Greeks, and the Romans, all having utilised systems of check and counter-check as between the various financial officials.

The ancient records of Auditing are confined principally to public accounts, but there is clear indication that from an early date it was customary for an Audit of the accounts of manors and estates to be performed. The person whose duty it was to make such an examination of accounts became known as the Auditor, the word being derived from the Latin *audire*, to hear. Originally the accounting parties were required to attend before the Auditor who heard their accounts”.<sup>(1)</sup>

and by **Chatfield**:

“Every society which has developed systematic record keeping has also produced some kind of account verification. It is natural for a prudent man who is unable to directly supervise his property to arrange for an independent check on the stewardship of those entrusted with his wealth. The ancient Egyptians achieved this kind of control by having tax receipts recorded independently by two officials. In Greece the accounts of officeholders were audited at the expiration of their terms. The Romans developed an elaborate system of crosschecking between the records of officials who authorized expenditures and those who actually received and paid money. Renaissance Italy’s emergence as a trading centre led to the first extensive use of auditing in commercial ventures. The Genoa Commune ledger was duplicated by another ledger kept by city auditors. The overseas traders of Venice and Genoa employed auditors to verify the accounts of ship captains who were responsible for carrying on the actual trading.

The feudal English audit followed a similar pattern of development. The royal revenue was audited beginning in the reign of Henry I (1100-1135). Written records of manorial audits survive from the thirteenth century. About this

time the practice of investigating servants and tax collectors was extended to the financial reports of other officials who handled public money. Such examinations had strictly limited aims. 'Auditing as it existed to the sixteenth century was designed to verify the honesty of persons charged with fiscal responsibilities.' In other words, the early audit tested the personal integrity of stewards, not the quality of their accounts. Proof of bookkeeping accuracy and fairness were sought only insofar as they might indicate the existence of fraud.

.....

A final step was the annual Declaration of Audit. The charge and discharge statement as verified by the auditor was read in the presence of the lord and the assembly of stewards whose discharge of duties was under scrutiny. Each might be called on to answer questions and substantiate facts from his personal knowledge. One reason for an oral summary of accounts is obvious: the manor, like the Exchequer, had to be attuned to the realities of a largely illiterate society. But a public hearing (the word audit means 'to hear') also offered special protection against fraud, since the facts were being laid simultaneously before all those qualified to recognize omissions and mistakes. In this sense manorial audit was the culmination of a general policy of management by inquiry. ....

Yet underlying feudal audit procedures was a system of beliefs which has changed very little. Basic was the idea that men in positions of trust should be subject to public scrutiny. Corollary was the notion that expectation of audit made such stewards more honest. Also that examination of a subordinate's records benefitted him as well as the interests he served. And it was seen that this examination was most effective when made by outsiders and that publicizing the audit increased public confidence in the organization. In the nineteenth century these beliefs became the foundation for the British statutory audit, which in turn set standards for verification all over the world.

Beginning with the first Bankruptcy Act in 1542, the English government intervened directly to protect creditors against fraud. Recurring business crises during the nineteenth century resulted in a series of new statutes and a continuing demand for men trained in bookkeeping and asset appraisal. The Victorians chose to regard insolvency as a moral shortcoming. There was often a presumption of asset concealment, and the examination of debtors' accounts introduced an element of

extreme skepticism not usually found in the master-servant audit. And in both trustee and bankruptcy audits, court-appointed accountants were involved as third parties interested not only in creditor protection but in the administration of the auditee's affairs. The resulting tradition of examination and reporting by impartial experts added a new dimension to the verification process. Even more significant, investors in prosperous companies began to demand audits.

Up to this time audit objectives had hardly changed in 2000 years. The advent of double entry bookkeeping had introduced technical refinements, but fraud detection remained the goal. An entirely new audit environment was created by the combination of large-scale factory production and limited liability corporations organized to attract funds from the general public. Many more people became involved in business affairs than ever before, and as operating control passed from individual proprietors to hired professionals, reporting to absentee owners became a major accounting task. We have seen that corporate accounting conventions were often influenced by changing business conditions and changes in management policy, and that bookkeeping 'error' which misstated profits was not always accidental. It was realized that the credibility of financial statements which represented management's communication with stockholders would be enhanced by outside verification. The employment of independent experts to stand between company directors and investor-owners was another instance of the English gift for adapting traditional methods to new situations".<sup>(2)</sup>

**4.4** In England, in 1844, the First Report of the Select Committee of Enquiry into Joint Stock Companies (the Gladstone Committee) expressed the view that —

“Periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud and illegality”.

**4.5** The Joint Stock Company Act 1844 which followed on the Report, required directors of companies to cause the books to be balanced and 'full and fair' balance sheets to be made up which would then be examined by a number of stockholders (the auditors), who would thereafter report to the assembled stockholders whether it displayed 'a true and correct view' of the company's affairs.

“Though ambitious in intent, this first effort at audit legislation was weak procedurally and far ahead of its time in the sense that means to implement it did not yet exist. Moreover, audit attention was fixed on the traditional issues of company solvency and

managerial integrity, ignoring questions of profit measurement and dividend policy which the shareholders of most companies would have found more relevant. The acts provided for appointment of auditors but were silent as to their qualifications, tenure, remuneration, and specific duties. No attempt was made to specify the form or contents of the statutory balance sheet or the asset valuation methods to be used. This lack of precision would have been damaging had there been a coherent body of doctrine to give substance to the phrase 'true and correct'. But the 1844-45 Acts were needed precisely because there was no professional control over practice. The very factors which made accounting regulation necessary made it inadequate.

The acts assumed that stockholders themselves would form a committee, check the books, and report back to their colleagues. And at midcentury one might actually find teams of investors making periodic visits to corporations in which they held shares, ticking off ledger balances against their printed balance sheets and seeing that each cash payment was covered by a voucher. This was nothing but the traditional stewardship audit in modern dress, with shareholders taking the part of manorial lords and company directors cast in the role of medieval bailiffs. One writer calls audits under the 1845 Act a 'complete farce', and certainly directors found it easy to file misleading or simply uninformative statements. Parliament had neglected to provide enforcement machinery, and the Companies Registrar had no authority to reject balance sheets submitted to him. The law did not require the date of the statutory balance sheet to be related to the date of the stockholder's meeting, and some firms filed identical statements year after year. In other cases meetings were called with minimum notice, or shareholders friendly to management were appointed as auditors. It soon became evident that only an examination by professionals could provide the meaningful check on directors intended by the law. The 1844—1845 statutes provided for the employment of skilled accountants as 'assistants' to the stockholder-auditors. Finally these assistants took over the whole audit examination".<sup>(3)</sup>

**4.6** The compulsory audit was abolished by the Joint Stock Companies Act of 1856, largely, it is believed, as a result of the prevailing philosophy that accounting disclosure was a personal matter best settled by agreement between shareholders and company directors.

**4.7** In 1878 the failure of the City of Glasgow Bank led to the Companies Act of 1879 which introduced compulsory annual audits for all banks registered with limited liability. The directors of the City of Glasgow Bank had for years continued to pay dividends while hiding its insolvency by over-valuing assets, undervaluing debts and by misdescribing balance sheet items.

4.8 During this period, specific Acts of Parliament prescribed accounting methods and audits for building societies, waterworks, gasworks, electric light and railway companies.

4.9 In his authoritative treatise on the duties and responsibilities of auditors published in 1891, **Pixley** stated as follows —

“The majority of companies now in existence are registered under the Act of 1862; and these Associations, known generally under the name of Limited Companies (although the Act of 1862 provides for the incorporation and management of unlimited Companies), have invaded almost every department of commerce and trade, and the capital embarked in these undertakings is enormous.

All classes of persons who have either inherited or acquired means, even the artizan, who out of his wages have saved a few pounds, is interested more or less in the management and welfare of these Associations, and every person holding a share is consequently a partner in each one in which he is a Shareholder.

As, however, it would be impossible for each of the partners in these undertakings to have a voice in the general management of the business, in the same manner as have the partners in a private firm, it is the practice to delegate this power to a few (varying according to the size and the nature of the business of the Company) of their number, now generally styled Directors, who undertake the superintendence and the administration of the affairs of the Company on behalf of themselves and their co-partners. ....

The meetings of the shareholders are almost invariably held yearly or half-yearly, and it is now the recognised practice for accounts to be prepared showing the result of the transactions of the Company since the previous meeting. ....

As it would be impossible in many instances, and very inconvenient in all, for each partner to examine these Statements of Accounts with the Books kept at the offices of the Company, and frequently elsewhere, their correctness is usually certified by their representative or representatives, elected annually, for the purpose of ascertaining that the funds of the Company have been properly accounted for, that such of them as have been expended have been applied in the manner indicated in the Accounts, that the unexpended portion is invested as stated in the Accounts, and generally that, in their opinion, the Accounts, as put forward by the Directors for adoption by their co-partners, are accurate in every respect, and to be relied on as showing the result of

their management and the true position of their Company, as set forth in the statement of its liabilities and assets”.<sup>(4)</sup>

**4.10** Pixley also stated that in some companies additional auditors were appointed to look after the interests of a particular class or section of interested persons.<sup>(5)</sup>

**4.11** During the latter part of the 19<sup>th</sup> century a number of decisions by the Courts clarified the scope of audit engagements and the responsibilities of auditors.

“The scope of audit engagements and the responsibilities of auditors were clarified by a series of landmark court decisions, the first of which was Leeds Estate Building and Investment Co. v Shepard (1887). Leeds’ articles of association provided that the manager and directors were entitled to bonuses based on the amount of income available for dividends. To increase these bonuses they inflated profits by overstating asset valuations. Without making a detailed examination, the auditor certified to the correctness of financial statements given him by the directors, and dividends were illegally paid out of capital. When the company went into liquidation the auditor and directors were sued, and the auditor, though he had been elected by the stockholders, maintained that he was simply a servant of management. The judge disagreed, saying that it was the auditor’s duty to inquire into the ‘substantial accuracy’ of the balance sheet provided by management, not merely its arithmetic correctness. It followed that an auditor had to examine the records from which statements were taken and satisfy himself as to the existence and approximate value of company resources.

In the Kingston Cotton Mill Company case (1896), the court ruled that an auditor, having no reason to suspect dishonesty, had no duty to verify inventory figures given him by a company official who himself certified to the amount of inventory on hand. A stricter interpretation of audit responsibility resulted from the London and General Bank case (1895). The bank had been organized to make loans to a group of building companies, and for several years most of its funds had been loaned to four such companies, the loans being secured by inadequate collateral. The bank’s auditor called the directors’ attention to the bank’s weak financial position, and in his 1891 report concluded that no dividend should be paid. But the directors persuaded him to delete this from his report to the stockholders, after which they paid a dividend which was in fact a return of capital. The stockholders sued the auditor, who was found guilty of misfeasance. The court held that while an auditor is not ‘an insurer’ of the balance sheet, he must be honest and prudent, must never certify what he knows to be untrue, and must exercise ‘reasonable care and skill’ before expressing his opinion. Previously it had been usual for either an affirmative audit opinion to be given, or

none at all. The precedent established by this case required auditors to express an opinion even if it was negative.

The rule that dividend payments could not reduce capital below the amount paid in by stockholders was modified by *Lee v The Neuchatel Asphalte Co.* (1889). The Court of Appeals held that in calculating profits from which dividends were to be paid, the company could ignore declines in the value of wasting assets. This and similar decisions led accountants to distinguish sharply between the valuation of fixed and current assets and to emphasize the latter as being more important. Also, to avoid the legal risks which resulted from paying dividends out of capital, accountants tended to go to the other extreme by deliberately understating asset values and income. The lower of cost or market rule became more respectable. Judicial rulings on capital maintenance gave the doctrine of conservatism legal backing at one of the most formative stages in the development of asset valuation and profit measurement concepts”.<sup>(6)</sup>

**4.12** The Companies Act 1900 re-introduced the compulsory appointment of an auditor by all companies registered under the Companies Act and required the auditors to state in their reports —

“whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company’s affairs as shown by the books of the company”.

The act followed upon the recommendation of the Davey Committee (1895) that annual audits be made compulsory for all registered companies.

“This in effect restored the main statutory requirements of the 1844 Act, since by requiring an audit the law inferred an obligation to prepare annual balance sheets. The act also specified that at the first stockholder’s meeting of a new corporation there be submitted a summary of receipts and payments incurred since the date of incorporation, including details of organizational expenses, contracts entered into, and stock issued, all of which was to be certified as correct by the auditor. But there was still no prescribed form of balance sheet and no provisions that professional auditors be appointed”.<sup>(7)</sup>

**4.13** The Companies Act 1907 required auditors to state —

- “(a) whether or not they have obtained all the information and explanations they have required; and
- (b) whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company’s affairs according to the best of their information and the explanations given to them, and as shown by the books of the company”.

**4.14** The Wrenbury Committee (1918) reported as follows regarding auditors and the auditor's certificate:

"58. We have made enquiry into the question whether the law should be amended by requiring that the auditors must have some and what professional qualification. We do not make any recommendation to that effect. We have not traced any mischief which requires remedy in the matter.

59. Section 113 of the Act of 1908 requires that the auditors shall report whether the balance sheet ‘is properly drawn up so as to exhibit a true and correct view of the state of the company’s affairs according to the best of their information and the explanations given to them and shown by the books of the company’. We have made enquiry whether the words ‘and as shown by the books of the company’ should be omitted and the certificate should be that the balance sheet exhibits ‘a true and correct view of the state of the company’s affairs’. We are without hesitation of opinion that it would be highly inexpedient indeed, we may say impossible, to require a certificate in that form. The decisions in *London and General Bank (No. 2)*, 1895, 2 Ch. 673, and *Kingston Cotton Mill Co.*, 1 Ch. 331, 2 Ch. 279 have delimited with great distinctness the extent and limits of the auditor’s responsibility. We do not think they can reasonably or profitably be extended.

**4.15** The Greene Committee (1925) expressed the view:

"67. We are of the opinion that in general the law as it stands with regard to the powers and duties of auditors is satisfactory. It would be a mistake in our view to attempt further to define these by statute having regard to the multifarious circumstances which in practice arise. It appears to us far better that the law should retain its elasticity in this respect than that an attempt should be made to confine it within the bounds of a rigid formula. Cases in which auditors fall below the level of their duty are few and far between."

The Companies Act of 1928-29 contained major changes in accounting and audit regulations: (1) For the first time an annual income statement had to be submitted to stockholders, though it did not have to be filed with the Registrar of Companies and was not specifically covered by the auditor's report. (2) On the balance sheet, current and fixed assets had to be segregated, and corporations were required to state how they had valued fixed assets. Authorized and issued capital stock were to be distinguished, and organizational expenses, goodwill, patents, and trademarks were to be stated as separate items. Disclosure had to be made of loans to directors and officers, of loans made for the purchase of the firm's own shares for the benefit of employees, and of discounts on shares issued. Corporations could no longer file out of date balance sheets with the Registrar. (3) While not requiring a consolidated balance sheet, the new law defined holding companies and required disclosure of the treatment of subsidiary income. The holding company's balance sheet was to describe investments in and loans to and from subsidiaries. (4) Prospectuses of new stock issues were to be accompanied by auditors' reports on past profits of the company whose securities were to be issued, as well as past profits of any business that was to be acquired from the proceeds of the sale.

The Cohen Committee on Company Law Amendment recommended in its 1945 report that only members of a recognized professional body be allowed to serve as corporate auditors, and a clause to this effect was included in the Companies Act 1947, then consolidated into the Act of 1948. The Committee further recommended, and the 1947-48 Acts provided, that the auditor's report should state whether in his opinion the company had kept proper account books, whether he had obtained all data necessary for the audit, and whether the balance sheet and income statement were in agreement with the books and gave a 'full and fair' view of the company's financial status and operating results. Consolidated financial statements were required for the first time. The principle of independence was reinforced by giving the auditor tenure from one stockholder's meeting to the next and the right to attend such meetings and defend himself before the stockholders if he received notice that he would not be reappointed".

**4.16** Before 1932 the auditor usually 'certified'

“that in his opinion the balance sheet exhibited a 'true and correct view' of the company's affairs as shown by the account books. But underlying the British certificate were statutes and accepted procedures which gave these phrases a precise technical meaning which did not yet exist in the United States. Also, the American audit had different purposes. The basis for English certification was largely

bookkeeping accuracy, but it was useless for an American accountant making a credit examination merely to show that the financial statements agreed with a properly posted ledger. In the American context 'true and correct' was inappropriate and even dangerous, conveying a false sense of exactness but leaving the CPA's audit responsibility in doubt and his legal liability undefined.

.....

During the 1920s, when the general public first began buying corporate securities, auditors faced the problem of certifying financial data for distribution to investors who had little or no accounting knowledge. J.M.B. Hoxsey of the New York Stock Exchange believed that overconservatism and other accounting practices which might have been excusable in an era of smaller firms and short-term bank borrowing were misleading in reports to this much less sophisticated class of readers. Arguing for improved corporate publicity, he pointed out that many corporations kept sales figures secret, others did not take depreciation, still others failed to treat nonoperating income consistently, to separate retained earnings from paid-in capital, or to disclose arbitrary asset writeups. Harvard Economics Professor William Z. Ripley's analysis of annual reports during the 1920s produced a similar picture of withheld information and deceptive reporting methods. Criticizing the absence of uniform accounting standards, he advocated that the Federal Trade Commission enforce disclosure of corporate affairs. In retrospect it seems that the rapid expansion of equity financing, the existence of so many questionable accounting options, and the profession's inability to standardize practice made some form of federal regulation inevitable.

A revised edition of the 1917 Federal Reserve-American Institute bulletin was published in 1929. Verification of Financial Statements still emphasized the balance sheet audit made for companies seeking bank credit. But income statement accounts were discussed in detail, as were reporting procedures. The preface to the 1929 edition also stressed reliance on internal control systems:

The extent of the verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others, where the system of internal check is good, tests only may suffice. The responsibility for the extent of the work required must be assumed by the auditor.

Following issuance of the 1929 bulletin, changes were made in the audit certificate used by many leading CPA firms. The new report, worded to emphasize reporting

fairness, omitted references to the examination of the books and to the ‘correctness’ of financial statements:

We have examined the accounts of ABC Company for the period from January 1 to December 31, 1929.

We certify that the accompanying balance sheet and statement of profit and loss, in our opinion, set forth the financial condition of the company at December 31, 1929 and the results of operations for the period”.

**4.17** During the 19<sup>th</sup> century, in South Africa, as in the UK, the auditor was appointed as the representative of the shareholders of the company. The only qualification required for the appointment was the holding of a prescribed minimum shareholding in the company. Examples are section 17 of Act 33 of 1861 (an Act to Incorporate the Cape Town and Green Point Tramway Company), and section 18 of the Sea Point Waterworks Company Act 34 of 1861 —

“The accounts of the company shall be audited annually by two auditors not being directors, such auditors to be appointed by the shareholders at each annual general meeting : provided, however, that no person shall be eligible to act as an auditor unless he shall be the proprietor of at least ten shares in the capital stock of the company”.

**4.18** In its submission to the Commission, the South African Institute of Chartered Accountants (SAICA), sketched the evolution of the auditors’ certificate in South Africa as follows:

“In the South African context, companies’ legislation has provided a progression from ‘true and correct’ (Companies Act 46 of 1926 section 90) to ‘true and fair’ (Companies Amendment Act 46 of 1952 which amended the 1926 Act) to ‘fairly present’ (Companies Act 61 of 1973 section 301(1)).

The wording of the audit report has evolved over time. Internationally, countries moved away from the concept of ‘true and correct’ after the Second World War. When the Companies Act (1926) was amended in 1952, the Joint Council of the Societies of Chartered Accountants of South Africa (Joint Council) issued a memorandum where it commented: *‘The use of the word ‘fair’ in place of the word ‘correct’ places increased responsibility upon the auditor in regard to the manner in which accounts are presented’*. In effect, an auditor cannot make a statement that the financial statements are correct because there are a number of items in the financial

statements that are estimates, for example, depreciation and provision for doubtful debts.

In 1963 a Commission of Inquiry into the Companies Act under the chairmanship of the Honourable Acting Justice Jan van Wyk de Vries (the van Wyk de Vries Commission) was appointed. In its main report, submitted in April 1970, the van Wyk de Vries Commission recommended that *'.....the phrase 'fairly present the state of affairs of a company' should supersede the phrase 'give a true and fair view of the state of affairs of the company'....'*. The change in terminology was recommended by the National Council of Chartered Accountants and followed the direction taken by the USA and Canada. In an article by Professor ML Benade (a member of the van Wyk de Vries Commission) in *'The Comparative and International Law Journal of Southern Africa'* (November 1970) entitled *'A Survey of the Main Report of the Commission of Enquiry into the Companies Act'*, the author gives the reason for the change as *'....in its literal sense the term 'true' creates an unattainable requirement in respect of trading results and the financial position of companies'*.

Currently, countries in the European Union, Australia and New Zealand, use the term *'true and fair view'*, whilst the USA and Canada use the term *'presents fairly'* or *'fairly presents'*.

Internationally the two terms are accepted as synonymous as highlighted by an extract of International Standard on Auditing ISA 700 paragraphs 17 and 18.

*'The auditor's report should clearly state the auditor's opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects), in accordance with the financial reporting framework, and, where appropriate, whether the financial statements comply with statutory requirements.'*

*The terms used to express the auditor's opinion are 'give a true and fair view' or 'present fairly, in all material respects', and are equivalent. Both terms indicate, amongst other things, that the auditor considers only those matters that are material to the financial statements.'*

SAICA believes that as the terms are well known internationally, it would not help to change back to a *'true and fair view'*, particularly as the USA seems to be exerting a greater influence on global events these days. This is particularly relevant in the light

of the collapse of governance structures in some of the other world economic powers, particularly Japan”.

**4.19** SAICA also summarised the history of the profession in South Africa as follows:

- “1. The formative period of the accountancy profession in South Africa commenced in 1894 when the first organised body of accountants in the country was established in the Transvaal under the name of the Institute of Accountants and Auditors in the South African Republic. The founder members were almost exclusively members of the Institute of Chartered Accountants in England and Wales (established in 1880) and of the Society of Incorporated Accountants and Auditors (established in the United Kingdom in 1885).
2. Another body, the Institute of Chartered Accountants in South Africa, came into being after the Anglo Boer war in 1902 and the first provincial society was formed in 1904 when Transvaal members of the existing bodies combined to establish the Transvaal Society of Accountants.
3. Societies in each of the four provinces of South Africa then worked towards the goal of unification of the profession and in 1921 established the South African Accountants Societies’ General Examining Board, with provision for uniform conditions of admission, examinations and regulations for service under articles.
4. The exclusive right to the use of the designation ‘Chartered Accountant (South Africa)’ was conferred on members of the four provincial societies by the Chartered Accountants Designation (Private) Act, 1927 (Act No.13 of 1927).
5. Adoption of uniform by-laws by the provincial societies followed. Service under articles was compulsory after February 1934, the period being five years with a remission of two years for graduates of a recognised university.
6. Then in 1946 the Joint Council of Societies of Chartered Accountants of South Africa was formed to deal with professional matters at national level. It was renamed the National Council of Chartered Accountants (S.A.) in 1966. This body greatly contributed to the enhancement of the status and image of the profession in South Africa.

7. From 1934 to 1950, several abortive attempts were made to introduce controlling legislation. Eventually, in March 1950 Joint Council submitted a draft bill which was accepted by the Treasury and received the unanimous support of the entire South African profession. The bill was enacted on 18 June 1951 as the Public Accountants' and Auditors' (PAA) Act (No.51 of 1951) which came into operation on 1 November 1951.
8. The Act provided for the establishment of a register of public accountants and auditors who were entitled to engage in public practice and describe themselves as Registered Accountants and Auditors. It further provided for the establishment of the Public Accountants' and Auditors' Board (PAAB), the registration and control of articled clerks and for the conduct of examinations. Significantly, the Act established the right of all who passed the qualifying examination to be admitted to one of the provincial societies and thereby to acquire the right to the designation 'Chartered Accountant (S.A.)'.
9. In 1956 the General Examining Board ceased to exist and its functions were from then onwards undertaken by the PAAB, with the universities providing education to the level of the Certificate in the Theory of accountancy, which certificate (or equivalent) is the entry requirement for the qualifying examination set by the PAAB.
10. Registration of the public practice of accountancy having been achieved in terms of the PAA Act, efforts could then be directed, at national and provincial levels, to the changing and developing needs of the profession. To achieve this various studies were undertaken.
11. In 1970 National Council appointed Mr LF Bowsher to investigate the desirability of a national society of CAs. He recommended that a national society be formed, that it should take over all the assets and liabilities of the provincial societies, of their benevolent funds (in trust) and of National Council and that thereafter the four provincial societies should be dissolved.
12. These recommendations were not accepted. Nevertheless a National Society Committee consisting of one representative from each province was established as recommended by Mr Bowsher:
  - < to monitor the progress of the establishment of regional associations;

< to work towards the ultimate creation of a national society.

13. That committee recommended in 1978 the creation of a national institute without the dissolution of the provincial societies as a step towards the unification of the profession.
14. At a meeting held on 12 February 1980, National Council was dissolved and the South African Institute of Chartered Accountants (SAICA) was established retrospective to 1 January 1980. At that time it had a membership of approximately 9 000, of which just 2 800 were in public practice.
15. From that time onwards, the PAAB has continued as the regulatory body looking after the public interest. SAICA has operated as the body servicing the needs of its members. To this end, it has provided a wide range of services described in Section D of this submission.
16. The Public Accountants' and Auditors' Act was -revised in 1991 but the new Act is substantially the same as the 1951 Act.

## NOTES

**Spicer & Pegler.**

**Chatfield, Michael** : 'A History of Accounting Thought', p. 111 – 113.  
(Dryden Press, Illinois, 1974).

**Ibid** : p. 114

**Pixley, F. W.** : 'Auditors : Their Duties and Responsibilities', 6<sup>th</sup> Ed., p. 4 – 6.  
(Henry Good & Son. London, 1891).

**Ibid** : p. 17.

**Chatfield** : **ob. cit.** : p. 116 – 117.

**Ibid** : p. 118.

# CHAPTER 5 - REGULATORS AND SUPERVISORS – THE HOLISTIC OR INTEGRATED APPROACH

**5.1** It is axiomatic that the primary functions of securities regulators and supervisors are the protection of investors and the promotion of stability and integrity of financial markets. This is recognized in virtually every country in the world and also the expressed objectives of many of these entities. <sup>(1)</sup>

**5.2** For many years and in many countries (including South Africa), securities regulation stagnated and became less effective. One of the causes was the unnecessary proliferation of regulators.

It is universally acknowledged that the rapid development of financial products and financial markets and the phenomenal growth of conglomerates have outstripped the development of securities regulation. As a consequence sweeping changes to securities laws have been or are about to be effected in jurisdictions as disparate as the Argentine, Australia, Latvia, Lithuania, New Zealand, Pakistan and Hong Kong and even in G7 countries such as Canada, the United Kingdom and the United States.

**5.3** The Consultation Paper on 'The Securities and Futures Bill' issued by the **Hong Kong** Government (April 2000) states some of the reasons for reform

"Our current set of statutory provisions governing the securities and futures industry is scattered over ten different Ordinances. It is not user-friendly. The core piece of legislation, the Securities Ordinance, is a quarter of a century old. Many of the concepts and definitions in use are out of date. The paradigm shifts that are taking place in the economies and financial markets across the globe have increasingly highlighted gaps in this patchwork of legislation. The existing statutes could be (and have been) amended to patch over the problems but the result would not be very

satisfactory. The different statutes would operate largely by reference to an increasing number of other statutes, resulting in an increasingly complex labyrinth of legislative provisions. The decision was therefore taken by the Financial Secretary in 1999 to replace the existing body of different statutes with one composite statute — the composite Bill".<sup>(2)</sup>

**5.4** A similar situation exists in South Africa.

**5.5** The rapid development of financial markets in recent years was caused by the expansion of markets and investment funds, financial innovation (such as credit securitisation, growth of derivatives and technology advances), and increased global fund flows. It led to diversification (one institution offering a wide range of financial services), conglomeration (merging many financial businesses into one group) and globalization (expanding beyond national boundaries), and has necessitated changes in the regulatory structures; changes such as the curtailment of the proliferation of regulators and more holistic regulation.

**5.6** This was the theme of a speech talk by Anthony Neoh, SC, JP, the then Chairman of the Securities and Futures Commission of Hong Kong. He defined the four major models of financial regulation, namely the Centralised, Quasi-Centralised, Institutional and Functional.

<b>"Centralised Model</b>	Usually undertaken by Central Bank
<b>Quasi-Centralised Model</b>	Financial regulation undertaken by a single agency separate from the Central Bank (such as the Financial Services Authority (FSA) in the UK).
<b>Institutional Model</b>	Regulation by type of institution. (US has 51 securities regulators, 51 futures regulators, 65 banking regulators, 50 insurance regulators, one Federal Reserve Board with 12 District Reserve Banks. HK has 1 banking regulator, 1 securities and futures regulator, 1 insurance regulator, 1 Monetary Authority).
<b>Functional Model</b>	Regulator divided by function (an institution offering diversified services may be regulated by a number of regulators). Usual division:  (1) central banking,  (2) financial soundness,

(3) market integrity and consumer protection.

**Issues arising from  
Various models**

The World is moving towards either the Quasi-centralised or the functional model as institutional model fails to deal effectively with diversification and conglomeration.

Domestically and internationally, the concept of an 'umbrella' regulator will emerge.<sup>(3)</sup>

**5.7** The necessity for more holistic regulation is also underscored in papers recently published in **Australia, Canada**, and the **United Kingdom**.

**5.8** The **Australian Consultation Paper** issued by Asic under the heading '**Uniform Regulation of Financial Products**', expressed the following view –

“A more efficient and flexible regime for financial markets and products will be achieved through an integrated regulatory framework for financial products. This will provide consistent regulation of functionally similar markets and products.

The new framework will apply to all existing financial products. Financial products will include: Securities, Futures and other derivatives, Superannuation, General and life insurance, Deposit accounts, Credit arrangements that fall outside the scope of the Uniform Consumer Credit Code, Means of payment services such as smart cards and e cash and Foreign exchange”.

**5.9** In the **Canadian** review '**Investment Funds and Consumer Protection - Strategies for the Millennium**', **Glorianne Stromberg** summarised the need for a holistic approach —

“Integration, Simplification and Rationalization: There is a need to integrate, simplify, streamline and rationalize regulatory requirements to serve the needs of the marketplace and of consumer/investors better. This theme underlies all of the recommendations in the Review.

The continued maintenance of a segmented regulatory structure based either on:

- (i) the fragmented 'four pillar' structure of the financial services industry that existed prior to the 1987 deregulation, or
- (ii) the fragmented 'inter' or 'intra' provincial (and national) boundaries;

is becoming increasingly unrealistic.

Retailization of the Marketplace: The convergence of strategic forces has resulted in:

- (i) the consumer/investor (the 'retail investor') assuming more market risk; and
- (ii) providers of financial services (the 'institutional investor') structuring their activities and products to reduce or eliminate their market risk.

This in turn has led to:

- (i) an increased blurring of the lines between the 'retail investor' and the 'institutional investor'; and
- (ii) a corresponding erosion of the basis for distinguishing regulatory strategies on whether the investor is a 'retail investor' or an 'institutional investor'.

In this environment, the regulatory and supervisory structure should not favor the 'institutional investor' over the 'retail investor'. This is particularly so when the institutional investor may also be a purveyor of advice, services and products to the individual consumer/investor.

Fusion of Product, Function and Advice: The activities of industry participants have outpaced the regulatory structure.

The focus of all participants in the financial services industry is on asset gathering, asset allocation services and asset management. This has led to substantial changes in the distribution side of the financial services industry as it shifts from a transactions-based business to a fee-based, relationship-driven, financial services business. It has also led to substantial changes in the advisory side of the financial services industry as it shifts to gain access to distribution.

The need to gain market share and to protect income streams has resulted in the blurring (and in some instances the fusion) of product, function and advice. With this fusion has come a corresponding shift in emphasis from the success of the transaction to the success of the portfolio. The traditional product sales-oriented representative has evolved into, or is being replaced with, a relationship-oriented advisory-based

manager whose role is focused on acting as a conduit for internal or external money managers.

Banks, insurance companies, trust companies, credit unions, independent mutual fund management organizations, independent mutual fund dealers and full service investment dealers now offer, directly and indirectly, a full range of investment advisory services and products. Many of them, through equity interests in other segments or sectors of the financial services industry or through strategic alliances, have multiple entries into both advisory and distribution channels.

The activities carried on, directly or indirectly, by the various sectors of the financial services industry are virtually indistinguishable to consumer/investors yet they are often regulated differently. Regulation (or the lack thereof) varies according to the type of investment product, the institution issuing the investment product and the intermediary involved. The ramifications of these differences are not readily apparent.

It is difficult for consumer/investors to identify:

- (a) when they are being provided with independent advice; and
- (b) when they are simply being sold a product which may be:
  - (i) advice packaged as a product,
  - (ii) a proprietary product, or
  - (iii) a product in which the seller/adviser has a substantial financial interest.

**Common Regime for Money Management:** Consumer/investors are seldom able to appreciate the legal and regulatory differences that flow from the different types of investment participations or products. This highlights the need for there to be a uniform regime for all aspects of money management and to bring all aspects of money management for others under a common regulatory structure.

**Integrated Needs of the Consumer/Investor:** The needs of consumer/investors are integrated.

Consumer/investors have recognized the need to adopt sound personal financial management practices. A large number have recognized that because of their lack of personal financial expertise (or their lack of confidence in their expertise) they will need to turn to someone for advice. When they turn to an adviser for advice they expect (and should be entitled to expect) that:

- (i) the advice they get will be based on a full client-needs assessment;
- (ii) the person providing the advice and the related financial planning/investment advisory services will have the capability to make that assessment;
- (iii) the person providing them with financial planning/investment advisory services will be able to (and will) provide them with advice that is in their best interests;
- (iv) this advice (and the plan to implement such advice) will be based upon a full range of money management services and products being available to meet their goals and objectives; and
- (v) the ability to carry out transactions to implement the plan and to provide ongoing monitoring and reporting services is and will be ancillary to the foregoing.

In order to meet these reasonable expectations, a fresh approach to regulatory structure, educational courses and proficiency requirements, and to registration requirements is required. The changes should be enabling (as opposed to maintaining or creating barriers) provided that minimum standards based on competence and safety are met.

**5.10** In the **United Kingdom** the **Consultation Document** which preceded the Financial Services and Markets Act 2000 stated —

"The existing arrangements for financial regulation involve a large number of regulators, each responsible for different parts of the industry. In recent years there has been a blurring of the distinctions between different kinds of financial services business: banks, building societies, investment firms, insurance companies and others. This has added further to the complexity of financial regulation. The Government believes the current system is costly, inefficient and confusing for both regulated firms and their customers. It is not delivering the standard of supervision and investor protection that the public has a right to expect. We are therefore establishing a single,

statutory regulator for the UK financial services industry, with clearly defined regulatory objectives and a single set of coherent functions and powers.

The fragmented structure which has developed for the regulation of financial services, with its unsatisfactory division of responsibility between several regulators, is reflected in the statute book. The Government believes that much of the benefit of a single regulator would be lost if the FSA had to operate on the basis of five or more separate sets of powers. The opportunity is therefore being taken for a fresh approach, harmonising the provisions of these Acts.

The main aim of the Bill is a single, coherent system that does not make unnecessary distinctions between different sectors of the financial services industry.

In creating a single regulator the government intends to put in place a regime which is flexible and effective in dealing with modern financial services providers, who increasingly operate across traditional sectoral boundaries. It is also an opportunity to eliminate unnecessary duplication in the burdens placed on firms. The logic of a single regulatory framework therefore points strongly in the direction of a single authorisation process, which is a key aspect of the new regime and of the Bill".

**5.11** In the Research Paper (99/68) of 24 June 1999 published by the **UK House of Commons** Library, the Financial Services and Markets Bill (121/1998-99) is summarised as follows —

"(It) reforms the structure of financial regulation in the UK.. It sets out the powers of a new body, the Financial Services Authority, which will become the sole regulator of the sector. It aims to replace the current fragmented and overlapping structure of regulation with a single regulator equipped with coherent, statutory powers. At the same time, the consumer redress systems are being unified to create a single financial ombudsman scheme".

The key reasons for the proposed reforms were stated to be that

"The present system is not delivering the standards of investor protection or supervision which both the industry and the public is entitled to.

The financial services sector is increasingly global, and the UK needs a regulator which is structured appropriately to regulate multinational firms effectively".

**5.12** One of the latest additions to the countries which are moving towards more holistic regulation, is **the Netherlands**. On 7 July 1999, the "**Raad van Financiële Toezichthouders**" (Council of Financial Supervisors) was established. It consists of '**de Stichting Verzekeringkamer**', '**De Nederlandse Bank N.V.**' and '**de Stichting Toezicht Effecten verkeer**'. (The regulatory authorities of insurance, banking and securities). The need for the establishment of the Council was stated to be

- the rapid development of products in the financial markets;
- the increasing blurring of boundaries between financial sectors;
- the increasing need to provide adequate information to the consumers of financial products.<sup>(6)</sup>

**5.13** Even more recently, on 21 December 1999, the **Hungarian Parliament** approved a law which created the **State Supervision of Financial Organizations** as from April 1, 2000. This body incorporated the State Banking and Capital Market Supervision, the State Insurance Supervision and the State Private Funds Supervision.

**5.14** Similarly, the government of the **Slovak Republic** has approved draft legislation to establish a new financial markets regulator to oversee securities, banking and insurance activities. The new entity is to take over the supervision of banks by the year 2002.

**5.15** On July 1, 2000 the **Japanese Government** established a new regulatory body, the Financial Services Agency (FSA) to oversee securities, banking, insurance and other financial activities.

**5.16** In **Latvia** parliament has adopted the Finance and Capital Markets Commission Act which established a single regulator to undertake the banking supervision functions of the Bank of Latvia, as well as the functions of the Securities Market Commission and the Insurance Supervision Office.<sup>(7)</sup>

**5.17** On 25 January 2001 the Finance Minister of **Germany** announced his intention to create a single 'super regulator' of financial markets.

The proposed law would merge three supervisory authorities for the securities sector, the banking system and the insurance industry into a 'Federal Institution for the Supervision of Financial Markets'.

**5.18** Other countries with a holistic or integrated approach include **Denmark, Norway and Sweden.**<sup>(8)</sup>

**5.19** During the 20<sup>th</sup> century, the **United States** clung to the Institutional model as a result of

— the zealous protection of the federal system of government by individual States;

— the provisions of the Glass-Steagall Banking Act of 1933 and the Bank Holding Company Act of 1956.

**5.20** Both acts were repealed during November 1999 by the Financial Services Act of 1999 and the joint supervision of financial conglomerates by the US Treasury and the SEC was announced. This was the first step towards more integrated supervision in the United States.

**5.21** In **South Africa** the **Melamet Commission** of Inquiry was appointed during March 1993 to report on, *inter alia* -

“The feasibility of a holistic approach for financial supervision of financial institutions, financial services and deposit-taking institutions.”

It had no hesitation in recommending a holistic approach.

“The Committee, supported by the vast majority of submissions received and opinions of persons encountered during research both here and abroad, endorses very clearly the need for a HRA (*Holistic Regulatory Approach*). This need is founded principally on:

2.3.1.1 different philosophies and practices between regulators;

2.3.1.2 the lack of supervision and enforcement in many instances where regulation is in place but not given effect to; and

2.3.1.3 the existence of the three main regulatory structures — The South African Reserve Bank, the Financial Services Board, and the Companies Office — each with its own areas of jurisdiction. This

does not give the necessary overall control of all financial activities which affect systemic risk in the financial sector, or which affect reasonable protection of the general public. With the international and national trend towards financial conglomeration and new product development where older, more specific structures are becoming inadequate it is necessary to consider financial supervision from a 'top-down' holistic perspective."

**5.22** During July 1996 the **Policy Board for Financial Services and Regulation** issued a Consultative Paper on the **Regulation of Retail Investment Services in South Africa**.

In response thereto this Commission stated (13 August 1996)

**"As more and more people begin to buy financial products and enter the market for the first time there is an ever growing need for better investor protection.**

**As far as possible regulatory standards must be brought in line with international standards and must also establish an opportunity for the economically excluded part of the population to participate in a relatively safe investment environment."**

The Commission also expressed the view that one regulatory authority is a prerequisite for efficient regulation and supervision.

**"There should be one regulating authority. The most important function of regulating authorities is the protection of the public. At present such regulation in the Republic is fragmented amongst, inter alia, the Reserve Bank, the Registrar of Banks, the Financial Services Board, the Department of Trade and Industry, The Registrar of Companies, the Registrar of Co-operatives, the Registrar of Medical Schemes and the Harmful Business Practice Committee.**

**The Consultative Paper envisages yet another Registrar and Advisory Committee with their own infrastructure and ombudsman.**

**Fragmentation of supervision means divided responsibilities, restricted powers of inspection and supervision, restricted access to information, and 'grey' areas where no supervision takes place. Supervision of financial and mixed conglomerates is virtually impossible. The fragmentation of supervision between the Registrar of Banks and the Financial Services Board and its**

predecessor, led to inadequate supervision of the Masterbond, Owen Wiggins and Supreme groups of companies with resultant losses to investors. This can be illustrated by excerpts from an exchange of letters during 1994. There was reason to suspect that certain companies within these groups were carrying on business in contravention of the Banks Act. The Registrar of Banks believed that the necessary inspections should be carried out by the Financial Services Board who in turn, correctly so it seems, believed that it had no jurisdiction so to do. The tone of the letters reflect such a degeneration of mutual respect that even combined supervision would have been difficult to achieve".

**5.23** In its First Report issued on 19 November 1997, the Commission reiterated this view and stated that

"The necessity for a holistic approach when supervising a financial or mixed conglomerate is obvious and accepted worldwide by supervisors, but many are not prepared to lose their own identities and this has led to the suggested compromise that there should be a 'lead' supervisor or 'convenor' of supervisors when dealing with conglomerates".

**5.24** It is recommended that one regulatory authority should be established in South Africa.

It should be an autonomous body with, amongst others, the regulatory functions presently fragmented amongst the Reserve Bank, the Registrar of Banks, the Financial Services Board, the Department of Trade and Industry, the Registrar of Companies, the Registrar of Co-operatives, the Registrar of Medical Schemes, the Harmful Business Practice Committee, the Stock Exchange and Others.

## NOTES

1. Some examples are

**Australia (Asic)** "Our purpose is to reduce fraud and unfair practices in financial markets and financial products so consumers use them confidently and companies and markets perform effectively".

**Fesco<sup>(4)</sup>** "Considering that the objectives of protecting investors, ensuring the integrity and transparency of markets and securing the overall safety of the financial system are fundamental to achieving and maintaining sound and stable financial markets".

"2.4 (a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;

(b) to promote the understanding by the public of the operation and functioning of the securities and futures industry;

(c) to secure the appropriate degree of protection for members of the public investing in or holding financial products;

(d) to minimize crime and misconduct in the securities and futures industry;

(e) to reduce systemic risks in the securities and futures industry".

<b>France</b>	<p><b>The Commission des Opérations de Bourse</b></p> <p>"The protection of investors whether their investments be in securities or other financial products involving public offerings.</p> <p>The adequacy of the information given to investors.</p> <p>The proper operation of the markets in financial instruments".</p>
<b>Germany</b>	<p><b>The Bundesaufsichtsamt für den Wertpapierhandel</b></p> <p>"One of the most important preconditions for the proper functioning of a financial market is the protection of investors. Of particular importance for investor protection are the rules of conduct which investment services enterprises (credit institutions, exchange brokers, portfolio managers, investment brokers) are required to observe in regard to their customers. The rules of conduct aim at guaranteeing minimum standards for investment services in order to achieve that any conflict of interests between customers, the enterprise and its employees can be avoided and that possible disadvantages for the investors are minimised".</p>
<b>Iosco<sup>(5)</sup></b>	<p>"2.3 (a) the protection of investors;</p> <p>(b) ensuring that markets are fair, efficient and transparent; and</p> <p>(c) the reduction of systemic risks".</p>
<b>Kansas</b>	<p>"The mission is to protect and inform Kansas investors through the administration and enforcement of the Kansas Securities Act, an act prohibiting fraud in securities transactions and requiring the registration of broker-dealers, agents, investment advisers and investment adviser representatives and the registration of securities".</p>

**Netherlands Raad van Financiële Toezichthouden**

"the transparency, stability and integrity of the financial systems and financial markets;

the protection of the consumer against failure of financial institutions".

**Ontario**

"1.1 The purposes of this Act are,

(a) to provide protection to investors from unfair, improper or fraudulent practices; and

(b) to foster fair and efficient capital markets and confidence in capital markets".

**SEC**

"The primary mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors and maintain the integrity of the securities markets. As more and more first-time investors turn to the markets to help secure their futures, pay for homes, and send children to college, these goals are more compelling than ever".

**Texas**

"The primary mission of the State Securities Board, as set forth in the Texas Securities Act, is to protect Texas investors. Consistent with that mission, the State Securities Board attempts to ensure a free and competitive securities market in Texas, increase investor confidence, and thereby encourage the formation of capital and the creation of new jobs in Texas".

**United Kingdom**

"The FSA's aims are:

to protect consumers of financial services;

to promote clean and orderly markets; and

to maintain confidence in the financial system".

2. **Hong Kong** The Government of the Hong Kong Special Administrative Region (April 2000).
3. **Hong Kong Securities Institute** : 28 September 1998..
4. **The Statutory Securities Commissions of the Member States of the European Economic Area.**
5. **International Organization of Securities Commissions.**
6. "Er zijn verschillende aanleidingen om de regelgeving ten aanzien van informatieverstrekking aan consumenten van financiële diensten tegen het licht te houden. De eerste is de snelle productontwikkeling op de financiële markten. Deze roept de vraag op of de regelgeving uit het verleden ook nu nog adequaat is. De tweede aanleiding is de toenemende vervaging van grenzen tussen financiële sectoren. Nu er steeds minder sprake is van verschillende deelmarkten in de financiële sector, moet worden bezien of de regelgeving – vanuit een sectoroverstijgend perspectief – consistent is. Immers, de regelgeving is historisch veelal sector gewijs ontstaan. In een markt met vervagende grenzen tussen producten en tussen aanbieders bestaat het gevaar van overlap, en van niet-gemotiveerde verschillen. De derde aanleiding is de idee dat de eigen verantwoordelijkheid van consumenten in een steeds dynamischer financieel speelveld zijn basis vindt in adequate informatieverstrekking".
7. **World Securities Law Report.** Volume 6, No. 7 (July 2000).
8. **Denmark** Finanstilsynet is the Danish Financial Supervisory Authority of
  - credit institutions
  - mortgage credit institutions
  - life insurance and non-life insurance companies and pension funds
  - stock exchange field (including securities exchanges, authorised markets, securities brokers, money market

brokers, clearing undertakings, registration undertakings and joint credit institution data centres).

**Norway** Kredit Tilsynet is responsible for the supervision of banks, finance companies, mortgage companies, insurance companies, pension funds, securities trading, estate agency, debt collectors and accounting and auditing activities.

**Sweden** Finansinspektionen is the supervisory authority for financial markets. It conducts its activities in

- the credit market (banks, credit market companies, financial groups of undertakings which include banks and credit-market companies)
- the securities market (securities institutions, fund management companies, exchanges and other organized markets, clearing organizations)
- the insurance market (insurance companies, insurance brokers, friendly societies).

# CHAPTER 6 - FINANCIAL PRODUCTS

**6.1** Before considering how a Regulator could best achieve the protection of both the public and the financial markets by the regulation of financial products, it is necessary to define the 'products' which are sought to be regulated.

**6.2** Whilst some authors (including Professor Long) believe that it should be possible to isolate and identify the common characteristics which apply to products such as securities and thereby obviate the necessity for enumeration, such an exercise has not yet been successful.

**6.3** Though a tedious process, definition by enumeration is the method used worldwide. It has two distinct advantages, namely, it is usually easier to decide whether a particular financial product falls within the definition, thus reducing disputes, and it is also easy to add a new and innovative product (or gimmick) to the list.

**6.4** Once again experience in the United States, where pro-active regulators battle with creative designers of financial gimmicks, serves to illustrate the difficulties encountered by regulators and Courts to find an adequate and workable definition of a 'security'. Professor Long summarizes it as follows:

"There has been no adequate definition of a security since securities regulations first came into being. The first securities act did not even contain a definition of a security, but merely assumed that the word had a common meaning. Subsequent state acts added rudimentary enumerative definitions. The beginnings of the modern enumerative definition are found in the Illinois Securities Act of 1919 which provided:

'The word 'securities' shall include stocks, bonds, debentures, notes, participation certificates, certificates of shares or interest, preorganizational certificates and subscription, certificates evidencing shares in trust estates or associations and profit sharing certificates'.

This 1919 definition foreshadowed the approach that other legislatures were to follow. First, the definition would contain a series of items having rather fixed, generally recognized meanings such as stock, bonds, and debentures.

These specific terms were then followed by a series of general terms having no fixed legal meaning, such as profit-sharing certificates and evidences of indebtedness, which were included in an attempt to cover unusual or irregular securities.

Through the 1920s, as new, irregular investment forms appeared, the legislatures would simply add additional general terms in hopes of plugging the gap. The Securities Act of 1933, however, tended to act as a catalyst in this process of definition by enumeration. Congress examined the existing state definitions and combined most of the general phrases into the single enumerative definition now found in Section 2(1) of the Act. It should be noted that several phrases often found in the preexisting state definitions are conspicuously absent from the definition. These are the phrases 'beneficial interests in or title to property or profits' and 'interests in foreign real estate'. This federal definition has served as the model for most of the modern state enumerative definitions. Professor Loss drew heavily upon that definition when he drafted the Uniform Securities Act definition found in Section 401(1) which provides:

'(1) 'Security' means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. 'Security' does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed number of dollars either in a lump sum or periodically for life or some other specified period'.<sup>(1)</sup>

Lack of an adequate definition has not been a serious problem through much of the history of securities regulation because, by and large, offerings have tended to be of

established 'regular' forms of securities, such as stock, bonds, and debentures, where there is little question that the instruments come within the regulatory purview of the securities acts. However, there have been certain times when for one reason or another the traditional capital markets have tended to break down. When this occurs, a flock of irregular financing gimmicks — some legitimate, others extremely fraudulent — appear on the scene. The phenomenon occurred in the mid- and late 1920's and to a lesser extent in the 1930's. It recurred in the 1960's with the emergency of the founder membership and Glen Turner type of schemes.

Since 1970 the regulatory agencies and the courts have been inundated with irregular investment devices which they have had to consider and measure against the statutory definitions to determine whether the devices are securities. These opportunities range from the more legitimate condominium and resort membership to often fraudulent sales of commodity options or coins and bullion and forward delivery contracts.

Tied to the existing statutory enumerative definitions, both the agencies and the courts have found themselves ill-equipped to handle the task and the results, at best, are rather spotty. For the most part, the courts have attempted to develop formulas or definitions for the individual general phrases found within the enumerative definition. In doing so all too often there has been little attempt to consider whether the attributes assigned to the individual categories are consistent with the attributes assigned to the other general categories or whether these characteristics are consistent with the general purpose behind the securities act itself".<sup>(2)</sup>

**6.5** As pointed out, historically, the lack of an exhaustive list of 'securities' has not caused too many problems, because, by and large, offerings have tended to be of established and well-known securities such as shares and debentures. However, as a result of the rapidly growing market in exotic forms of financial derivative products, and the dematerialization of the traditional securities, there is an obvious need for an extended definition.

**6.6** The financial product known as a 'derivative product' or 'derivative contract, and generally referred to as a 'derivative', has a history which can be traced back to ancient Greece.

"Trading in derivative contracts has a long history. The first recorded accounts of derivative contracts can be traced back to philosopher Thales of Miletus in ancient Greece, who, during winter, negotiated what were essentially call options on oil presses for the spring olive harvest. De la Vega reported in 1688 that options and futures, or 'time bargains' as they were known, were trading on the Amsterdam Bourse

soon after it was opened. Evidence also suggests that futures contracts for rice was traded in Japan in the 17<sup>th</sup> and 18<sup>th</sup> centuries (e.g., Sill, 1997)".<sup>(3)</sup>

**6.7** During the past few decades trading in 'derivatives' has become one of the fastest growing industries. In addition to the growth in its trading, new derivatives are continuously being added. For instance, it is stated that during the period 1994 – 1998, 140 new commodity derivatives had been introduced.<sup>(4)</sup>

**6.8** The growing importance of the trade in derivative contracts is underscored in the recent publication by the Office for Futures and Options Research at the University of Illinois (OFUR).

"With a constant new stream of financial services coming to the market, each often more exotic and complicated than the last, the financial services industry, which includes commodity derivatives exchanges, brokerage houses and banks providing price risk reduction services (the so-called hedging services), is one of the fastest growing industries. In order to assure survival, these companies show a rapid product innovation. However, for commodity derivatives the risk of failure is considerable.

Commodity derivative exchanges are and have been very important institutions in commodity pricing and have been prominent in the United States for over a century. In Europe too, commodity derivatives are booming. Price volatility for raw materials has increased for many reasons including the recent changes within the Common Agricultural Policy of the European Union and the WTO which have increased price risks for both the primary producers and the processing industry as well.

The growth of commodity derivative exchanges has also been stimulated by technological developments. Of increasing importance, in this respect, is the use of automatic computer-guided trading systems. Also, the introduction of the single European currency will give an impulse to commodity derivatives, since exchange rate risk within the European Union will be eliminated, making national commodity derivatives markets more attractive for hedgers and speculators from other EU-countries. All these developments contribute

to the renewed interest financial institutions have in commodity derivatives markets. They have led several derivatives exchanges, including the Amsterdam Exchanges, the Chicago Board of Trade, the Chicago Mercantile Exchange, the London International Financial Futures & Options Exchange and the Marché à Terme International de France, to develop new commodity derivatives.<sup>(5)</sup>

**6.9** The almost exponential growth of trading in derivative products is described by the Office for Futures and Options Research as follows:

"Futures markets have undergone tremendous changes during the past three decades. After futures contracts for nonstorable commodities were successfully introduced in the 1960's, innovative and successful contracts for currencies, interest rate instruments, stock indices, the energy complex, and others were introduced. These expansions and industry growth brought an increase in futures trading volume in the United States of more than 16% per annum (approximately 19-fold) since 1970. In addition, of major significance to the futures industry was the introduction ten years ago of options on futures contracts. Concurrently, the industry has transformed and adapted rapidly to the highly technical computer, electronic telecommunication and information revolution.

Even with these successes, leadership and innovation, the futures industry faces many challenges as it moves toward the 21<sup>st</sup> century. Despite the tremendous growth domestically, trading volume in the U.S. now totals less than 50 percent of world futures trading. Most of the new derivative exchanges being introduced overseas are fully automated with computerized trading. Competition internationally will become intense, especially as trading shifts toward being conducted 24-hours a day and markets become globally linked. Responding to customer needs, exchanges are devising and testing new contracts such as air pollution rights, catastrophic insurance, rolling spots on currencies, crop yield insurance, and others. Regulation will soon address the huge related industry of over-the counter derivatives such as swaps".<sup>(6)</sup>

**6.10** The trading in derivative products have become so important that regulation focussed only on the well-known and established securities and futures without effective regulation of derivatives is unimaginable.<sup>(7)</sup>

**6.11** Before attempting to find an adequate definition for derivative products, it would be expedient to refer to 'A Brief Guide to Financial Derivatives' recently published by the **Pennsylvania Securities Commission**:

"Financial derivatives have crept into the nation's popular economic vocabulary on a wave of recent publicity about serious financial losses suffered by municipal governments, well-known corporations, banks and mutual funds that had invested in these products. Congress has held hearings on derivatives and financial commentators have spoken at length on the topic.

Derivatives, however, remain a type of financial instrument that few of us understand and fewer still fully appreciate, although many of us have invested indirectly in derivatives by purchasing mutual funds or participating in a pension plan whose underlying assets include derivative products.

#### **What is a Derivative?**

In short, a derivative is a contractual relationship established by two (or more) parties where payment is based on (or 'derived' from) some agreed-upon benchmark. Since individuals can 'create' a derivative product by means of an agreement, the types of derivative products that can be developed are limited only by human imagination. Therefore, there is no definitive list of derivative products. Some common financial derivatives, however, are described at the end of this brochure.

When one enters into a derivative product arrangement, the medium and rate of repayment are specified in detail. For instance, repayment may be in currency, securities or a physical commodity such as gold or silver. Similarly, the amount of repayment may be tied to movement of interest rates, stock indexes or foreign currency. Derivative products also may contain leveraging. Leveraging acts to multiply (favourably or unfavourably) the impact on the total repayment obligations of the parties to the derivative instrument.

#### **Why have Derivatives**

Derivatives are risk-shifting devices. Initially, they were used to reduce exposure to changes in foreign exchange rates, interest rates, or stock indexes.

For example, if an American company expects payment for a shipment of goods in British Pound sterling, it may enter into a derivative contract with another party to reduce the risk that the exchange rate with the U.S. Dollar will be more unfavourable at the time the bill is due and paid. Under the derivative instrument, the other party is obliged to pay the company the amount due at the exchange rate in effect when the derivative contract was executed. By using a derivative product, the company has shifted the risk of exchange rate movement to another party.

More recently, derivatives have been used to segregate categories of investment risk that may appeal to different investment strategies used by mutual managers, corporate treasurers or pension fund administrators. These investment managers may decide that it is more beneficial to assume a specific 'risk' characteristic of a security.

For instance, several derivative products may be created based on debt securities that represent an interest in a pool of residential home mortgages. One derivative product may provide that the purchaser receives only the interest payments made on the mortgages while another product may specify that the purchaser receives only the principal payments. These derivative products, which react differently to movements in interest rates, may have specific appeal to different investment strategies employed by investment managers.

The financial markets increasingly have become subject to greater 'swings' in interest rate movement than in past decades. As a result, financial derivatives have appealed to corporate treasurers who wish to take advantage of favourable interest rates in the management of corporate debt without the expense of issuing new debt securities. For example, if a corporation has issued long term debt with an interest rate of 7 percent and current interest rates are 5 percent, the corporate treasurers may choose to exchange (i.e., Swap), interest rate payments on the long term debt for a floating interest rate, without disturbing the underlying principal amount of the debt itself<sup>(8)</sup>.

**6.12** In South Africa, the Safe Deposit of Securities Act No. 85 of 1992 was promulgated to provide for the registration of a central securities depository for the safe custody of securities.

The intention is to dematerialize securities, including share certificates, thus following the worldwide trend.

**6.13** One of the results of dematerialization of the certificates which record the ownership of securities is a change in the traditional ownership of the securities. Section 4(1) of the Act provides as follows:

**"Ownership of securities.—(1)** Where securities of any kind are deposited with a depository institution or with a central securities depository, or accrue to securities held by such institution in a securities repository or by such depository in a central securities repository, the person who was the owner of the securities at the time of deposit or accrual shall become entitled to an interest as co-owner of all the securities of the same kind comprised in the securities repository or central securities repository, as the case may be".

**6.14** The reasons for dematerialization of securities are sketched in a Report published by the **Law Revision Commission of the State of New Jersey** in respect of a revised Article 8 of the Uniform Commercial Code of the United States. The Report deals with some of the practical aspects of dematerialization and points out that concepts such as the transfer of physical certificates and the registration of the transfers by the issuer have become out of touch with reality.

"When Article 8 was drafted in the 1940's and 1950's, the securities industry used a 'direct holding system' to define the relationship between the issuer of the security and its owner. In the direct holding system, the issuer records the name of the owner on its books, thus giving rise to the 'direct relation' between issuer and owner, and issues a certificate representing ownership or a debt relation. The rules of Article 8 covering delivery of securities and the rights and obligations of parties to securities transactions were predicated on the assumption that possession and delivery of physical certificates were the key elements of transfer of ownership in the securities holding system.

In the 1960's, the business practices of the securities industry changed. In response to increased trading volume, the securities industry adopted the practice of issuing non-paper securities called in the terminology of Article 8 'uncertificated securities'. This is because the 'mechanical problems of processing the paperwork for securities transfers reached crisis proportions in the late 1960's, leading to calls for the elimination of the physical certificates and development of modern electronic systems for recording ownership of securities and transfers of ownership'. As a result, NCCUSL promulgated the 1978 amendments to Article 8 which added parallel

provisions dealing with uncertificated securities to the existing rules of Article 8 on certificated securities. The system of securities holding contemplated by the 1978 amendments differed from the traditional system only in that ownership of securities would not be evidenced by physical certificates. Instead of surrendering an indorsed certificate for registration of transfer, an instruction would be sent to the issuer directing it to register the transfer on its books. The State of New Jersey enacted the 1978 amendments to Article 8 in 1990.

However, contrary to the assumption of the 1978 amendments that uncertificated securities would replace paper certificates, securities continued to be issued in certificated form. Virtually all forms of publicly traded securities are still issued in certificated form. However, these certificates are held, not by individual investors, but by clearing corporations in what is called an 'immobilized' form, designating that the physical document remains in the possession of the clearing corporation and does not change hands to indicate transfers in ownership. This type of securities holding system is called the indirect holding system. 'Settlement of securities trading occurs not by delivery of certificates or by registration of transfer on the records of the issuers or their transfer agents, but by computer entries in the records of clearing corporations and securities intermediaries'. Thus, even after the 1978 amendments, the rules of Article 8 did not deal effectively with the indirect holding system.

A large proportion of publicly traded securities are held in the name of the Depository Trust Company (DTC), and the clearing and settling of trades made with these securities is carried out by the National Securities Clearing Corporation. For example, the shareholder of record for most shares of IBM traded on the New York Stock Exchange is the DTC. The members of the DTC — about 600 banks and brokers — have accounts at the DTC that show their respective positions in IBM stock. In turn, the members of DTC hold these IBM shares on behalf of their customers, say smaller securities firms. These securities firms then hold IBM shares on behalf of their retail customers — individual investors. No person in the chain delivers physical stock certificates of IBM to execute a trade. Rather, DTC holds an IBM 'jumbo certificate' and transfers of the ownership of IBM shares are recorded by adjustments to the participants' DTC accounts. The DTC members provide analogous clearance and settlement functions to their own customers thereby completing transfers in ownership at each level of the indirect holding system.

As is the case with DTC, most securities are represented by immobilized certificates. Just as nothing happens to these certificates as a result of daily trading, nothing happens to the official registry of stockholders maintained by the issuers or their

transfer agents. 'The principal mechanism through which securities trades are settled today is not delivery of certificates or registration of transfers on the issuer's books, but netted settlement arrangements and accounting entries on the books of a multi-tiered pyramid of securities intermediaries'. Since the 1978 amendment of Article 8 is geared to concepts of transfer of physical certificates and registration of transfers on issuer's books, the existing Article 8 rules are out of touch with the reality of the securities market".

**6.15** When defining concepts such as 'securities', 'financial products', 'investments' and the like, it is expedient to have regard to definitions used in other jurisdictions, particularly in view of the globalization of financial markets, the blurring of financial boundaries and the growth of international financial conglomerates.

**6.16** For purposes of comparison the definitions of regulated 'securities' in Ontario (Canada), 'investment' in the Financial and Markets Services Act of the United Kingdom, 'financial product' in the proposed Australian Financial Services Reform Bill, 'financial product' in the Hong Kong Bill and 'securities' in the Bulgarian law have been chosen to reflect the most recent thoughts in North America, Europe, the Pacific Rim and Asia.

**6.17** In the Ontario act, 'security'

"includes

- (a) any document, instrument or writing commonly known as a security,
- (b) any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company,
- (c) any document constituting evidence of an interest in an association of legatees or heirs,
- (d) any document constituting evidence of an option, subscription or other interest in or to a security,
- (e) any bond, debenture, note or other evidence of indebtedness, share, stock, unit, unit certificate, participation certificate, certificate of share or interest, preorganization certificate or subscription other than a contract of insurance issued by an insurance company licensed under the *Insurance Act* and an evidence of deposit issued by a bank listed in Schedule I or II to the *Bank Act* (Canada), by a credit union or league to which the *Credit Unions and Caisses*

*Populaires Act 1994* applies or by a loan corporation or trust corporation registered under the *Loan and trust Corporation Act*,

- (f) any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets, except a contract issued by an insurance company licensed under the *Insurance Act* which provides for payment at maturity of an amount not less than three quarters of the premiums paid by the purchaser for a benefit payable at maturity,
- (g) any agreement providing that money received will be repaid or treated as a subscription to shares, stock, units or interests at the option of the recipient or of any person or company,
- (h) any certificate of share or interest in a trust, estate or association,
- (i) any profit-share agreement or certificate,
- (j) any certificate of interest in an oil, natural gas or mining lease, claim or royalty voting trust certificate,
- (k) any oil or natural gas royalties or leases or fractional or other interest therein,
- (l) any collateral trust certificate,
- (m) any income or annuity contract not issued by an insurance company or an issuer within the meaning of the *Investment Contracts Act*,
- (n) any investment contract, other than an investment contract within the meaning of the *Investment Contracts Act*,
- (o) any document constituting evidence of an interest in a scholarship or educational plan or trust, and
- (p) any commodity futures contract or any commodity futures option that is not traded on a commodity futures exchange registered with or recognized by the Commission under the *Commodity Futures Act* or the form of which is not accepted by the Director under that Act,

whether any of the foregoing relate to an issuer or proposed issuer";

**6.18** It is to be noted that the definition in the Ontario Act does not specifically include derivatives and does not cater for dematerialized securities.

**6.19** The definition of 'Investments' in the Financial Services Markets Act of the United Kingdom reads as follows:

***"Securities***

11. (1) Shares or stock in the share capital of a company.
- (2) 'Company' includes-
  - (a) any body corporate (wherever incorporated), and
  - (b) any unincorporated body constituted under the law of a country or territory outside the United Kingdom,  
other than an open-ended investment company.

***Instruments creating or acknowledging indebtedness***

12. Any of the following-
  - (a) debentures;
  - (b) debenture stock;
  - (c) loan stock;
  - (d) bonds;
  - (e) certificates of deposit;
  - (f) any other instruments creating or acknowledging a present or future indebtedness.

***Government and public securities***

13. (1) Loan stock, bonds and other instruments-
  - (a) creating or acknowledging indebtedness; and
  - (b) issued by or on behalf of a government, local authority or public authority.
- (2) Government, local authority or public authority' means –
  - (a) the government of the United Kingdom, of Northern Ireland, or of any country or territory outside the United Kingdom;
  - (b) a local authority in the United Kingdom or elsewhere;

- (c) any international organisation the members of which include the United Kingdom or another member State.

*Instruments giving entitlement to investments*

- 14. (1) Warrants or other instruments entitling the holder to subscribe for any investment.
- (2) It is immaterial whether the investment is in existence or identifiable.

*Certificates representing securities*

- 15. Certificates or other instruments which confer contractual or property rights –
  - (a) in respect of any investment held by someone other than the person on whom the rights are conferred by the certificate or other instrument; and
  - (b) the transfer of which may be effected without requiring the consent of that person.

*Units in collective investment schemes*

- 16. (1) Shares in or securities of an open-ended investment company.
- (2) Any right to participate in a collective investment scheme.

*Options*

- 17. Options to acquire or dispose of property.

*Futures*

- 18. Rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date.

*Contracts for differences*

- 19. Rights under –
  - (a) a contract for differences; or
  - (b) any other contract the purpose of pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in –
    - (i) the value or price of property of any description; or
    - (ii) in an index or other factor designated for that purpose in the contract.

*Contracts of insurance*

20. Rights under a contract of insurance, including rights under contracts falling within head C of Schedule 2 to the Friendly Societies Act 1992.

*Participation in Lloyd's syndicates*

21. (1) The underwriting capacity of Lloyd's syndicate.  
(2) A person's membership (or prospective membership) of a Lloyd's syndicate.

*Deposits*

22. Rights under any contract under which a sum of money (whether or not denominated in a currency) is paid on terms under which it will be repaid, with or without interest or a premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it.

*Loans secured on land*

23. (1) Rights under any contract under which –  
(a) one person provides another with credit; and  
(b) the obligation of the borrower to repay is secured on land.  
(2) 'Credit' includes any cash loan or other financial accommodation.  
(3) 'Cash' includes money in any form.

*Rights in investments*

24. Any right or interest in anything which is an investment as a result of any other provision made under section 20(1)".

**6.20** Dematerialized securities are included in section 15 and derivatives in section 19.

**6.21** The proposed Australian definition of 'financial product' reads as follows:

"(1) For the purposes of this Chapter, a *financial product* is a facility through which, or through the acquisition of which, a person does one or more of the following:

- (a) makes a financial investment (see section 763B);

- (b) manages financial risk (see section 763C);
  - (c) makes non-cash payments (see section 763D)
- (2) For the purposes of this Chapter, a particular facility that is of a kind through which people commonly make financial investments, manage financial risks or make non-cash payments is a *financial product* even if that facility is acquired by a particular person for some other purpose.
- (3) For the purposes of this Chapter, if:
- (4) a term of an arrangement (including a term that is implied by law or that is required by law to be included) might be regarded as a facility by which a person manages financial risk; and
- (a) the person's dominant purpose in entering into the arrangement is something other than managing a financial risk; and
  - (b) the arrangement (disregarding that term) is not a facility of a kind through which people commonly manage financial risk; and
  - (c) the person has not paid, and is not required to pay, an identified or identifiable amount of consideration in respect of that term;

that term is not a *financial product*, and its presence in the arrangement does not make the arrangement a *financial product*.

*facility* includes:

- (a) intangible property; or
  - (b) an arrangement or a term of an arrangement (including a term that is implied by law or that is required by law to be included); or
  - (c) a combination of intangible property and an arrangement or term of an arrangement.
- (1) Subject to Division D, the following are *financial products* for the purposes of this Chapter:

- (a) a security
- (b) any of the following in relation to a registered scheme:
  - (i) an interest in the scheme;
  - (ii) a legal or equitable right of interest in an interest covered by subparagraph (i)
  - (iii) an option to acquire, by way of an issue, an interest or right covered by subparagraph (i) or (ii);but not including an excluded security
- (c) a derivative
- (d) a contract of insurance that is not a life policy, or a sinking fund policy, within the meaning of the *Life Insurance Act – 1995*, but not including such contract of insurance;
- (e) a life policy, or a sinking fund policy, within the meaning of the *Life Insurance Act 1995*, that is a contract of insurance, but not including such a policy
- (g) a superannuation interest within the meaning of the *Superannuation Industry (Supervision) Act 1993*
- (h) an RSA (retirement savings account) within the meaning of the *Retirement Savings Accounts Act 1997*
- (i) any deposit-taking facility made available by an ADI within the meaning of the *Banking Act 1959* in the course of its banking business within the meaning of that Act, other than an RSA (RSAs are covered by paragraph [h])
- (j) a debenture, stock or bond issued or proposed to be issued by a government

- (k) something declared by the regulations to be a financial product for the purposes of this section.

*security* means

- (a) a share in a body; or
- (b) a debenture of a body; or
- (c) a legal or equitable right or interest in a security covered by paragraph (a) or (b); or
- (d) an option to acquire, by way of issue, a security covered by paragraph (a), (b) or (c);

but does not include an excluded security.

*derivative*

- (1) For the purposes of this Chapter, subject to subsections (2), (3) and (4), a *derivative* is an arrangement in relation to which the following conditions are satisfied:
  - (a) under the arrangement a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind to someone; and
  - (b) the amount or value of that consideration is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:

- (i) an asset
- (ii) a rate (including an interest rate or exchange rate)
- (iii) an index
- (iv) a commodity.

(2) Without limiting subsection (1), anything declared by the regulations to be a derivative for the purposes of this section is a derivative for the purposes of this Chapter. A thing so declared is a derivative despite anything in subsections (3) and (4).

*transfer of a financial product means:*

- (a) a transfer of legal title to, or an equitable interest in, the financial product; or
- (b) a change in the ownership of the financial product; or
- (c) the transmission of ownership of the financial product; or
- (d) if the financial product is a right—the renunciation and transfer of the right".

**6.22** Although derivatives are specifically included in the definition, derivatives such as 'weather derivatives' are not included while dematerialized securities are not specifically included.

**6.23** 'Financial Product' is defined in the **Hong Kong Bill** as

- "(a) any securities;
- (b) any futures contract;
- (c) any collective investment scheme;

(d) any leveraged foreign exchange contract".

'Securities' are defined as

- "(a) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority;
- (b) rights, options or interests (whether described as units or otherwise) in or in respect of such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (c) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (d) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities;
- (e) interests, rights or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as being regarded as securities in accordance with the terms of the notice,

but does not include

- (i)-(v) .....
- (vi) interest, right or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as not being regarded as securities in accordance with the terms of the notice".

A 'Futures contract' is defined as

- "(a) a contract or any option on a contract made under the rules or conventions of a futures market; or
- (b) interests, rights or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as being regarded as futures contracts in accordance with the terms of the notice,

but does not include interests, rights or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as not being regarded as futures contracts in accordance with the terms of the notice".

A 'Collective investment scheme' is defined as

- "(a) a mutual fund;
- (b) a unit trust; or
- (c) any investment arrangements".

A 'mutual fund' is defined as

"any arrangement made for the purpose, or having the effect, of providing facilities for investment in shares in a mutual fund corporation".

'mutual fund corporation' means a corporation —

- (a) which is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in any property (including securities and futures contracts); and
- (b) the shares which are exclusively, or primarily redeemable shares".

'Unit trust' is defined as

"any arrangement made for the purpose, or having the effect, of providing facilities for the participation by persons in profits or income arising from the acquisition, holding, management or disposal of any property (including securities and futures contracts), where their participation is —

- (a) as beneficiaries under a trust; or
- (b) under an arrangement prescribed by rules made by the Commission, either generally or in any particular case, as being a unit trust for the purposes of this definition".

'Investment arrangements' is defined as

- "(a) arrangements in respect of any property —

- (i) under which the participating persons do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions in respect of such management;
  
- (ii) under which –
  - (A) the property is managed as a whole by or on behalf of the person operating the arrangements;
  
  - (B) the contributions of the participating persons and the profits or income from which payments are made to them are pooled; or
  
  - (C) the property is managed as a whole by or on behalf of the person operating the arrangements, and the contributions of the participating persons and the profits or income from which payments are made to them are pooled; and
  
- (iii) the purpose or effect, or pretended purpose or effect, of which is to enable the participating persons, whether by acquiring any right, interest, title or benefit in the property or any part of the property or otherwise, to participate in or receive –
  - (A) profits, income or other returns represented to arise or to be likely to arise from the acquisition, holding, management or disposal of the property or any part of the property, or sums represented to be paid or to be likely to be paid out of any such profits, income or other returns; or
  
  - (B) a payment or other returns arising from the acquisition, holding or disposal of, the exercise of any right in, the redemption of, or the expiry of, any right,

interest, title or benefit in the property or any part of the property; or

- (b) arrangements which are arrangements, or are of a class or description of arrangements, specified as investment arrangements under section 101(1).

'Leveraged foreign exchange contract' is defined as

" a contract or arrangement the effect of which is that one party agrees or undertakes to –

- (a) make an adjustment between himself and the other party or another person according to whether a currency is worth more or less (as the case may be) in relation to another currency;
- (b) pay an amount of money or to deliver a quantity of any commodity determined or to be determined by reference to the change in value of a currency in relation to another currency to the other party or another person; or
- (c) deliver to the other party or another person at an agreed future time an agreed amount of currency at an agreed consideration".<sup>(9)</sup>

**6.24** The 'Law on Public Offering of Securities' of **Bulgaria**, (Title One Chapter 1 – Section 2) is an example of a definition of dematerialized securities.

"Art. 2. (1) The securities subject to this law are transferable rights registered on accounts with the Central Depository (dematerialized securities) or documents evidencing transferable rights (materialized securities) which may be offered publicly such as

1. equity shares
2. bonds and other debt securities;
3. other rights relating to shares, debentures or other debt securities.

- (2) For the purposes of this law debt securities express transferable claims against the issuer of the securities stemming from funds or other property rights lent to that issuer for an income fixed in advance or to be determined in the future. Debt securities may also express other rights where this is not contrary to the law.
- (3) Securities shall also be the investment contracts under which investors transfer funds or other property rights to another person without directly participating in the management thereof with the purpose of generating income".

**6.25** In South Africa and in the Statement of Generally Accepted Accounting Practice AC125 (Financial Instruments : Disclosure and Presentation) issued by SAICA, derivative financial instruments are stated to be

".11 Financial instruments include both primary instruments, such as receivables, payables and equity securities, and derivative instruments, such as financial options, futures and forwards, interest rate swaps and currency swaps. Derivative financial instruments, whether recognised or unrecognised, meet the definition of a financial instrument and, accordingly, are subject to this statement.

.12 A derivative financial instrument creates rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. A derivative instrument does not result in a transfer of the underlying primary financial instrument on inception of the contract and such a transfer does not necessarily take place on maturity of the contract".

**6.26** It is to be noted that derivatives with no underlying primary financial instrument such as 'weather derivatives' are not included in this definition.

**6.27** An attempt to define 'financial products' is the definition in the South African 'Draft Financial Advisory and Intermediary Services Bill, 2000' published by the Financial Services Board. It is defined by enumeration as –

"(a) securities and instruments, including –

- (i) shares in a company other than a 'share block company' as defined in the Share Block Control Act, 1980 (Act No 59 of 1980);
- (ii) debentures and securitised debt;
- (iii) any money-market instrument;
- (iv) any warrant, certificate, and other instrument conferring rights to subscribe to, acquire, dispose of, or convert instruments referred to in subparagraphs (i), (ii) and (iii) of this paragraph;
- (v) any security as defined in section 1 of the Stock Exchanges Control Act, 1985 (Act No 1 of 1985);

**(defined in that Act as)**

*'securities' includes stocks, shares, debentures, [issued by a company having a share capital], notes, units of stock issued in place of shares, and options on stocks or shares or on such debentures, notes or units, and rights thereto, options on indices of information as issued by a stock exchange on prices of any of the afore-mentioned instruments, as well as any other instruments declared by the Registrar by notice in the Gazette to be securities, but excluding —*

- (i) shares in a private company; or*
- (ii) stocks or shares in a public company which cannot be acquired or transferred without the consent or approval of the directors or representatives of the company, other than such consent or approval required by, under or by virtue of any law, or options on or rights to such stocks or shares; or*
- (iii) bankers' acceptances, negotiable certificates of deposit issued by a bank registered under the Banks Act, 1990 [Act No. 94 of 1990], or by a mutual bank registered under the Mutual Banks Act, 1993 (Act No. 124 of 1993), or any other*

*similar short-term instruments designated by Registrar by notice in the Gazette, or options on or rights to such acceptances, certificates or instruments).*

- (vi) any financial instrument as defined in section 1 of the Financial Markets Control Act, 1989 (Act No 55 of 1989);

**(defined in that Act as)**

**'financial instrument'** means —

- (a) *a futures contract;*
- (b) *an option contract;*
- (c) *loan stock; or*
- (d) *any other instrument declared by the Registrar by notice in the Government Gazette to be a financial instrument*

**"futures contract"** means a standardized contract the effect of which is that —

- (a) *a person agrees to deliver to or receive from another person a certain quantity of corporeal or incorporeal things on a future date at a pre-arranged price; or*
- (b) *a person will pay to or receive from another person an amount of money on a future date according to whether the pre-arranged value or price of an asset, [an] index as referred to in the definition of 'securities' in section 1 of the Stock Exchanges Control Act, 1985 [Act No 1 of 1985], currency, rate of interest or any other factor is higher or lower on that future date than the pre-arranged value or price;*

**'option contract'** means a standardized contract the effect of which is that a person acquires the option —

- (a) *to buy from or sell to another person a certain quantity of corporeal or incorporeal things before or on a future date at a pre-arranged price; or*
- (b) *that an amount of money will be paid to or received from another person before or on a future date according to whether the pre-arranged value or price of an asset, [an]*
- (c) *index as referred to in the definition of 'securities' in section 1 of the Stock Exchanges Control Act, 1985 [Act No 1 of 1985], currency, rate of interest or any other factor is higher or lower before or on that future date than the pre-arranged value or price;*

**'loan stock'** means an instrument creating or acknowledging indebtedness, issued by —

- (a) *the Government of the Republic of South Africa;*
- (b) *a local government body contemplated in the Local Government Transition Act, 1993 [Act No 209 of 1993], or a provincial government;*
- (c) *Eskom;*
- (d) *the Rand Water Board*
- (e) *the Land and Agricultural Bank of South Africa;*
- (f) *the Industrial Development Corporation of South Africa, Limited; or*
- (g) *any other institution designated by the Registrar by notice in the Gazette,*

*but excluding any such instrument specified from time to time by the Registrar by notice in the Gazette)*

- (b) participatory interest in any one or more collective investment schemes;
- (c) a long-term or a short-term insurance contract or policy, referred to in the Long-term Insurance Act, 1998 (Act No 52 of 1998), and the Short-term Insurance Act, 1998 (Act No 53 of 1998), respectively;
- (d) a benefit provided by –
  - (i) a pension fund organisation as defined in section 1(1) of the Pension Funds Act, 1956 (Act No 24 of 1956), to the members of the organisation by virtue of membership; or
  - (ii) a friendly society referred to in the Friendly Societies Act, 1956 (Act No 25 of 1956), to the members of the society by virtue of membership;
- (e) a foreign currency denominated investment instrument, including a foreign currency deposit;
- (f) a deposit as defined in section 1(1) of the Banks Act, 1990 (Act No 94 of 1990);
- (g) a health service benefit provided by a medical scheme as defined in section 1(1) of the Medical Schemes Act, 1998 (Act No 131 of 1998);
- (h) any other product similar in nature to any financial product referred to in paragraphs (a) to (g), inclusive, of this definition, declared by the registrar, after consultation with the Advisory Committee, by notice in the *Gazette* to be a financial product for the purposes of this Act;
- (i) any combined product containing two or more of the financial products referred to in paragraphs (a) to (h), inclusive, of this definition; and
- (j) any financial product issued by any foreign product supplier and marketed in the Republic and which in nature and character is essentially similar or corresponding to a financial product referred to in paragraphs (a) to (i) of this definition".

**6.28** When the definition section of a statute is consulted, it is irritating to be referred to definitions in other statutes. References to other statutes also mean onerous searches and the virtual impossibility for the layman to feel assured of having found the latest amended versions thereof.

**6.29** The inclusion of definitions in other statutes also creates serious inconsistencies and lacunae. In addition, a vast number of derivative products are excluded and terminology is used without appropriate definitions.

**6.30** Examples of inconsistencies and lacunae created by the incorporation of the definitions in the Stock Exchanges Control Act and the Financial Markets Control Act are

- Subsection (a)(i) of the proposed Bill which defines a 'financial product' includes shares in a company (any company) other than a 'share block company' as securities. On the other hand, section 1 of the Stock Exchanges Control Act specifically excludes from its definition of 'securities' shares in a private company and stocks or shares in a public company which cannot be acquired or transferred without the consent or approval of directors or other representatives.
- Subsection (f) of the proposed Bill lists 'deposits' as defined in section 1(1) of the Banks Act as a 'financial product', whilst section (1) of the Stock Exchanges Control Act specifically excludes bankers' acceptances and negotiable certificates of deposits issued by a bank, or options on or rights to such acceptances, certificates or instruments from its definition of 'securities'.

**6.31** The proposed Bill also includes 'any financial instrument' as defined in section (1) of the Financial Markets Control Act in the list of 'financial products'. The effect thereof is to include future contracts and option contracts as defined in that Act. This is presumably an attempt to include derivative products in the list of 'financial products'.

If that was the intention, the attempt is not successful and in fact creates serious lacunae because

- futures and option contracts as defined in the Financial Markets Control Act specifically excludes all futures and options contracts which are not standardized;<sup>(10)</sup>
- futures and option contracts which do not have pre-arranged values or prices are similarly excluded from that definition;

- the indices referred to in the definition of 'securities' in section (1) of the Stock Exchanges Control Act are the indices of information relating to prices of securities traded on the Stock Exchange and no other, and to currencies, rates of interest or any other factor which is higher or lower before or on a future date than the pre-arranged value or price. Factors used internationally and which are not dependent upon a higher or lower value or price than a pre-arranged value or price such as temperature, weather, etc., are thus excluded.

**6.32 After consideration of the definitions of regulated financial products in other jurisdictions, and in view of the globalization of financial markets and the blurring of the traditional distinction between securities and derivatives, it is recommended that 'financial product' be defined as follows:**

**"Unless the context otherwise indicates —**

**'Financial product' means**

- (1)
  - (a) **Securities, whether in documentary form or in dematerialized form;**
  - (b) **futures and derivative contracts;**
  - (c) **collective investment schemes;**
  - (d) **leveraged foreign exchange contracts;**
  - (e) **deposits.**
- (2) **Rights under a contract of insurance.**
- (3) **A benefit provided by –**
  - (i) **a pension fund organization to the members of the organization by virtue of membership; or**
  - (ii) **a friendly society to the members of the society by virtue of membership.**

- (4) A health service benefit provided by a medical scheme.**
- (5) Any product, whether in the form of an instrument or otherwise, prescribed by the Minister by Notice in the Gazette, as being regarded as a financial product.**
- (6) Any other financial product issued by any foreign product supplier and marketed in the Republic and which in nature and character is essentially similar or corresponding to a financial product referred to in paragraphs (1) to (5) of this definition.**
- (7) Any combination of two or more of the financial products enumerated in (1) and (2) above.**

**but does not include —**

**any product, whether in the form of an instrument or otherwise, prescribed by the Minister by Notice in the Gazette as not being regarded as a financial product.**

**'Collective Investment Scheme' means a participatory interest in one or more of the following:**

- (i) a mutual fund;**
- (ii) a unit trust;**
- (iii) an investment arrangement**
  - (a) in respect of any property**
    - (i) under which the participating persons do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions in respect of such management;**
    - (ii) under which —**

- (A) the property is managed as a whole by or on behalf of the person operating the arrangements,
  - (B) the contributions of the participating persons and the profits or income from which payments are made to them are pooled; or
  - (C) and the contributions of the participating persons and the profits or income from which payments are made to are not pooled; and
- (iii) the purpose or effect, or pretended purpose or effect, of which is to enable the participating persons, whether by acquiring any right, interest, title or benefit in the property or any part of the property or otherwise, to participate in or receive –
- (A) profits, income or other returns represented to arise or to be likely to arise from the acquisition, holding, management or disposal of the property or any part of the property, or sums represented to be paid or to be likely to be paid out of any such profits, income or other returns; or

- (B) a payment or other returns arising from the acquisition, holding or disposal of, the exercise of any right in, the redemption of, or the expiry of, any right, interest, title or benefit in the property or any part of the property.**

**'Deposits' include**

**Rights under any contract under which a sum of money (whether or not denominated in a currency) is paid on terms under which it will be repaid, with or without interest or a premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it.**

**'Futures and derivative contracts' include**

- (a) Rights under a contract to deliver to or receive from another person corporeal or incorporeal property on a future date, whether at a pre-arranged price or at a price to be calculated as agreed upon.**
- (b) Rights or obligations under
  - (i) a contract for differences; or**
  - (ii) any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in
    - (aa) the value or price of property of any description; or**
    - (bb) an index or other factor designated for that purpose in the contract.******

## **'Leveraged Foreign Exchange Contracts' include**

**contracts or arrangements the effect of which is that one party agrees or undertakes to —**

- (a) make an adjustment between himself and the other party or another person according to whether a currency is worth more or less (as the case may be) in relation to another currency;**
- (b) pay an amount of money or to deliver a quantity of any commodity determined or to be determined by reference to the change in value of a currency in relation to another currency to the other party or another person; or**
- (c) deliver to the other party or another person at an agreed future time an agreed amount of currency at an agreed consideration.**

## **'Securities' include**

- (i) shares, stocks, debentures, debenture stocks, loan stocks, funds, bonds or notes of, or issued by or to be issued by, a body, whether incorporated or unincorporated, or a government or a local government authority;**
- (ii) rights, options or interests (whether described as units or otherwise) in or in respect of such shares, stocks, debentures, debenture stocks, loan stocks, funds, bonds or notes;**
- (iii) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, debenture stocks, loan stocks, funds, bonds or notes;**
- (iv) any other instrument creating or acknowledging a present or future indebtedness;**
- (v) any other interest, right or property, whether in the form of an instrument or otherwise, commonly known as a security.**

## NOTES

1. **Insurance** has its own regulators in the United States, so do commodities and futures.

Historically, securities were regarded as the means whereby capital was attracted (fundraising) or investments were made, and futures and derivatives were regarded as risk management agreements.

The traditional view that there is a fundamental distinction between the role of the securities markets and derivative markets is no longer valid.

New products have been developed which contain characteristics of both 'securities' and 'futures', such as endowment warrants which permit holders of a derivative instrument to benefit from dividends paid on the underlying security.

This is the theme of Part 4 of 'Financial Markets and Investment Products' Paper No. 6 of the Corporate Law Economic Reform Program of the Australian Government. The following excerpt will serve as an illustration. (p. 36 – 39)

"Commercial practice does not accord with the traditional view that securities are investment products while derivatives are risk management tools. Currently, investors use related derivatives and securities products as alternatives to achieving a particular investment strategy. For example, an investor wishing to risk capital for future profit based on movements in the price of shares has a number of choices available: to purchase the share, take an option over it, take out a warrant or buy an individual share future. In order to diversify the investment to reduce risk, the same investor may purchase a share portfolio or a share price index futures contract. All transactions represent risk-taking on the future movement of share prices.

The extent to which a person is risk averse will influence the type of financial instrument they wish to purchase. For example, some investors prefer 'safe' investments where the capital value is relatively fixed but long term returns tend to be relatively low. Others will invest in riskier investments where the expected long term return is relatively high but there is a risk of losing part of the initial capital investment. Risk can be managed in a number of ways, including portfolio

diversification which allows the subdivision and broadening across a range of investments. Alternatively, instruments which limit down-side risk, like options over shares, permit a risk-averse investor to participate in profits while only risking a small premium.

The creation of a new distinction based on 'securities' and 'derivatives' does not appear to meet the policy objectives outlined in Part 3 of this paper. Regulation based on legal definitions is inherently inflexible and, in time, is likely to become redundant given the rapid changes that have been experienced in financial markets. Further, it would result in inefficiencies, as a market operator would be required to seek dual authorization as a securities exchange and a derivative exchange in order to conduct trading in both types of instruments (eg shares and options over shares).

From an economic perspective, the creation of a new regulatory regime based on the separate regulation of securities and derivatives would be inefficient as it would regulate functionally similar products differently depending on their legal classification.

The economic functions of securities and derivatives markets are similar, notwithstanding the varying characteristics of particular instruments. As noted in Part 3, the fundamental functions of financial markets include price discovery and the management and pricing of risk. Both securities and derivatives markets perform a price discovery function through the exchange and evaluation of information. Stock index futures markets now often function as the dominant price discovery mechanism for the stock market.

The similar economic functions of securities and derivatives become clear from an examination of the intrinsic pricing links between securities and derivatives markets. The prices of an underlying asset and the related derivative contract are simultaneously determined due to arbitrage where differences in one market are quickly transmitted to related markets. The similar price behaviour between derivatives and securities markets provides investors with real alternatives to achieve investment strategies. For example, warrants may be used to achieve capital gains from an equity issue without legally owning the underlying securities. Investors commonly use derivatives as alternatives to holding physical assets.

A securities position may be replicated by a position in a risk-free bond plus an equity futures contract. A bought position in a call can be replicated with a bought position in the security and a bought put. The relationship between various financial

instruments means that investors may achieve their investment strategies without being confined to traditional institutional arrangements or products. For example, innovative uses of derivative instruments may be used to achieve the same economic outcome which was previously achieved through the buying and selling of assets".

2. **Long, Joseph C** : 'Blue Sky Law' Vol. 12, p. 1 – 15 to 1 – 19.  
(The West Group, St Paul. 12/99.).
3. **Pennings, Joost M.E. and Meulenber, M. T. G.** : 'The Financial Industry's Challenge of Developing Commodity Derivatives', p. 1.  
(University of Illinois. May 1999.)
4. **Ibid.** p.8.
5. **Ibid.** p.4.
6. **OFOR** : 'Futures Markets in the 21<sup>st</sup> Century.'
7. **The International Swaps and Derivatives Association (ISDA)** reported that the combined total of outstanding interest rate swaps, currency swaps and interest rate options stood at \$58,265 trillion in notional principal at December 31, 1999.  
[www.isda.org/statistics/recent.html](http://www.isda.org/statistics/recent.html)
8. **Rutledge, Philip.**

See also see some other examples and definitions of derivatives.

**"Derivative.** A contractual relationship established by two (or more) parties where payment is based on (or 'derived' from) some agreed-upon benchmark such as interest rates, stock indexes, foreign currency and the like and whether payment is in currency, securities or a physical commodity.

**Options.** An Option represents the right (but not the obligation) to buy or sell a security or other asset during a given time for a specified price (the'**Strike**' price). An Option to buy is known as a '**Call**', and an Option to sell is called a '**Put**'. You can purchase Options (the right to buy or sell the security in question) or sell (write) Options. As a seller, you could become obligated to sell a security to, or buy a security from, the party that purchased the option. Options can be either '**Covered**' or '**Naked**'. In a

**Covered Option**, the contract is backed by the asset underlying the Option, e.g., you could purchase a **Put** on 300 shares of the ABC Corp. that you now own. In a **Naked Option**, the contract is not backed by the security underlying the Option. Options are traded on organized exchanges and OTC.

**Forward Contracts.** In a Forward Contract, the purchaser and its counterparty are obligated to trade a security or other asset at a specified date in the future. The price paid for the security or asset is agreed upon at the time the contract is entered into, or may be determined at delivery. Options generally are traded OTC.

**Futures.** A Future represents the right to buy or sell a standard quantity and quality of an asset or security at a specified date and price. Futures are similar to Forward Contracts, but are standardized and traded on an exchange, and are valued, or '**Market to Market**' daily. The **Market to Market** provides both parties with a daily accounting of their financial obligations under the terms of the Future. Unlike Forward Contracts, the counterparty to a Futures contract is the clearing corporation on the appropriate exchange. Futures often are settled in cash or cash equivalents, rather than requiring physical delivery of the underlying asset. Parties to a Futures contract may buy or write Options on Futures.

**Stripped Mortgage-Backed Securities.** Stripped Mortgage-Backed Securities, called '**SMBS**', represent interests in a pool of mortgages, called '**Tranches**', the cash flow of which has been separated into interest and principal components.

**Interest only securities**, called '**IOs**', receive the interest portion of the mortgage payment and generally increase in value as interest rates rise and decrease in value as interest rates fall. Where the underlying mortgages for an **IO** carry variable ('floating') rates of interest, the value of the **IOs** tend to increase in periods of rising interest due to anticipated higher interest payments on the underlying mortgages. For **IOs** that have underlying mortgages at a fixed rate, the value of **IOs** tends to increase in value during periods of rising interest rates because individual homeowners are less likely to refinance and prepay their mortgages. The value of the **SMBS** would, therefore, tend to increase over the 'life' of the mortgage instrument. Principal only securities, called '**POs**', receive the principal portion of the mortgage payment and respond inversely to interest rate movement. As interest rates go up, the value of the **PO** would tend to fall, as the **PO** becomes less attractive compared with other investment opportunities in the marketplace.

Some **Tranches** may offer interest and principal payments in various combinations. Planned Amortization Classes, '**PACs**', for instance, provide stable interest and principal repayments if the rates of prepayments on the underlying mortgages stay within a specified predetermined range.

**Structured Notes.** Structured Notes are debt instruments where the principal and/or the interest rate is indexed to an unrelated indicator. An example of Structured Note would be a bond whose interest rate is decided by interest rates in England or the price of a barrel of crude oil. Sometimes the two elements of a Structured Note are inversely related, so as the index goes up, the rate of payment (the 'coupon rate') goes down. This instrument is known as an '**Inverse Floater**'. With leveraging, Structured Notes may fluctuate to a greater degree than the underlying index. Therefore, Structured Notes can be an extremely volatile derivative with high risk potential and a need for close monitoring. Structured Notes generally are traded OTC.

**Swaps.** A Swap is a simultaneous buying and selling of the same security or obligation. Perhaps the best-known Swap occurs when two parties exchange interest payments based on an identical principal amount, called the 'national principal amount'.

Think of an interest rate Swap as follows: Party A holds a 10-year \$10,000 home equity loan that has a fixed interest rate of 7 percent, and Party B holds a 10-year \$10,000 home equity loan that has an adjustable interest rate that will change over the 'life' of the mortgage. If Party A and Party B were to exchange interest rate payments on their otherwise identical mortgages, they would have engaged in an interest rate Swap.

Interest rate swaps occur generally in three scenarios. Exchanges of a fixed rate for a floating rate, a floating rate for a fixed rate, or a floating rate for a floating rate.

The 'Swaps market' has grown dramatically. Today, Swaps involve exchanges other than interest rates, such as mortgages, currencies, and 'cross-national' arrangements. Swaps may involve cross-currency payments (U.S. Dollars vs. Mexican Pesos) and crossmarket payments, e.g., U.S. short-term rates vs. U.K. short-term rates. Swaps may include '**Caps**', '**Floors**', or Caps and Floors combined ('**Collars**').

A derivative consisting of an Option to enter into an interest rate Swap, or to cancel an existing Swap in the future is called a '**Swaption**'. You can also combine an interest rate and currency Swap (called a '**Circus**' Swap).

Swaps generally are traded OTC through Swap dealers, which generally consist of large financial institution, or other large brokerage houses. There is a recent trend for Swap dealers to **Market to Market** the Swap to reduce the risk of counterparty default".

And also see **Derivative Dictionary (William Margrabe Group Inc.)**

**"Bankruptcy futures** — The futures contract based on the CME Quarterly Bankruptcy Index. The CME computes the index daily, based on personal and business bankruptcy filings, with personal bankruptcies getting 96% of the weight. (Aaron Luchetti, 'Commodity Traders May Go for Broke With Novel Contract', *WSJ*, 4/3/98.)

**Catastrophe Options** — The CBOT's option contracts on several regional indexes of losses. The option on the Eastern Catastrophic contract boomed as Hurricane Fran smashed the Carolinas in the fall of 1996. (Source Robert Clow, 'Coping with catastrophe', *Institutional Investor*, December 1996, pp. 138.)

**Catastrophe options** come in two main varieties: (1) **Property Claims (PCS)** options pay out (European style) based on an index of all claims against property insurance companies. (2) **Single-Cat options** pay out (American or one-touch style) based on a single, large atmospheric or seismic disaster in a single region (northeast, southeast, east, midwest, or west) or in California, Texas, or Florida. ('A New Take on Cat Options', *Derivatives Strategy*, February 1998, pp. 5-6.)

**Certificate** — The actual piece of paper which is evidence of ownership (eg of shares in a corporation).

**Derivatives**— Securities that derive their value from another security, (eg. *futures* and *options*). Also known as **Synthetics**)

**Derivative product** — A financial contract whose value depends on a risk factor, such as □ the price of a bond, commodity, currency, share, etc.

- a yield or rate of interest
- an index of prices or yields
- weather data, such as inches of rainfall or heating-degree-days,

- insurance data, such as claims paid for disastrous earthquake or flood, etc.

**Overnight Indexed Swaps** — Swaps with a floating rate based on Sonia (*q.v.*)

- Security** — a) In relation to financial markets, the paper right to a (generally tradeable) asset. In this context the term includes *Bills of Exchange*, *bonds*, share certificates or any other interest-bearing paper traded on financial markets;
- b) An asset pledged to ensure the repayment of financial obligation (eg. loan), and forfeited in the event of a default on that obligation.

**Share Certificate** — A piece of paper representing legal evidence of ownership of a stipulated number of shares in a company. Also known as Scrip.

**Sonia** — Sterling Overnight Interbank Average (*q.v.*). An average of the rates that London's largest money brokers pay for overnight deposits on a given day.

**Warrant** — An option that a corporation issues, with its own shares as the underlying asset. The crucial implication is that exercise of the option changes the number of claims against the corporation's assets. Thus, the pricing equations for Call (Put) Warrants and ordinary Call (Put) Options differ by the dilution (antidilution) effect. Empirically, warrants are options with a long time to expiration, which may be several or many years, or even decades or an infinite time. An option on asset A that party B issues and lists on an exchange. Party B might [be] a corporation, a government, etc. Endowment Warrants (*q.v.*) Installment Warrants (*q.v.*).

### **Weather derivatives**

*Definition:* Derivative products whose values depend on risky weather variables, such as temperature, precipitation, or dollar damage from extreme weather.

*Example:* Options on heating or cooling degree days, hurricane-based catastrophe bonds.

*Application:* An insurer or reinsurer who wanted to lay off some risk in the capital markets might issue a bond that repaid principal as a function of the loss rate for Florida East Gulf Coast property casualty rates.

*Pricing:* The pricing models are sensitive to assumptions, as usual. Historical results depend on the historical period. With global warming and *El Nino*, pricing isn't simple.

*Risk Management:* Catastrophe contracts are simple ways of laying off weather risk".

**9. The full text reads as follows:**

" 'financial product' means —

- (a) any securities;
- (b) any futures contract;
- (c) any collective investment scheme;
- (d) any leveraged foreign exchange contract.

'Securities' are defined as

- "(a) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority;
- (b) rights, options or interests (whether described as units or otherwise) in or in respect of such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (c) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
- (d) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities;
- (e) interests, rights or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as being regarded as securities in accordance with the terms of the notice,

but does not include —

- (i) shares or debentures of a company which is a private company within the meaning of section 29 of the Companies Ordinance (Cap. 32);

- (ii) an interest arising under a general partnership agreement or proposed general partnership agreement unless the agreement or proposed agreement relates to an undertaking, scheme, enterprise or investment contract promoted by or on behalf of a person whose ordinary business is or includes the promotion of similar undertakings, schemes, enterprises or investment contracts (whether or not that person is, or is to become, a party to the agreement or proposed agreement);
- (iii) a negotiable receipt or other negotiable certificate or document evidencing the deposit of a sum of money, or any rights or interest arising under the receipt, certificate or document;
- (iv) a bill of exchange within the meaning of section 3 of the Bills of Exchange Ordinance (Cap. 19) and a promissory note within the meaning of section 89 of that Ordinance;
- (v) a debenture that specifically provides that it is not negotiable or transferable;
- (vi) interest, right or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as not being regarded as securities in accordance with the terms of the notice".

'Futures contract' is defined as

- "(a) a contract or any option on a contract made under the rules or conventions of a futures market; or
- (b) interests, rights or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as being regarded as futures contracts in accordance with the terms of the notice,

but does not include interests, rights or property, whether in the form of an instrument or otherwise, prescribed by notice under section 369 of this Ordinance as not being regarded as futures contracts in accordance with the terms of the notice".

'Collective investment scheme' is defined as

- (a) a mutual fund;
- (b) a unit trust; or

(c) any investment arrangements".

A 'mutual fund' is defined as

" 'mutual fund' means any arrangement made for the purpose, or having the effect, of providing facilities for investment in shares in a mutual fund corporation.

'mutual fund corporation' means a corporation —

- (a) which is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in any property (including securities and futures contracts); and
- (b) the shares which are exclusively, or primarily redeemable shares".

'Unit trust' is defined as

"any arrangement made for the purpose, or having the effect, of providing facilities for the participation by persons in profits or income arising from the acquisition, holding, management or disposal of any property (including securities and futures contracts), where their participation is —

- (a) as beneficiaries under a trust; or
- (b) under an arrangement prescribed by rules made by the Commission, either generally or in any particular case, as being a unit trust for the purposes of this definition".

'Investment arrangements' is defined as

- "(a) arrangements in respect of any property —
  - (i) under which the participating persons do not have day-to-day control over the management of the property, whether or not

they have the right to be consulted or to give directions in respect of such management;

.....

(iv) under which –

(A) the property is managed as a whole by or on behalf of the person operating the arrangements;

(B) the contributions of the participating persons and the profits or income from which payments are made to them are pooled; or

(C) the property is managed as a whole by or on behalf of the person operating the arrangements, and the contributions of the participating persons and the profits or income from which payments are made to them are pooled; and

(v) the purpose or effect, or pretended purpose or effect, of which is to enable the participating persons, whether by acquiring any right, interest, title or benefit in the property or any part of the property or otherwise, to participate in or receive –

(A) profits, income or other returns represented to arise or to be likely to arise from the acquisition, holding, management or disposal of the property or any part of the property, or sums represented to be paid or to be likely to be paid out of any such profits, income or other returns; Or

(B) a payment or other returns arising from the acquisition, holding or disposal of, the exercise of any right in, the redemption of, or the expiry of, any right, interest, title or benefit in the property or any part of the property; or

- (b) arrangements which are arrangements, or are of a class or description of arrangements, specified as investment arrangements under section 101(1)

but does not include –

- (i) arrangements operated by a person otherwise than by way of business;
- (ii) arrangements under which each of the participating persons carries on a business other than investment business and enters into the arrangements for commercial purposes related to that business;
- (iii) arrangements under which each of the participating persons is a corporation in the same group of companies as the person operating the arrangements;
- (iv) arrangements under which each of the participating persons is a bona fide employee or former employee of a corporation in the same group of companies as the person operating the arrangements, or a spouse, widow, widower, minor child (natural or adopted) or minor step-child of such employee or former employee;
- (v) franchise arrangements under which the franchisor or franchisee earns profits or income by exploiting a right conferred by the arrangements to use a trade name or design or other intellectual property or the goodwill attached to it;
- (vi) arrangements the purpose of which is the provision of services provided by a recognized exchange company or recognized clearinghouse and which are operated by such recognized exchange company or recognized clearing house (as the case may be);
- (vii) arrangements under which money is taken by a solicitor from his client, or as a stakeholder acting in his professional capacity in the ordinary course of his practice;

- (viii) arrangements made for the purposes of any fund or scheme maintained by the Commission, or by a recognized exchange company, recognized clearing house, recognized exchange controller or recognized investor compensation company, under this Ordinance for the purpose of providing compensation in the event of default by an exchange participant or a clearing participant;
- (ix) arrangements made by any credit union in accordance with the object thereof;
- (x) arrangements made for the purposes of any chit-fund permitted to operate under the Chit-Fund Businesses (Prohibition) Ordinance (Cap. 262);
- (xi) arrangements made for the purposes of the Exchange Fund established by the Exchange Fund Ordinance (Cap. 66); and
- (xii) arrangements which are arrangements, or are of a class or description of arrangements, specified as not constituting investment arrangements under section 101(2)".

'Leveraged foreign exchange contract' is defined as

" a contract or arrangement the effect of which is that one party agrees or undertakes to –

- (a) make an adjustment between himself and the other party or another person according to whether a currency is worth more or less (as the case may be) in relation to another currency;
- (b) pay an amount of money or to deliver a quantity of any commodity determined or to be determined by reference to the change in value of a currency in relation to another currency to the other party or another person; or
- (c) deliver to the other party or another person at an agreed future time an agreed amount of currency at an agreed consideration".

10. The **Ontario** Securities Act specifically **includes** futures contracts and options which are not traded on a commodity futures exchange in the definition of 'securities' (see par.6.17 above).

# CHAPTER 7 - THE REGULATOR – ITS OBJECTIVES, FUNCTIONS AND POWERS

7.1 In the United States a number of factors such as the traditional distinction between the role of the securities markets and the role of the futures and derivative markets, the federal system of government, the Glass-Steagall Banking Act of 1933 and the Bank Holding Company Act of 1956 have led to an incredible proliferation of securities regulators.<sup>(1)</sup>

The Securities and Exchange Commission of the United States is thus not the sole regulator of financial products, but within its field (i e securities) it is without doubt pre-eminent.

Its success is attributed to a number of factors, but the most important are

- its flexibility to make, amend and rescind rules and regulations pertaining to its functions;
- its powers to inspect; and
- its powers to intervene.

7.3 Sections 19 (a) and (b) and 20 (a), (b), (c) and (d) of the Securities Exchange Act of 1934 which created the Commission, read as follows:

"19 (a) The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to

carry out the provisions of this title, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this title. Among other things, the Commission shall have the authority, for the purposes of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

(b) For the purpose of all investigations which, in the opinion of the Commission, are necessary and proper for the enforcement of this title, any member of the Commission or any officer or officers designated by it are empowered to administer oaths and affirmations, subpoena witnesses, take evidence, and require the production of any books, papers, or other documents which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of such documentary evidence may be required from any place in the United States or any Territory at any designated place of hearing.

20 (a) **Investigation of violations.** Whenever it shall appear to the Commission, either upon complaint or otherwise, that the provisions of this title, or of any rule or regulation prescribed under authority thereof, have been or are about to be violated, it may, in its discretion, either require or permit such person to file with it a statement in writing, under oath, or otherwise, as to all the facts and circumstances concerning the subject matter which it believes to be in the public interest to investigate, and may investigate such facts.

(b) **Action for injunction or criminal prosecution in district court.**

Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof, the Commission may, in its discretion, bring an action in any district court of the United States, or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing, a permanent or temporary injunction or restraining order shall be granted without bond.

(c) **Writ of mandamus.** Upon application of the Commission, the district courts of the United States and the United States courts of any Territory shall have jurisdiction to issue writs of mandamus commanding any person to comply with the provisions of this title or any order of the Commission made in pursuance thereof.

7.4 During the past two decades there has been a growing awareness in many jurisdictions that existing securities laws have become outdated.

7.5 The cumbersome and time consuming processes inherent in amendments to legislation are anathema to the flexibility which is presently required to enable regulators to cope with the rapid changes in financial markets.

7.6 Flexibility has become the recurrent theme underlying proposals to modernize securities laws.

7.7 **The Final Report of the Ontario Task Force on Securities Regulation** reads

"The principles which underlie our recommendations are as follows:

- A. The need for flexibility and responsiveness in securities policy-making and regulation.

In crafting our recommendations, we have endeavoured to devise institutional arrangements that promote regulatory responsiveness and flexibility. We believe that the vitality of a given capital market is strengthened by the capacity of its regulators to respond to market trends and changes in a timely, creative and flexible manner. To the extent that outdated or rigid regulation is permitted to remain in force, community respect for the regulatory regime will diminish. Further, such regulation imposes burdensome costs on investors and issuers alike that may fuel the flight of capital to more congenial regulatory environments".<sup>(2)</sup>

**7.8** Following upon the Report, the **Securities Commission of Ontario** was provided with additional rule-making powers, and the underlying purpose was stated

"to provide the Commission with sufficient authority to continue to regulate effectively in a flexible and responsive manner. One of the most significant aspects of the amendments is that they grant the Commission the authority to make rules having the effect of regulations in respect of a range of specified matters"<sup>(3)</sup>

**7.9** In its comments on the **Clerp 6 Consultation Paper**<sup>(4)</sup> ASIC (The Australian Securities Commission) stated

"If the new disclosure regime is to work efficiently ASIC will need clear powers to specify content and format of disclosure documents, so as to ensure that:

- disclosure obligations are adjusted to the changing market environment in a flexible and timely manner; .....

Comparable regulators in comparable overseas jurisdictions such as the United States and the United Kingdom have such powers. There is a recognition in those jurisdictions that the explosive growth in, and growing complexity of, financial service industries, and the urgency of transactions in those industries, require the regulator to have the capacity to administer the regime flexibly to accommodate innovation and change. ASIC submits that it should be no less well-equipped".<sup>(5)</sup>

**7.10** A final example is the view expressed in the guide to the proposed new **Securities and Futures Bill of Hong Kong** (July 1999):

"11. Financial markets are changing rapidly, with growing globalization, innovation and competition. We need a flexible regulatory framework that can cope with these rapid changes and maintain Hong Kong in the forefront of competitiveness as an international financial centre.

Even the definitions of financial products have changed. The SFCO was enacted when the instruments traded in Hong Kong's financial markets were predominantly equity interests and traditional futures. It was therefore practical as well as practicable to describe the Commission's role by reference to such terms.

However, modern financial engineering has created a proliferation of derivative products, where many hybrid instruments do not fit within the existing definitions of 'securities' or 'futures contracts'. For example, warrants and options derive their value from the underlying stocks, but often have time limitation features like futures.

14. In short, constant innovation in the marketplace in tradable financial instruments necessitates a more flexible approach to defining the Commission's regulatory jurisdiction. Accordingly, references to 'securities, futures contracts and property investment arrangements' will be replaced by the inclusive term 'financial products'. Similarly, intermediaries, exchanges and clearing houses will be referred to

collectively as the 'securities and futures industry' with an appropriate definition. These new references will better reflect the ambit of the role that the Commission is to fulfil.

15. The rapid growth of financial innovation necessitates a certain degree of flexibility in the powers of the Commission. With the advent of Internet trading and the arrival of new players such as hedge funds, it is simply not possible to predict the future landscape of Hong Kong's securities and futures markets. Crafting the Commission's powers in rigid terms would at best allow things to slip through the cracks, and at worst create opportunities for fraud and abuse.
20. Currently, the powers of the Commission to make rules, codes and guidelines are dispersed among many different provisions. Such an approach confines the Commission's ability to make rules to those areas specifically covered in particular provisions. However, to be effective as a regulator, the Commission needs the flexibility to issue such rules, codes and guidelines as it considers necessary. Only in this way can new issues be addressed swiftly without the need for repeated amendments to the governing legislation.
21. It is therefore proposed that the Composite Bill provide a general power for the Commission to prescribe such rules, codes of conduct, guidelines and statements of principles in the performance of its functions. The Commission shall take great care in exercising this proposed power<sup>11</sup>.<sup>(6)</sup>

**7.11** The worldwide recognition of the need to reform has led to extensive amendments or proposed amendments to the securities laws in many jurisdictions, some as disparate as the **Argentine, Bangladesh, Brazil, Bulgaria, Hong Kong, Lithuania, Pakistan, the Philippines** and the **United Kingdom**. This list is not intended to be exhaustive but is merely an illustration of the worldwide acceptance of the necessity to modernize securities laws.

**7.12** Many of the features which the regulators in these and other jurisdictions have or will have in common illustrate that effective regulation and supervision require the ability

- to set regulatory and supervisory standards by the issuing of rules with statutory force either by the securities commission or by the government;
- to investigate, intervene, discipline, and to compel restitution of loss by effective dispute resolution;
- to prosecute or actively assist in the prosecution of offenders.

**7.13** The National Securities Commission (CNV) of the **Argentine** is a self-governed agency of the Argentine government whose principal functions are described as

- "(i) To authorize in each case the public offering of securities issued by private entities.....This function covers all steps related to the issuance of the offering, including the control of compliance of the law and of the charter of the decisions taken by the corporate bodies of the issuing entity, the sequence of events and publications, and the need and disclosure level of any prospectuses as well as their distribution among the interested investors. ....";
- (ii) To authorize and control compliance with the law of all corporate resolutions by the entities subject to the authority of the CNV connected with the charter, the offering of securities or that may have an impact on the trading of the securities issued by such entities;
- (iii) To create a continuing disclosure legal regime, and, in that regard, control compliance with it by the entities subject to the authority of the CNV, to prevent, investigate and prosecute any fraud or manipulation and insider trading;  
.....
- (vi) To keep a register of all persons authorised to make public offerings of securities, and prescribe the rules that such persons and those acting for their own account are to observe;

- (vii) To approve the rules and regulations of Exchanges relating to the public offering of securities and those of Securities Markets;
- (viii) To supervise compliance with applicable laws, rules and regulations in all matters within the scope of the Law;
- (ix) To request the National Executive Branch to revoke the registration of Stock Exchanges and Securities Markets, whenever such institutions should fail to comply with the functions herein assigned to them".

The CNV also has to

"within its function to regulate persons involved in any capacity with the public offering of securities, the CNV, in the exercise of such functions may require reports and carry out inspections and investigations with respect to such persons, and request the aid of other law enforcement agencies. Finally, the CNV can report crimes or prosecute them in court".

The CNV has published a comprehensive set of Rules and Regulations based on the regulatory framework of the Securities and Exchange Commission of the United States. It is too voluminous for the purposes of this Report, but the index thereto is sufficient indication of its rule-making ability.<sup>(7)</sup>

**7.14** In **Bangladesh**, the Securities and Exchange Commission was constituted under the Securities and Exchange Act, 1993, to provide for protection of investors and the regulation of capital markets and the issue of and dealing in securities.

In terms of section 33 of the Securities and Exchange Ordinance the Commission may make rules for the carrying out of the purposes of the Ordinance and also in particular may make rules pertaining to stock exchanges, the listing of securities and the information and returns to be furnished by the issuers of securities.

**7.15** The **Securities Commission of Brazil** is the entity exclusively in charge of regulating, overseeing and inspecting the securities market. It is also based on the United States model. It may issue regulations and its purposes are to

- "(a) stimulate the creation of savings and their investment in securities;

- (b) promote the expansion as well as the regular and efficient operation of the stock market, and to stimulate permanent investments in the capital stock of publicly-held companies under the control of Brazilian private capital;
- (c) guarantee the efficient and regular operation of stock markets and over-the-counter markets;
- (d) protect owners of securities and market investors against:
  - (i) irregular issues of securities; and
  - (ii) illegal acts of officers and controlling shareholders of publicly-held companies, or illegal acts of managers of securities portfolios;
- (e) avoid or prevent any kind of fraud or manipulation intended to create artificial conditions of supply, demand or pricing of the securities traded on the market;
- (f) guarantee availability to the general public of information on the securities traded and the companies issuing them;
- (g) guarantee the observance of equitable business practices on the securities market;
- (h) guarantee the observance on the market of the conditions established by the National Monetary Council regarding the use of credit;
- (i) perform all other activities provided for in the Securities Market Law, the Corporation Law and other legal provisions relating to the securities market;<sup>(8)</sup>

**7.16** The 'Law on Public Offering of Securities' of 15 December 1999, constituted the **Bulgarian National Securities Commission**, an independent state body, to

- "15. 1. control the regulated securities markets, the investment intermediaries, the investment companies and the management companies, as well as the public companies and the issuers in the cases provided for in this

law and in its implementing instruments, as to the lawful and correct carrying on of their business in accordance with the public interest, including through conducting inspections;

2. issue and withdraw the licenses envisaged by this law;
3. give the confirmations and approvals envisaged by this law;
4. carry out inspections of the operations of banks, in connection with their activities as investment intermediaries and depositories;
5. exchange the information indispensable for its activities with the Bulgarian National Bank, other state institutions and bodies, bodies of local self-governance and administration, as well as with non-governmental organizations related to the securities market;
6. prepare ordinances and regulations for the implementation of this law which shall be presented to be adopted by the Council Ministers;
7. prepare ordinances and regulations for the implementation of this law which shall be presented to be adopted by the Council of Ministers;
8. cooperate with similar foreign institutions and specialized international organizations and shall represent the Republic of Bulgaria for concluding relevant international contracts;
9. decide on other issues attributed to its competence".

**7.17 The regulatory objectives, functions and powers of the proposed Hong Kong Securities and Futures Commission are the following**

**"4. Regulatory objectives of the Commission**

The regulatory objectives of the Commission are —

- (a) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;

- (b) to promote the understanding by the public of the operation and functioning of the securities and futures industry;
- (c) to secure an appropriate degree of protection for members of the public investing in or holding financial products;
- (d) to minimize crime and misconduct in the securities and futures industry;
- (e) to reduce systemic risks in the securities and futures industry; and
- (f) to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

5. **Functions and powers of Commission**

- (1) The functions of the Commission are to, so far as reasonably practicable —
  - (a) take such steps as it considers appropriate to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
  - (b) supervise, monitor and regulate —
    - (i) the activities carried on by recognized exchange companies, recognized clearing houses, recognized exchange controllers or recognized investor compensation companies, or by persons carrying on activities regulated by the Commission under any of the relevant provisions, other than exempt persons; and
    - (ii) such of the activities carried on by exempt persons as are regulated by the Commission under any of the relevant provisions;
  - (c) promote and develop an appropriate degree of self-regulation in the securities and futures industry;
  - (d) promote, encourage and enforce the proper conduct, competence and integrity of persons carrying on activities regulated by the

Commission under any of the relevant provisions in the conduct of such activities;

- (e) encourage the provision of sound, balanced and informed advice regarding transaction or activities related to financial products;
- (f) take such steps as it considers appropriate to ensure that the relevant provisions are complied with;
- (g) promote and maintain confidence in the securities and futures industry in such manner as it considers appropriate, including by the exercise of its discretion to disclose to the public any matter relating or incidental to the performance of any of its functions;
- (h) co-operate with and provide assistance to regulatory authorities or organizations, whether formed or established in Hong Kong or elsewhere;
- (i) promote the understanding by the public of the securities and futures industry and of the benefits, risks and liabilities associated with investing in financial products;
- (j) encourage the public to appreciate the relative benefits of investing in financial products through persons carrying on activities regulated by the Commission under any of the relevant provisions;
- (k) promote the understanding by the public of the importance of making informed decisions regarding transactions or activities related to financial products and of taking responsibility therefor;
- (l) secure the appropriate degree of protection for members of the public investing in or holding financial products, having regard to their degree of understanding and expertise in respect of investing in or holding financial products;
- (m) promote, encourage and enforce —
  - (i) the adoption of appropriate internal controls and risk management systems by persons carrying on activities

regulated by the Commission under any of the relevant provisions, other than exempt persons; and

- (ii) the adoption of appropriate internal controls and risk management systems by exempt persons in the conduct of activities regulated by the Commission under any of the relevant provisions;
  - (n) suppress illegal, dishonourable and improper practices in the securities and futures industry;
  - (o) take appropriate steps in relation to the securities and futures industry further to the requirement of the Financial Secretary for the purpose of providing assistance in maintaining the financial stability of Hong Kong;
  - (p) recommend reforms of the law relating to the securities and futures industry
  - (q) advise the Financial Secretary on matters relating to the securities and futures industry and provide him with such information in relation thereto as it consider appropriate; and
  - (r) perform functions conferred or imposed on it by or under this or any other Ordinance.
- (2) Subsection (1)(c) does not limit or otherwise affect any other function of the Commission.
- (3) The Commission, in performing any of its functions in relation to —
- (a) any authorized financial institution as an exempt person or as an associated entity of an intermediary; or
  - (b) any person as an associated entity of an authorized financial institution that is an exempt person,

may rely, in whole or in part, on the supervision of such authorized financial institution or person (as the case may be) by the Monetary Authority.

- (4) The Commission has the power to do such things as it consider necessary in connection with, or reasonably incidental to, the performance of its functions and, without limiting the generality of the foregoing, may —
- (a) acquire, hold and dispose of property of any description;
  - (b) make contracts or other agreements;
  - (c) receive and expend moneys;
  - (d) with the approval of the Financial Secretary, borrow money on security or other conditions;
  - (e) publish or otherwise make available materials, however described, indicating to persons who are, or who carry on activities, regulated by the Commission under any of the relevant provisions and, where the Commission considers appropriate, any other persons the manner in which, in the absence of any particular consideration or circumstance, the Commission proposes to perform any of its functions; and
  - (f) publish or otherwise make available materials, however described, indicating to the public any matter relating or incidental to the performance of any of the functions of the Commission.
- (5) Materials published or otherwise made available under subsection (4)(e) or (f) are not subsidiary legislation.
- (6) General duties of Commission
- (1) In performing its functions, the Commission shall, so far as reasonably practicable, act in a way which —
    - (a) is compatible with its regulatory objectives; and
    - (b) it considers most appropriate for the purpose of meeting those objectives.

- (2) In pursuing its regulatory objectives and performing its functions, the Commission shall have regard to —
- (a) the international character of the securities and futures industry and the desirability of maintaining the status of Hong Kong as a competitive international financial centre;
  - (b) the desirability of facilitating innovation in connection with financial products and with activities regulated by the Commission under any of the relevant provisions;
  - (c) the principle that competition among persons carrying on activities regulated by the Commission under any of the relevant provisions should not be impeded unnecessarily;
  - (d) the importance of acting in a transparent manner, having regard to its obligations of preserving secrecy and confidentiality;
  - (e) the need to make efficient use of its resources".

**7.18** Part VIII of the Securities and Futures Bill deals with supervision and investigation by the Commission.

**7.19** If it appears to the Commission that there are circumstances in relation to a listed corporation suggesting that its business is being conducted or has been conducted with the intent to defraud creditors for a fraudulent or unlawful purpose or in a manner oppressive to its members or any part of its members, or it appears that members might not have been given all the information with respect to the affairs of the corporation that they might reasonably expect, the Commission may authorize a person to conduct an investigation.

In addition to the records of the corporation, such a person will also have access to the working papers of the external auditor.<sup>(9)</sup>

**7.20** Section 173 empowers the Commission to inspect the affairs of intermediaries and their associated entities.<sup>(10)</sup>

**7.21** The **Lithuanian** Securities Commission was created as an independent supervising institution of the capital market as of January 16, 1996.

Its main objectives are

- "to monitor how principles of fair trading and competition are observed in public trading in securities;
- to provide necessary measures that guarantee effective functioning of the capital market and protect interests of investors;
- in co-operation with ministries, other governmental institutions, the Bank of Lithuania, intermediaries of public trading in securities and market participants, to design the economic policy of the state that fosters the development of the capital market;
- to disseminate information about the principles of functioning of the capital market;"

and it performs the following main functions

- "establishes and approves rules regulating the activities of securities issuers, intermediaries, stock exchanges, investment companies, and the Central Securities Depository of Lithuania;
- registers the issue of securities;
- issues and revokes permits and licences to natural and legal persons the licensing of which is within the competence of the Securities Commission;
- monitors, analyses and inspects operations of market participants;
- presents official explanations with regard to public trading in securities;
- imposes sanctions provided for in the Law on Public Trading in Securities and other legal acts of the Republic of Lithuania".<sup>(11)</sup>

**7.22** Act 42 of 1997 established the **Securities and Exchange Commission of Pakistan** which became operational with effect from 1 January 1999 for

"the beneficial regulation of the capital markets, superintendence and control of cooperate entities....."

Its functions include the conduct of investigations for the purpose of prosecuting offenders and the calling for information from and undertaking inspections and audit of the Stock Exchange and intermediaries and self-regulatory organizations in the securities market.<sup>(12)</sup>

**7.23** Following the American model, the **Philippines** established a Securities and Exchange Commission (SEC). It also has extensive powers of supervision, monitoring and prosecution relating to corporations, partnerships, associations, stock exchanges and the like.<sup>(13)</sup>

**7.24** In the **United Kingdom** the Financial Services Authority (FSA) became the sole regulator of the financial sector. (The Financial Services and Markets Act, June 2000.)

The statutory objectives of the Authority, as set out in the Act, are

- "maintaining confidence in the UK financial system;
- promoting public understanding of the financial system, including awareness of the benefits and risks associated with different kinds of investment of other financial dealing;
- securing the appropriate degree of protection for consumers, having regard to the different degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have, and the general principle that consumers should take responsibility for their decisions; and
- reducing the extent to which it is possible for a business carried on by a regulated person to be used for a purpose connected with financial crime".

The FSA also has extensive rule-making powers, disciplinary powers, powers to seek injunctions and restitution and powers to impose penalties.<sup>(14)</sup>

**7.25 The Securities and Futures Bill of Hong Kong (Part XIV)** contains a number of exemplary provisions relating to insider dealing and other market misconduct such as

- false trading;
- price rigging;
- disclosure of information about prohibited transactions;
- disclosure of false or misleading information inducing transactions;
- stock market manipulation;
- involving fraudulent or deceptive devices in transactions in securities, futures contracts or leveraged foreign exchange trading;
- disclosure of false or misleading information inducing others to enter into leveraged foreign exchange contracts;
- falsely representing dealings in futures contracts on behalf of others.<sup>(15)</sup>

**7.26 Following the worldwide trend towards more flexibility and with adequate powers to intervene, it is recommended that the regulatory authority should have as its objectives**

- to maintain and promote fair, efficient, transparent and orderly securities, futures and related financial markets;**
- to maintain and promote public confidence in the financial systems operating in South Africa, including financial markets and exchanges, regulated activities and other activities connected therewith;**
- to protect members of the investing public;**
- to minimize financial crime and misconduct;**
- to reduce systemic risks in the securities and futures industry;**
- to assist the Government in maintaining the stability and integrity of the monetary and financial systems of South Africa;**
- any other objective conferred upon it by any other law.**

**7.27 It is further recommended that the regulatory authority should have the power to make such rules as appear to it to be necessary or expedient for the purposes of carrying out its functions, including rules relating**

- to the carrying on of any activity regulated by it;**

- to the issue of any financial products by any person;
- to the inspection of any issuer of financial products;
- to the conduct of the business of any issuer of financial products;
- to the inspection of any person carrying on any activity regulated by it.

**7.28** It is further recommended that the regulatory authority should have the power to seek injunctions and restitution whenever it appears to it that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of any of the provisions relating to financial products, the functions and powers of the regulator or any rule or regulation issued or prescribed in regard thereto.

**7.29** It is further recommended that the provisions of the Hong Kong Bill relating to market misconduct (suitably amended) should replace the present provisions of the South African law.

## NOTES

1. **The United States** has 51 securities regulators, 51 futures regulators, 65 banking regulators, 50 usury regulators, one Federal Reserve Board with 12 District Reserve Banks. (**Anthony Neoh**. Regulatory Development in the International Arena. 28 September 1998 [Hong Kong Securities Institute]).
2. (1994), 17 OSCB, p. 1 — 305.
3. **Ontario Securities Commission** : 'Rule-Making in Ontario'.  
[www.osc.gov.on.ca/en/Regulation/Rulemaking](http://www.osc.gov.on.ca/en/Regulation/Rulemaking)
4. **Financial Products, Service Providers, and Markets** — An Integrated Framework — Implementing CLERP 6 — (Corporate Law Economic Program, Commonwealth of Australia, 1999).
5. ASIC. Major Policy Comments on the CLERP 6 Consultation Paper, p. 19 (April 1999).
6. **The Government of the Hong Kong** Special Administrative Region.
7. **International Securities Regulation**. Argentina. Book 1 (Oceana Publications Inc.).

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(Translation by Estudio Becar Varela)

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**8. International Securities Regulation. Brazil. Book 1.**

The Securities Commission of Brazil has the authority to

- (a) examine and inspect the accounting records, books and documents of individuals and legal entities acting on the securities market;
- (b) order the above mentioned individuals and legal entities to render information or clarifications;
- (c) request information from any government entity;
- (d) investigate illegal acts and inequitable practices of the parties intervening on the securities market, and impose the appropriate penalties;
- (e) suspend the trading of a given security and declare the recess of stock exchanges;

(f) suspend or cancel any registration; and

(g) disclose information or make recommendations for the purpose of advising market participants".<sup>(9)</sup>

**9. The full text of section 172(1) reads as follows:**

(1) Where, in relation to a corporation which is, or was at the relevant time, listed

—

(a) it appears to the Commission that there are circumstances suggesting that the business of the corporation is being or has been conducted

—

(i) with intent to defraud its creditors, or the creditors of any other person;

(ii) for any fraudulent or unlawful purpose; or

(iii) in a manner oppressive to its members or any part of its members;

(b) it appears to the Commission that there are circumstances suggesting that the corporation was formed for any fraudulent or unlawful purpose;

(c) it appears to the Commission that there are circumstances suggesting that persons concerned in the process by which the corporation became listed (including that for making the securities of the corporation available to the public in the course of such process) have engaged, in relation to such process, in defalcation, fraud, misfeasance or other misconduct;

(d) it appears to the Commission that there are circumstances suggesting that persons involved in the management of the affairs of the corporation are or have engaged, in relation to such management, in defalcation, fraud, misfeasance or other misconduct towards it or its members;

- (e) it appears to the Commission that there are circumstances suggesting that members of the corporation or any part of its members have not been given all the information with respect to its affairs that they might reasonably expect; or
- (f) a matter in respect of the investigation in which the Commission decides to provide assistance under section 179 relates to the corporation and is, in the opinion of the Commission, of a nature similar to the matter described in paragraph (a), (b), (c), (d) or (e) as being suggested by the circumstances referred to in such paragraph.

an authorized person may, subject to subsections (5) to (10), give a direction to —

- (i) the corporation;
- (ii) a corporation that is, or was at the relevant time, a related corporation of the corporation;
- (iii) an authorized financial institution, other than the corporation or a corporation described in paragraph (ii);
- (iv) an auditor, other than the corporation or a corporation described in paragraph (ii);
- (v) any other person,

requiring the production, within the time and at the place specified in the direction, of any record and document specified in the direction".

**10. Section 173 (1) and (2) read as follows:**

- (1) Subject to subsections (9) and (10), an authorized person may at any reasonable time, for the purpose of ascertaining whether an intermediary or an associated entity of an intermediary is complying or has complied with, or is likely to be able to comply with, the requirement specified in subsection (2) —
  - (a) enter —

- (i) in the case of an intermediary —
    - (A) where it is a licensed corporation, its premises as approved by the Commission under section 129(1); or
    - (B) where it is an exempt person, the premises of the exempt person; or
  - (ii) in the case of an associated entity of an intermediary, the premises of the associated entity;
- (b) inspect, and make copies or otherwise record details of, any record or document relating to —
- (i) the business conducted by the intermediary or the associated entity (as the case may be);
  - (ii) any transaction carried out by a related corporation of the intermediary or the associated entity (as the case may be); or
  - (iii) any transaction or activity which was undertaken in the course of, or which may affect, the business conducted by the intermediary or the associated entity (as the case may be); and
- (c) make inquiries of —
- (i) the intermediary or the associated entity (as the case may be);
  - (ii) a related corporation of the intermediary or the associated entity (as the case may be);
  - (iii) subject to subsection (7), any other person, whether or not connected with the intermediary or the associated entity (as the case may be), whom the authorized person has reasonable cause to believe has information relating to, or

is in possession of, any record or document referred to in paragraph (b), concerning any record or document referred to in paragraph (b), or concerning any transaction or activity which was undertaken in the course of, or which may affect, the business conducted by the intermediary or the associated entity (as the case may be).

(2) The requirement specified for the purposes of subsection (1) is the requirement not to contravene —

- (a) any provision of this Ordinance;
- (b) any notice or requirement given or made under or pursuant to any of the relevant provisions;
- (c) any of the terms and conditions of a licence or an exemption under this Ordinance;
- (d) any other condition imposed under or pursuant to any provision of this Ordinance".

11. [www.lsc.lt/english/apie.html](http://www.lsc.lt/english/apie.html)

12. **The text reads as follows:**

**20. Powers and functions of the Commission. —**

(1) "The Commission shall have all such powers as may be necessary to perform its duties and functions under this Act.

.....  
.....

(4) The Commission shall be responsible for the performance of the following functions:

- (a) Regulating the issue of securities;
- (b) Regulating the business in Stock Exchanges and any other securities markets;

- (c) Supervising and monitoring the activities of any central depository and Stock Exchange clearing house;
- (d) Registering and regulating the working stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deed, registrars to an issue, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with the securities markets in any manner;
- (e) Proposing regulations for the registration and regulating the working of collective investment schemes, including unit trust schemes;
- (f) Promoting and regulating self-regulatory organizations including securities industry and related organizations such as Stock Exchanges and associations of mutual funds, leasing companies and other NBFIs;
- (g) Prohibiting fraudulent and unfair trade practices relating to securities markets;
- (h) Promoting investors' education and training of intermediaries of securities markets;
- (i) Conducting investigations in respect of matters related to this Act and the Ordinance and in particular for the purpose of investigating insider trading in securities and prosecuting offenders;
- (j) Regulating substantial acquisition of shares and the merger and take-over companies;
- (k) Calling for information from and undertaking inspections, conducting inquiries and audits of the Stock Exchanges and intermediaries and self-regulatory organizations in the securities market;

- (l) Considering and suggesting reforms of the law relating to companies and bodies corporate, securities markets, including changes to the constitution, rules and regulations of companies and bodies corporate, Stock Exchanges or clearing houses;
  - (m) Encouraging the organized development of the capital market and the corporate sector in Pakistan;
  - (n) Conducting research in respect of any of the matters set out in this sub-section;
  - (o) Performing such functions and exercising such powers of the Authority, including any powers of the Federal Government delegated to the Authority, (other than the power to make any rules or regulations) under the provisions of the Ordinance, and under any other law for the time being in force under which any function or power has been conferred on the Authority including, but not limited to, the functions and powers set out in the Schedule to this Act;
  - (p) Performing such functions and exercising such powers (other than the power to make any rules or regulations) under the Ordinance or any other law for the time being in force as may, after the commencement of this Act, be delegated to it by the Federal Government and exercising any power or performing any functions conferred on it by or under any other law for the time being in force; and
  - (q) Proposing regulations in respect of all or any of the aforesaid matters for the consideration and approval of the Board.
- (5) Without prejudice to the provisions of sub-section (4), the approval of the Commission shall be required by —
- (a) All public companies incorporated in Pakistan which intend to issue or offer for sale securities in markets outside

Pakistan or to list such securities on a Stock Exchange outside Pakistan, in each case, whether directly or through an intermediary;

- (b) All bodies corporate incorporated outside Pakistan which or persons who intend to issue or offer for sale, securities to the public in Pakistan or to list such securities on a Stock Exchange; and
  - (c) All bodies corporate incorporated outside Pakistan, which are already listed on a Stock Exchange, for the listing of and quotation for any additional securities.
- (6) In performing its functions and exercising its powers, the Commission shall strive —
- (a) To maintain facilities and improve the performance of companies and of securities markets, in the interest of commercial certainty, reducing business costs, and efficiency and development of the economy;
  - (b) To maintain the confidence of investors in the securities markets by ensuring adequate protection for such investors;
  - (c) To achieve uniformity in how it performs those functions and exercises those powers;
  - (d) To administer laws effectively but with a minimum of procedural requirements;
  - (e) To receive, process, and store, efficiently and quickly, the documents lodged with, and the information given to, it under this Act, the Ordinance or any other law;
  - (f) To ensure that the documents, and the information referred to in clause (e) are available as soon as possible for access by the public; and

- (g) To take whatever action it can take, and is necessary, in order to enforce and give effect to the Act and the Ordinance or any other law.

**21. Functions and powers of the Board. —**

- (1) Subject to the provisions of this Act, the Board shall —
  - (a) When so asked to do and after consultation with the Commission, advise the Federal Government on all matters relating to —
    - (i) The securities industry;
    - (ii) Regulation of companies and corporate sector and protection of the interests of investors;
    - (iii) Measures to encourage self-regulation by the Stock Exchanges and NBFIs by specifying the standards for such self-regulatory organizations;
    - (iv) Measures to promote the development of and to regulate the securities market; and
    - (v) Other related matters;
  - (b) Consider and approve (with or without modification) any regulations proposed to be made by the Commission under this Act;
  - (c) Consider and approve (with or without modification) the budget for each financial year of the Commission prepared and submitted to it pursuant to the provisions of sub-section (2) of section 24;
  - (d) Express its opinion in writing on any policy matter referred to it by the Federal Government or the Commission;

- (e) Oversee the performance of the Commission to the extent that the purposes of this Act are achieved;
  - (f) Exercise all such powers and perform all such functions as are conferred or assigned to it under this Act; and
  - (g) Specify fees, penalties and other charges chargeable by the Commission for carrying out the purposes of this Act.
- (2) All policy decisions, including any change in previously established policy, in respect of all and any matters within the jurisdiction of the Commission shall be made only by the Board. The Board may make policy decisions suo moto or adopt such policy recommendations of the Commission, with or without modification, as the Board may deem fit in its sole discretion.

**22. Supplementary provisions. —**

- (1) All guidelines, decisions and directives whether of the Board or the Commission shall be in writing expressed by resolutions, order or in such other form as may be appropriate in the circumstances and shall be authenticated in the manner prescribed by the regulations and where so provided by regulations, also sealed with the seal of the Commission.
- (2) All policy decisions and directives of the Board and the Commission respectively shall be published in the official Gazette and the Board and the Commission shall make such publications available to the public.
- (3) The Commission shall, in adjudicating upon the rights of any person whose application on any matter it is required to consider in the exercise of any power or function under this Act, give the reasons for its decision after giving the person concerned a personal hearing, in addition to any written applications or submission which may be required to be made.
- (4) The Commission when exercising its powers under this Act shall have regard, so far as relevant to the circumstances of the particular case, to —

- (a) The viability of the company or body corporate;
- (b) The quality and capability of the management of the company or body corporate;
- (c) The suitability for listing of the company or body corporate on a Stock Exchange where applicable;
- (d) The interest of public investors, existing or potential, in the company or body corporate;
- (e) Any policy decision or directives of the Board; and
- (f) The general public interest".

Regulation and supervision of companies have also been vested in the Commission.

- "1. To call for any information, document etc. for purposes of any proceeding or inquiry (section 12(4) of the Companies Ordinance).
- 2. To allow alteration in the Memorandum of Association (section 21 of the Ordinance).
- .....
- 5. To accord approval by conversion of a public company into a private company (section 44 of the Ordinance).
- 6. Approval of prospectus (section 57 of the Ordinance).
- 7. To allow issue of securities outside Pakistan (section 62A of the Ordinance).
- 8. To specify minimum amount of shares to be applied for and the form of application for shares (section 67 of the Ordinance).
- 9. To prescribe minimum amount of shares on issue of shares (section 2 of the Ordinance).

10. To sanction issue of shares at discount (section 84 of the Ordinance).
11. To grant extension in time for holding AGM in the case of listed companies (section 158 of the Ordinance).
12. To allow a company to make a loan to a director (section 195 of the Ordinance).
- .....
15. To prescribe cost accounting records for manufacturing companies (section 230 of the Ordinance).
16. To extend period for laying annual accounts in the AGM by listed companies (section 233 of the Ordinance).
- .....
18. To call for additional statements of accounts from companies (section 246 of the Ordinance).
19. To appoint auditors in certain cases (section 252 (6) of the Ordinance).
20. To conduct investigation into the affairs of the companies (sections 263 and 265 of the Ordinance).
21. To prosecute a company or person found guilty as a consequence of investigation (sections 270 and 271 of the Ordinance).
22. To appoint an administrator (section 295 of the Ordinance).
23. To make application to the Court for winding up a company (section 309 of the Ordinance).
24. To recommend a panel of persons to the Court for appointment as official liquidator (section 321 of the Ordinance).
- .....
29. To force companies to comply with the provisions of the Ordinance (section 472 of the Ordinance).

30. To impose a fine as penalty (section 476 of the Ordinance).
31. To hear appeals against the orders of Registrar (section 477 of the Ordinance).
32. To exercise powers of court in relation to esquires and proceedings (section 478 of the Ordinance).
33. To direct the appearance of officers of companies (section 479 of the Ordinance).
34. To apply an amount of the fine towards payments of costs, compensations, etc. (section 483 of the Ordinance).
- .....
37. To impose a penalty for wrongful withholding of company profit (section 493 of the Ordinance).
38. To impose a penalty for non-compliance with directions (section 495 of the Ordinance)".

**13. The Securities and Exchange Commission of the Philippines**

- "(3) The Commission shall have absolute jurisdiction, supervision and control over all corporations, partnerships or associations, who are grantees of primary franchises and/or licenses or permit issued by the government to operate in the Philippines, and in the exercise of its authority, it shall have the power to enlist the aid and support of and to deputize any and all enforcement agencies of the government, civil or military as well as any private institution, corporation, firm, association or person.
- (5) In addition to the regulatory and adjudicative functions of the Securities and Exchange Commission over corporations, partnerships and other forms of associations registered with it as expressly granted under existing laws and decrees, it shall have original and exclusive jurisdiction to hear and decide cases involving:

- (a) Devices or schemes employed by or any acts of the board of directors, business associates, its officers or partners, amounting to fraud and misrepresentation which may be detrimental to the interest of the public and/or of the stockholders, partners, members of associations or organizations registered with the Commission.
  - (b) Controversies arising out of intracorporate or partnership relations, between and among stockholders, members, or associates; between any or all of them and the corporation, partnership or association of which they are stockholders, members, or associates, respectively, and between such corporation, partnership or association and the state insofar as it concerns their individual franchise or right to exist as such entity.
  - (c) Controversies in the election or appointment of directors, trustees, officers or managers of such corporation, partnerships or associations.
  - (d) Petitions of corporations, partnerships or associations to be declared in the state of suspension of payments in cases where the corporation, partnership or association possesses sufficient property to cover all its debts but foresees the impossibility of meeting them when they respectively fall due or in cases where the corporation, partnership or association has no sufficient assets to cover its liabilities, but is under the management of a Rehabilitation Receiver or Management Committee pursuant to this Decree.
- (6) In order to effectively exercise such jurisdiction, the Commission shall possess the following powers:
- (a) To issue preliminary or permanent injunctions, whether prohibitory or mandatory, in all cases in which it has the jurisdiction, and in which cases the pertinent provisions of the Rules of Court shall apply;

- (b) To issue writs of attachment in cases in which it has jurisdiction, in order to preserve the right of the parties and in such cases the pertinent provisions of the Rules of Court shall apply;
- (c) To appoint one or more receivers of the property, real or personal;
- (d) To create and appoint a management committee, board, or body upon petition or *motu proprio* to undertake the management of corporations, partnerships or other associations not supervised or regulated by other government agencies in appropriate cases when there is imminent danger of dissipation, loss, wastage or destruction of assets;
- (e) To punish for contempt of the Commission, both direct and indirect, in accordance with the pertinent provisions of, and penalties prescribed by the Rules of Court;
- (f) To compel the officers of any corporation or association registered by it to call meetings of stockholders or members thereof under its supervision;
- (g) To pass upon the validity of the issuance and use of proxies and voting trust agreements for absent stockholders or members;
- (h) To issue subpoena *duces tecum* and summon witnesses to appear in any proceedings of the Commission and in appropriate cases order the examination, search and seizure of all documents, papers, files and records, tax returns, and books of accounts of any entity or person under investigation as may be necessary for the proper disposition of the cases before it, notwithstanding the provisions of any law to the contrary;

- (i) To impose fines and/or penalties for violation of this Decree or any other laws being implemented by the Commission, the pertinent rules and regulations, its orders, decision and/or rulings;
- (j) To authorize the establishment and operation of stock exchanges, commodity exchanges and such other similar organizations and to supervise and regulate the same, including the authority to determine their number, size and location, in the light of national or regional requirements for such activities with the view to promote, conserve or rationalize investment;
- (k) To pass upon, refuse or deny after consultation with the Board of Investments, Department of Trade and Industry, National Economic and Development Authority or any other appropriate government agency, the application for registration of any corporation, partnership or association or any form of organization falling within its jurisdiction, if their establishment, organization or operation will not be consistent with the declared national economic policies;
- (l) To suspend, or revoke, after proper notice and hearing, the franchise or certificate of registration of corporations, partnerships or associations, upon any of the grounds provided by law, including the following:
  - 1. Fraud in procuring its certificate of registration;
  - 2. Serious misrepresentation as to what the corporation can do or is doing to the great prejudice of or damage to the general public;
  - 3. Refusal to comply or defiance of any lawful order of the Commission restraining commission of acts which would amount to a grave violation of its franchise;

4. Continuous inoperation for a period of at least five (5) years;
  5. Failure to file by-laws within the required period;
  6. Failure to file required reports in appropriate forms as determined by the Commission within the prescribed period; (As amended by P.D. 1758)
- (m) To exercise such other powers as may be provided by law as well as those which may be implied from, or which are necessary or incidental to the carrying out of, the express powers granted to the Commission to achieve the objectives and purposes of this Decree.

**The Prosecution and Enforcement Department** shall have, subject to the Commission's control and supervision, the exclusive authority to investigate on complaint or *motu proprio*, any act or omission of the Board of Directors/Trustees of corporations, or of partnerships, or of other associations, or of their stockholders, officers or partners, including any fraudulent devices, schemes or representations, in violation of any law or rules and regulations administered and enforced by the Commission, to file and prosecute in accordance with law and rules and regulations issued by the Commission and in appropriate cases, the corresponding criminal or civil case before the Commission or the proper court or body upon *prima facie* finding of violation of any laws or rules and regulations administered and enforced by the Commission, and to perform such other powers and functions as may be provided by law or duly delegated to it by the Commission.

**The Supervising and Monitoring Department** shall have the power of supervision over all corporations, partnerships and associations registered with the Commission in all matters pertaining to their compliance with laws, mandatory provisions and requirements of pertinent rules and regulations administered and enforced by the Commission, as well as their respective by-

laws duly approved by the Commission, integrate, analyze and coordinate with, and recommend to the appropriate departments for proper action and enforcement; and to do and perform such other functions as may be duly delegated by the Commission.

The proceeds and effect of crimes committed by any person or entity in violation of the laws and regulations administered and enforced by the Commission shall be forfeited, seized and confiscated in favor of the State upon order of the Commission, after due notice and hearing".

**14. Some examples of the Rule-making powers of the FSA are:**

**"Section 133**

- (1) The Authority may make such rules applying to authorised persons
  - (a) with respect to the carrying on by them of regulated activities, or
  - (b) with respect to the carrying on by them of activities which are not regulated activities,as appear to it to be necessary or expedient for the purpose of protecting the interests of consumers.

**Section 135**

- (1) The Authority may make rules prohibiting an authorised person who has permission to act as the manager of an authorised unit trust scheme from carrying on specified activity.
- (2) Such rules may specify an activity which is not a regulated activity.

**Section 136**

- (1) The Authority may make rules prohibiting an authorised person who has permission to deal in contracts of insurance from carrying on a specified activity.

- (2) Such rules may specify an activity which is not a regulated activity.
- (3) The Authority may make rules in relation to contracts entered into by an authorised person in the course of carrying on long-term insurance business.
- (4) Such rules may, in particular —
  - (a) restrict the descriptions of property or indices of the value of property by reference to which the benefits under such contracts may be determined;
  - (b) make provision, in the interests of the protection of policyholders, for the substitution of one description of property, or index of value, by reference to which the benefits under a contract are to be determined for another such description of property or index.
- (5) Rules made under this section are referred to in this Act as insurance business rules.

#### Section 138

- (1) The Authority may make rules ('endorsing rules') —
  - (a) endorsing the City Code on Takeovers and Mergers issued by the Panel on Takeovers and Mergers;
  - (b) endorsing the rules Governing Substantial Acquisitions of Shares issued by the Panel.
- (2) Endorsement may be —
  - (a) as respects all authorised persons; or
  - (b) only as respects a specified kind of authorised person.

#### Section 139

- (1) The Authority may make rules ('price stabilising rules') as to —

- (a) the circumstances and manner in which,
- (b) the conditions subject to which, and
- (c) the time when or the period during which

action may be taken for the purpose of stabilising the price of investments of specified kinds.

#### **Section 140**

- (1) The Authority may make rules applying to authorised persons about the communication by them, or their approval of the communication by others, of invitations or inducements —
  - (a) to engage in investment activity; or
  - (b) to participate in a collective investment scheme.
- (2) Rules under this section may, in particular, make provision about the form and content of communications.
- (3) Subsection (1) applies only to communications which —
  - (a) if made by a person other than an authorised person, without the approval of an authorised person, would contravene section 19(1);
  - (b) may be made by an authorised person without contravening section 233(1).

#### **Section 141**

The Authority may make rules in relation to the prevention and detection of money laundering in connection with the carrying on of regulated activities by authorised persons.

Section 142

- (1) The Authority may make rules ('control of information rules') requiring an authorised person ('A') to withhold information from a person ('B') for or with whom he does business in the course of carrying on any regulated or other activity.
- (2) Control of information rules may —
  - (a) require the withholding of information which A would otherwise have legal obligation to disclose to B;
  - (b) require A to restrict or prevent the passing of information within his business".

**15. The full text of the Hong Kong Bill** reads as follows:

Division 1 — Interpretation

**277.** Interpretation of Part XIV

- (1) In this Part, unless the context otherwise requires —

'associate', in relation to a person, means —

- (a) the person's spouse or reputed spouse, any person cohabiting with the person as a spouse, the person's brother, sister, parent, step-parent, child (natural or adopted) or step-child;
- (b) any corporation of which the person is a director;
- (c) any employee or partner of the person;
- (d) where the person is a corporation, each of its directors and its related corporations and each director or employee of any of its related corporations;

(e) without limiting the circumstances in which paragraphs (a) to (d) apply, in circumstances concerning the securities of or other interest in a corporation, or rights arising out of the holding of such securities or such interest, any other person with whom the person has an agreement or arrangement —

(i) with respect to the acquisition, holding or disposal of such securities or such interest; or

(ii) under which they undertake to act together in exercising their voting power at general meetings of the corporation;

'controller', in relation to a corporation, means any person —

(a) in accordance with whose directions or instructions the directors of the corporation or of another corporation of which it is a subsidiary are accustomed or obliged to act; or

(b) who, either alone or with any of his associates, is entitled to exercise or control the exercise of more than 33% of the voting power at general meetings of the corporation or of another corporation of which it is a subsidiary;

'relevant overseas market' —

(a) in relation to securities, means a stock market outside Hong Kong; or

(b) in relation to futures contracts, means a futures market outside Hong Kong;

'relevant recognized market' —

(a) in relation to securities, means a recognized stock market; or

(b) in relation to futures contracts, means a recognized futures market.

(2) In this subsection and sections 278 to 281 and Division 2, unless the context otherwise requires —

'derivatives', in relation to listed securities, means —

- (a) rights, options or interests (whether described as units or otherwise) in, or in respect of, the listed securities;
- (b) contracts, the purpose or pretended purpose of which is to secure or increase a profit or avoid or reduce a loss, wholly or partly by reference to the price or value, or a change in the price or value, of —
  - (i) the listed securities; or
  - (ii) any rights, options or interests referred to in paragraph (a) ;
- (c) rights, options or interests (whether described as units or otherwise) in, or in respect of —
  - (i) any rights, options or interests referred to in paragraph (a); or
  - (ii) any contracts referred to in paragraph (b) ;
- (d) instruments or other documents creating, acknowledging or evidencing any rights, options or interests or any contracts referred to in paragraph (a), (b) or (c) including certificates of interest or participation in, temporary or interim certificates for, receipts (including depositary receipts) in respect of, or warrants to subscribe for or purchase-
  - (i) the listed securities; or
  - (ii) the rights, options or interests or the contracts,

whether or not the derivatives are listed and regardless of who issued or made them;

'listed corporation' means a corporation which has issued securities that are, at the time of the relevant contravention in relation to the corporation, listed;

'listed securities' means —

- (a) securities which, at the time of the relevant contravention in relation to a corporation, have been issued by the corporation and are listed;
- (b) securities which, at the time of the relevant contravention in relation to a corporation, have been issued by the corporation and are not listed, but which, at that time, it is reasonably foreseeable will be and which, in fact, are subsequently listed;
- (c) securities which, at the time of the relevant contravention in relation to a corporation, have not been issued by the corporation and are not listed, but which, at that time, it is reasonably foreseeable will be and which, in fact, are subsequently so issued and listed;

'relevant contravention' means a contravention of any of the provisions of Division 2;

'relevant information', in relation to a corporation, means specific information about —

- (a) the corporation;
- (b) a shareholder or officer of the corporation; or
- (c) the listed securities of the corporation or their derivatives,

which is not generally known to the persons who are accustomed or would be likely to deal in the listed securities of the corporation but which would if it were generally known to them be likely to materially affect the price of the listed securities;

'securities' means —

- (a) shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, or which it is reasonably foreseeable will be issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority;

- (b) rights, options or interests (whether described as units or otherwise) in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
  - (c) certificates of interest or participation in, temporary or interim certificates for, receipts for, or warrants to subscribe for or purchase, such shares, stocks, debentures, loan stocks, funds, bonds or notes;
  - (d) interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities;
  - (e) interests, rights or property, whether in the form of an instrument or otherwise, prescribed by notice under section 379 as being regarded as securities in accordance with the terms of the notice.
- (3) For the purposes of the definition of "controller" in subsection (1), where a person is entitled to exercise or control the exercise of more than 33% of the voting power at general meetings of a corporation and the corporation is entitled to exercise or control the exercise of any of the voting power at general meetings of another corporation ("the effective voting power"), then the effective voting power at general meetings of the other corporation shall be regarded as exercisable by the person.
- (4) For the purposes of this Part, a person shall not be regarded as a person in accordance with whose directions or instructions the directors of a corporation are accustomed or obliged to act by reason only that the directors of the corporation act on advice given by him in a professional capacity.

**278. Interest in securities (insider dealing offence)**

For the purposes of sections 277(2) and 279 to 281 and Division 2, a reference to an interest in securities shall be construed as including an interest of any kind in the securities, and for that purpose any restraint or restriction to which the exercise of a right attached to the interest may be subject shall be disregarded.

**279. Connected with a corporation**

(insider dealing offence)

- (1) For the purposes of Division 2, a person shall be regarded as connected with a corporation if, being an individual —
- (a) he is a director or employee of the corporation or a related corporation of the corporation;
  - (b) he is a substantial shareholder of the corporation or a related corporation of the corporation;
  - (c) he occupies a position which may reasonably be expected to give him access to relevant information in relation to the corporation by reason of —
    - (i) a professional or business relationship existing between —
      - (A) himself, or his employer, or a corporation of which he is a director, or a firm of which he is a partner; and
      - (B) the corporation, a related corporation of the corporation, or an officer or substantial shareholder of either corporation; or
    - (ii) his being a director, employee or partner of a substantial shareholder of the corporation or a related corporation of the corporation;
  - (d) he has access to relevant information in relation to the corporation and —
    - (i) he has such access by reason of his being in such a position that he would be regarded as connected with another corporation by virtue of paragraph (a), (b) or (c); and
    - (ii) the relevant information relates to a transaction (actual or contemplated) involving both those corporations or involving one of them and the listed securities of the other

or their derivatives, or to the fact that the transaction is no longer contemplated; or

(e) he was, at any time within the 6 months preceding the relevant contravention in relation to the corporation, a person who would be regarded as connected with the corporation by virtue of paragraph (a), (b), (c) or (d).

(2) For the purposes of Division 2, a corporation shall be regarded as a person connected with another corporation so long as any of its directors or employees is a person who would be regarded as connected with that other corporation by virtue of subsection (1).

(3) In subsection (1), notwithstanding any other provisions of this Ordinance, "substantial shareholder" (~t ~t#), in relation to a corporation, means a person who has an interest of any kind in the relevant share capital of the corporation, the nominal value of which is equal to or more than 5% of the nominal value of the relevant share capital of the corporation.

**280. Connected with a corporation-possession of relevant information obtained in privileged capacity (insider dealing offence)**

(1) For the purposes of Division 2, where a public officer or a specified person in that capacity receives relevant information in relation to a corporation, he shall be regarded as a person connected with the corporation.

(2) In subsection (1), a reference to a specified person means a person who is —

(a) a member of the Executive Council;

(b) a member of the Legislative Council;

(c) a member of a board, commission, committee or other body appointed by or on behalf of the Chief Executive or the Chief Executive in Council under an Ordinance;

(d) an officer or employee of a recognized exchange company, a recognized clearing house or a recognized exchange controller;

- (e) an exchange participant;
- (f) an officer or employee of an exchange participant;
- (g) an officer or employee of a body corporate incorporated by an Ordinance; or
- (h) an officer or employee of a body corporate specified by the Financial Secretary under subsection (3),

whether, in the case of paragraph (a), (b), (c), (d), (f), (g) or (h), the person is such a member, officer or employee (as the case may be) on a temporary or permanent basis, and whether he is paid or unpaid.

- (3) The Financial Secretary may, by notice published in the Gazette, specify any body corporate for the purposes of subsection (2) (h).

**281. Dealing in listed securities or their derivatives (insider dealing offence)**

For the purposes of section 277(2) and Division 2, a person shall be regarded as dealing in listed securities or their derivatives if, whether as principal or agent, he sells, purchases, exchanges or subscribes for, or agrees to sell, purchase, exchange or subscribe for, any listed securities or their derivatives or acquires or disposes of, or agrees to acquire or dispose of, the right to sell, purchase, exchange or subscribe for, any listed securities or their derivatives.

**282. Interest in securities and beneficial ownership, etc. (market misconduct offence other than insider dealing offence)**

- (1) For the purposes of Division 3, a person shall be regarded as having an interest in securities if he has authority, whether formal or informal and whether express or implied, to dispose of or to exercise control over the disposal of the securities or, in the case of options in respect of the securities, to exercise the options.
- (2) It is immaterial that the authority of a person referred to in subsection (1) —
  - (a) is, or is capable of being made, subject to restraint or restriction; or

- (b) is exercisable jointly with another person.
  
- (3) A person shall be regarded as having the authority referred to in subsection (1) where a corporation has the authority referred to in that subsection and—
  - (a) the corporation is, or its directors are, accustomed or under an obligation, whether formal or informal, to act in accordance with the directions or instructions of the person in relation to the securities in question; or
  - (b) the person, or an associate of the person, is a controller of the corporation.
  
- (4) Where a person —
  - (a) has entered into a contract to purchase securities;
  - (b) has a right to have securities transferred to him or to his order whether the right is exercisable presently or in the future and whether on the fulfilment of a condition or not; or
  - (c) has the right to acquire securities, or an interest in securities, under an option, whether the right is exercisable presently or in the future and whether on the fulfilment of a condition or not,

the person shall, to the extent to which he could do so on completing the contract, enforcing the right or exercising the option, be regarded as having the authority referred to in subsection (1).
  
- (5) Where securities are subject to a trust, and a person who is not a trustee in those securities has an interest in those securities by virtue of subsection (4)(b), the interest of a trustee in those securities shall be disregarded for the purpose of determining whether the person has an interest in securities for the purposes of Division 3.
  
- (6) The Commission may make rules to prescribe that an interest, being an interest of a person or of the persons included in a class of persons, shall be disregarded for the purpose of determining whether the person or the persons has or have an interest in securities for the purposes of Division 3.

- (7) For the purposes of Division 3, a sale or purchase of securities does not involve a change in their beneficial ownership if a person who had an interest in the securities before the sale or purchase, or an associate of the person, has an interest in the securities after the sale or purchase.

## **Division 2 — Insider dealing offence**

### **283. Offence of insider dealing**

- (1) A person connected with a listed corporation and having information which he knows is relevant information in relation to the corporation shall not —
- (a) deal in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives; or
  - (b) counsel or procure another person to deal in such listed securities or derivatives, knowing or having reasonable cause to believe that the other person will deal in them.
- (2) A person who is contemplating or has contemplated making, whether with or without another person, a take-over offer for a listed corporation and who knows that the information that the offer is contemplated or is no longer contemplated is relevant information in relation to the corporation shall not —
- (a) deal in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives, otherwise than for the purpose of the take-over; or
  - (b) counsel or procure another person to deal in such listed securities or derivatives, otherwise than for the purpose of the take-over.
- (3) A person connected with a listed corporation and knowing that any information is relevant information in relation to the corporation shall not disclose the information, directly or indirectly, to another person, knowing or having reasonable cause to believe that the other person will make use of the

information for the purpose of dealing, or of counselling or procuring another person to deal, in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives.

- (4) A person who is contemplating or has contemplated making, whether with or without another person, a take-over offer for a listed corporation and who knows that the information that the offer is contemplated or is no longer contemplated is relevant information in relation to the corporation shall not disclose the information, directly or indirectly, to another person, knowing or having reasonable cause to believe that the other person will make use of the information for the purpose of dealing, or of counselling or procuring another person to deal, in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives.
- (5) A person who has information which he knows is relevant information in relation to a listed corporation and which he received, directly or indirectly, from a person whom he knows is connected with the corporation and whom he knows or has reasonable cause to believe held the information as a result of being connected with the corporation shall not —
  - (a) deal in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives; or
  - (b) counsel or procure another person to deal in such listed securities or derivatives.
- (6) A person who has received, directly or indirectly, from a person whom he knows or has reasonable cause to believe is contemplating or is no longer contemplating making a take-over offer for a listed corporation, information to that effect which he knows is relevant information in relation to the corporation shall not —
  - (a) deal in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives; or

- (b) counsel or procure another person to deal in such listed securities or derivatives.
- (7) A person who knowingly has relevant information in relation to a listed corporation in any of the circumstances described in subsection (1), (2), (3), (4), (5) or (6) shall not —
  - (a) counsel or procure another person to deal in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives, knowing or having reasonable cause to believe that the other person will deal in such listed securities or derivatives outside Hong Kong on a stock market other than a recognized stock market; or
  - (b) disclose the relevant information to another person knowing or having reasonable cause to believe that the other person or some other person will make use of the relevant information for the purpose of dealing, or of counselling or procuring any other person to deal, in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives, outside Hong Kong on a stock market other than a recognized stock market.
- (8) Subject to sections 284, 285 and 286, a person who contravenes subsection (1), (2), (3), (4), (5), (6) or (7) commits an offence.

**284. Insider dealing offence — general defences**

- (1) Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283, it is a defence to the charge for the person to prove that the conduct which constituted the contravention was carried out —
  - (a) for the sole purpose of acquiring shares required for his being qualified as a director or intending director of a corporation;
  - (b) in the performance in good faith of an underwriting agreement for the securities to which the transaction relates; or

- (c) in the performance in good faith of his functions as a liquidator, receiver or trustee in bankruptcy.
  
- (2) Where a corporation is charged with an offence under section 283(8) in respect of a contravention of section 283 by reason of having entered into a transaction in the listed securities of a listed corporation or their derivatives, it is a defence to the charge for the corporation to prove that —
  - (a) although one or more of its directors or employees had the relevant information in relation to the listed corporation, each person who took the decision to enter into the transaction for it did not have the relevant information up to (and including) the time when it entered into the transaction;
  - (b) arrangements then existed to secure that —
    - (i) the relevant information was, up to (and including) the time when it entered into the transaction, not communicated to any person who took the decision; and
    - (ii) none of its directors or employees who had the relevant information gave advice concerning the transaction to any person who took the decision at any time before it entered into the transaction; and
  - (c) the relevant information was in fact not so communicated to any person who took the decision and none of its directors or employees who had the relevant information in fact so gave the advice to any person who took the decision.
  
- (3) Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283 by reason of having entered into a transaction in listed securities or their derivatives, it is a defence to the charge for the person to prove that the purpose for which he entered into the transaction was not, or, where there was more than one purpose, the purposes for which he entered into the transaction did not include, the purpose of securing or increasing a profit or avoiding or reducing a loss, whether for himself or another, by using relevant information.

- (4) Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283 by reason of having entered into a transaction in listed securities or their derivatives, it is a defence to the charge for the person to prove that —
- (a) he entered into the transaction as agent for another person;
  - (b) he did not select or advise on the selection of the listed securities or the derivatives (as the case may be) ;
  - (c) he had no knowledge or reasonable cause to suspect that the other person had the relevant information in question; and
  - (d) he did not counsel or procure the other person in relation to the transaction.
- (5) Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283 by reason of having entered into a transaction in listed securities or their derivatives, it is a defence to the charge for the person to prove that —
- (a) he and the other party to the transaction entered into the transaction directly with each other; and
  - (b) at the time he entered into the transaction —
    - (i) the other party to the transaction knew, or ought reasonably to have known, of the relevant information in question; and
    - (ii) the transaction was not required to be recorded on a recognized stock market or to be notified to a recognized stock market under the rules of the recognized exchange company by which the recognized stock market is operated.
- (6) Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283 by reason of having entered into a transaction in listed securities of a corporation or their derivatives, it is a defence to the charge for the person to prove that

- (a) he entered into the transaction, otherwise than as a person who has counselled or procured the other party to the transaction to deal in listed securities or their derivatives; and
  - (b) at the time he entered into the transaction, the other party to the transaction knew, or ought reasonably to have known, that he was a person connected with the corporation.
- (7) Where a person is charged with an offence under section 283(8) by reason of having contravened section 283 as a person who has counselled or procured another person to deal in listed securities of a corporation or their derivatives, it is a defence to the charge for the person to prove that —
  - (a) the other person entered into the transaction, otherwise than as a person who has counselled or procured the other party to the transaction to deal in listed securities or their derivatives; and
  - (b) at the time the other person entered into the transaction, the other party to the transaction knew, or ought reasonably to have known, that the other person was a person connected with the corporation.
- (8) Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283 by reason of having entered into a transaction in listed securities or their derivatives, it is a defence to the charge for the person to prove that the transaction is a market contract.

**285. Insider dealing offence-defences for certain trustees and personal representatives**

Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283 by reason of having entered into a transaction in listed securities or their derivatives and he entered into the transaction as a trustee or personal representative, it is a defence to the charge for the person to prove that he acted on advice obtained in good faith from another person, and —

- (a) that other person appeared to him to be an appropriate person from whom to seek the advice; and

- (b) it did not appear to him that, had that other person entered into the transaction, that other person would contravene section 283.

**286. Insider dealing offence-defences for certain persons exercising right to subscribe for or acquire securities or derivatives**

Where a person is charged with an offence under section 283(8) in respect of a contravention of section 283 through his exercise of a right to subscribe for or otherwise acquire the listed securities of a corporation or their derivatives, it is a defence to the charge for the person to prove that the right was granted to him or was derived from securities or their derivatives that were held by him before he became aware of any relevant information in relation to the corporation.

Division 3 – Other market misconduct offences

**287. Offence of false trading**

- (1) A person shall not, in Hong Kong or elsewhere, intentionally or recklessly —
  - (a) create;
  - (b) cause to be created; or
  - (c) do anything that is likely to create,  
  
a false or misleading appearance —
    - (i) of active trading in securities or futures contracts traded on a relevant recognized market or by means of authorized automated trading services; or
    - (ii) with respect to the market for, or the price for dealings in, securities or futures contracts traded on a relevant recognized market or by means of authorized automated trading services.
- (2) A person shall not, in Hong Kong, intentionally or recklessly —

- (a) create;
- (b) cause to be created; or
- (c) do anything that is likely to create,

a false or misleading appearance —

- (i) of active trading in securities or futures contracts traded on a relevant overseas market; or
  - (ii) with respect to the market for, or the price for dealings in, securities or futures contracts traded on a relevant overseas market.
- (3) A person shall not, in Hong Kong or elsewhere, take part in, be concerned in, or carry out, directly or indirectly, one or more transactions (whether or not any of them is a dealing in securities or futures contracts), with the intention that, or being reckless as to whether, it or they has or have, or is or are likely to have, the effect of creating an artificial price, or maintaining at a level that is artificial (whether or not it was previously artificial) a price, for dealings in securities or futures contracts traded on a relevant recognized market or by means of authorized automated trading services.
- (4) A person shall not, in Hong Kong, take part in, be concerned in, or carry out, directly or indirectly, one or more transactions (whether or not any of them is a dealing in securities or futures contracts), with the intention that, or being reckless as to whether, it or they has or have, or is or are likely to have, the effect of creating an artificial price, or maintaining at a level that is artificial (whether or not it was previously artificial) a price, for dealings in securities or futures contracts traded on a relevant overseas market.
- (5) Without limiting the generality of subsection (1) or (2), a person who —
- (a) enters into or carries out, directly or indirectly, any transaction of sale or purchase, or any transaction which purports to be a transaction of sale or purchase, of securities that does not involve a change in the beneficial ownership of them;
  - (b) offers to sell securities at a price that is substantially the same as the price at which he has made or proposes to make, or knows that

an associate of his has made or proposes to make, an offer to purchase the same or substantially the same, number of them; or

(c) offers to purchase securities at a price that is substantially the same as the price at which he has made or proposes to make, or knows that an associate of his has made or proposes to make, an offer to sell the same or substantially the same, number of them, shall, for the purposes of subsection (1) or (2), be regarded as having intentionally or recklessly created, caused to be created, or done something that is likely to create, a false or misleading appearance

—  
(i) where the securities are traded on a relevant recognized market or by means of authorized automated trading services, of active trading in securities so traded or with respect to the market for, or the price for dealings in, securities so traded; or

(ii) where the securities are traded on a relevant overseas market, of active trading in securities so traded or with respect to the market for, or the price for dealings in, securities so traded.

(6) Subject to subsection (7), a person who contravenes subsection (1), (2), (3) or (4) commits an offence.

(7) Where a person is charged with an offence under subsection (6) in respect of a contravention of subsection (1) or (2) by reason of having committed an act referred to in subsection (5)(a), (b) or (c), it is a defence to the charge for the person to prove that the purpose for which he committed the act was not, or, where there was more than one purpose, the purposes for which he committed the act did not include, the purpose of creating a false or misleading appearance of active trading in securities, or with respect to the market for, or the price for dealings in, securities, referred to in subsection (1) or (2) (as the case may be).

(8) In this section —

(a) a reference to a transaction of sale or purchase, in relation to securities, includes an offer to sell or purchase securities and an

invitation (however expressed) that expressly or impliedly invites a person to offer to sell or purchase securities; and

- (b) a reference to entering into or carrying out a transaction of sale or purchase shall, in the case of an offer or an invitation referred to in paragraph (a), be construed as a reference to making the offer or the invitation (as the case may be).

**288. Offence of price rigging**

(1) A person shall not, in Hong Kong or elsewhere —

- (a) enter into or carry out, directly or indirectly, any transaction of sale or purchase of securities that does not involve a change in the beneficial ownership of those securities, which has the effect of maintaining, increasing, reducing, stabilizing, or causing fluctuations in the price of securities traded on a relevant recognized market or by means of authorized automated trading services; or
- (b) enter into or carry out, directly or indirectly, any fictitious or artificial transaction or device, with the intention that, or being reckless as to whether, it has the effect of maintaining, increasing, reducing, stabilizing, or causing fluctuations in, the price of securities, or the price for dealings in futures contracts, that are traded on a relevant recognized market or by means of authorized automated trading services.

(2) A person shall not, in Hong Kong —

- (a) enter into or carry out, directly or indirectly, any transaction of sale or purchase of securities that does not involve a change in the beneficial ownership of those securities, which has the effect of maintaining, increasing, reducing, stabilizing, or causing fluctuations in, the price of securities traded on a relevant overseas market; or
- (b) enter into or carry out, directly or indirectly, any fictitious or artificial transaction or device, with the intention that, or being

reckless as to whether, it has the effect of maintaining, increasing, reducing, stabilizing, or causing fluctuations in, the price of securities, or the price for dealings in futures contracts, that are traded on a relevant overseas market.

- (3) For the purposes of subsections (1)(b) and (2)(b), the fact that a transaction is, or at any time was, intended to have effect according to its terms is not conclusive in determining whether the transaction is, or was, not fictitious or artificial.
- (4) Subject to subsection (5), a person who contravenes subsection (1) or (2) commits an offence.
- (5) Where a person is charged with an offence under subsection (4) in respect of a contravention of subsection (1)(a) or (2)(a) taking place through any transaction of sale or purchase of securities that does not involve a change in the beneficial ownership of those securities, it is a defence to the charge for the person to prove that the purpose for which the securities were sold or purchased was not, or, where there was more than one purpose, the purposes for which the securities were sold or purchased did not include, the purpose of creating a false or misleading appearance with respect to the price of securities.
- (6) In this section-
  - (a) a reference to a transaction of sale or purchase, in relation to securities, includes an offer to sell or purchase securities and an invitation (however expressed) that expressly or impliedly invites a person to offer to sell or purchase securities; and
  - (b) a reference to entering into or carrying out a transaction of sale or purchase shall, in the case of an offer or an invitation referred to in paragraph (a), be construed as a reference to making the offer or the invitation (as the case may be).

## **289. Offence of disclosure of information about prohibited transactions**

- (1) A person shall not disclose, circulate or disseminate, or authorize or be concerned in the disclosure, circulation or dissemination of, information to the effect that the price of securities of a corporation, or the price for dealings in futures contracts, that are traded on a relevant recognized market or by means of authorized automated trading services will be maintained, increased, reduced or stabilized, or is likely to be maintained, increased, reduced or stabilized, because of a prohibited transaction relating to securities of either the corporation or a related corporation of the corporation or to the futures contracts (as the case may be), if he, or an associate of his —
  - (a) has entered into or carried out, directly or indirectly, the prohibited transaction; or
  - (b) has received, or expects to receive, directly or indirectly, a benefit as a result of the disclosure, circulation or dissemination of the information.
- (2) Subject to subsection (3), a person who contravenes subsection (1) commits an offence.
- (3) Where a person is charged with an offence under subsection (2) in respect of a contravention of subsection (1) on the basis that he, or an associate of his, received, or expected to receive, directly or indirectly, a benefit as a result of any disclosure, circulation or dissemination of information, it is a defence to the charge for the person to prove that —
  - (a) the benefit which he or the associate of his (as the case may be) received, or expected to receive, was not from a person who has entered into or carried out, directly or indirectly, the prohibited transaction in question, or an associate of such person; or
  - (b) the benefit which he or the associate of his (as the case may be) received, or expected to receive, was from a person who has entered into or carried out, directly or indirectly, the prohibited transaction in question, or an associate of such person, but up to

(and includingJ the time of the disclosure, circulation or dissemination of the information he has acted in good faith.

- (4) In this section —
- (a) a reference to a prohibited transaction means any conduct or transaction which constitutes market misconduct or a contravention of any of the provisions of Divisions 2 to 4; and
  - (b) a reference to any person having entered into or carried out the prohibited transaction shall be construed accordingly.

**290. Offence of disclosure of false or misleading information inducing transactions**

- (1) A person shall not, in Hong Kong or elsewhere, disclose, circulate or disseminate, or authorize or be concerned in the disclosure, circulation or dissemination of, information that is likely —
- (a) to induce another person to -subscribe for securities, or deal in futures contracts, in Hong Kong;
  - (b) to induce the sale or purchase in Hong Kong of securities by another person; or
  - (c) to maintain, increase, reduce or stabilize the price of securities, or the price for dealings in futures contracts, in Hong Kong,
- if —
- (i) the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact; and
  - (ii) the person knows that, or is reckless or negligent as to whether, the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact.
- (2) Subject to subsections (3) to (5), a person who contravenes subsection (1) commits an offence.

- (3) Where a person is charged with an offence under subsection (2) in respect of a contravention of subsection (1) taking place in relation to any disclosure, circulation or dissemination of information, it is a defence to the charge for the person to prove that —
- (a) he carried on a business the principal purpose of which was to provide the service of issuing or reproducing materials provided to him by others;
  - (b) the information was issued or reproduced by him in the ordinary course of that business;
  - (c) the contents of the information were wholly devised by a customer of his or by a person acting on behalf of a customer of his;
  - (d) the nature of the service which he provided in relation to the information was such that he did not select, modify or otherwise exercise control over the contents of the information prior to its issue or reproduction; and
  - (e) at the time he issued or reproduced the information, he did not know that it was false or misleading as to a material fact or was false or misleading through the omission of a material fact.
- (4) Where a person is charged with an offence under subsection (2) in respect of a contravention of subsection (1) taking place in relation to any disclosure, circulation or dissemination of information, it is a defence to the charge for the person to prove that —
- (a) he carried on a business the normal conduct of which involved the re-transmission of information to other persons within an information system or from one information system to another information system (wherever situated), whether directly or by facilitating the establishment of links between such other persons and third parties;
  - (b) the information was re-transmitted by him to other persons in the ordinary course of such re-transmission of information;

- (c) the contents of the information were devised by another person and he did not modify or otherwise exercise control over its contents prior to its re-transmission;
  - (d) the re-transmission of the information by him —
    - (i) was accompanied by a message to the effect; or
    - (ii) was effected following acknowledgment by the persons to whom it was re-transmitted of their understanding, that he did not devise the contents of the information and that he neither took responsibility for it nor endorsed its accuracy; and
  - (e) at the time he re-transmitted the information —
    - (i) he did not know that it was false or misleading as to a material fact or was false or misleading through the omission of a material fact; or
    - (ii) he knew that it was false or misleading as to a material fact or was false or misleading through the omission of a material fact, but in the circumstances of the case he could not reasonably be expected to prevent the re-transmission.
- (5) Where a person is charged with an offence under subsection (2) in respect of a contravention of subsection (1) taking place in relation to any disclosure, circulation or dissemination of information, it is a defence to the charge for the person to prove that —
- (a) he was a broadcaster;
  - (b) the information was broadcast live by him as a broadcaster;
  - (c) he did not modify the contents of the information prior to its broadcast;
  - (d) he has, in relation to the broadcast, acted in accordance with the terms and conditions of the licence (if any) by which he became entitled to broadcast and with any code of practice or guidelines (however described) issued under or pursuant to the

Telecommunications Ordinance (Cap. 106) or the Broadcasting Ordinance (48 of 2000) and applicable to him as a broadcaster; and

- (e) at the time of the broadcast-
  - (i) he did not know that the information was false or misleading as to a material fact or was false or misleading through the omission of a material fact; or
  - (ii) he knew that the information was false or misleading as to a material fact or was false or misleading through the omission of a material fact, but in the circumstances of the case he could not reasonably be expected to prevent the broadcast.

(6) In this section, "issue", in relation to any material (including any information), includes publishing, circulating, distributing or otherwise disseminating the material, whether —

- (a) by any visit in person;
- (b) in a newspaper, magazine, journal or other publication;
- (c) by the display of posters or notices;
- (d) by means of circulars, brochures, pamphlets or handbills;
- (e) by an exhibition of photographs or cinematograph films;
- (f) by way of sound or television broadcasting;
- (g) by computer or other electronic device; or
- (h) by any other means, whether mechanically, electronically, magnetically, optically, manually or by any other medium, or by way of production or transmission of light, image or sound or any other medium,

and also includes causing or authorizing the material to be issued.

## **291. Offence of stock market manipulation**

- (1) A person shall not, in Hong Kong or elsewhere —
  - (a) enter into or carry out, directly or indirectly, 2 or more transactions in securities of a corporation that by themselves or in conjunction with any other transaction increase, or are likely to increase, the price of any securities traded on a relevant recognized market or by means of authorized automated trading services, with the intention of inducing another person to purchase or subscribe for, or to refrain from selling, securities issued by the corporation or by a related corporation of the corporation;
  - (b) enter into or carry out, directly or indirectly, 2 or more transactions in securities of a corporation that by themselves or in conjunction with any other transaction reduce, or are likely to reduce, the price of any securities traded on a relevant recognized market or by means of authorized automated trading services, with the intention of inducing another person to sell, or to refrain from purchasing, securities issued by the corporation or by a related corporation of the corporation; or
  - (c) enter into or carry out, directly or indirectly, 2 or more transactions in securities of a corporation that by themselves or in conjunction with any other transaction maintain or stabilize, or are likely to maintain or stabilize, the price of any securities traded on a relevant recognized market or by means of authorized automated trading services, with the intention of inducing another person to sell, purchase or subscribe for, or to refrain from selling, purchasing or subscribing for, securities issued by the corporation or by a related corporation of the corporation.
  
- (2) A person shall not, in Hong Kong —
  - (a) enter into or carry out, directly or indirectly, 2 or more transactions in securities of a corporation that by themselves or in conjunction with any other transaction increase, or are likely to increase, the price of any securities traded on a relevant overseas market, with the intention of inducing another person to purchase or subscribe for, or to refrain from selling, securities issued by the corporation or by a related corporation of the corporation;

- (b) enter into or carry out, directly or indirectly, 2 or more transactions in securities of a corporation that by themselves or in conjunction with any other transaction reduce, or are likely to reduce, the price of any securities traded on a relevant overseas market, with the intention of inducing another person to sell, or to refrain from purchasing, securities issued by the corporation or by a related corporation of the corporation; or
  - (c) enter into or carry out, directly or indirectly, 2 or more transactions in securities of a corporation that by themselves or in conjunction with any other transaction maintain or stabilize, or are likely to maintain or stabilize, the price of any securities traded on a relevant overseas market, with the intention of inducing another person to sell, purchase or subscribe for, or to refrain from selling, purchasing or subscribing for, securities issued by the corporation or by a related corporation of the corporation.
- (3) A person who contravenes subsection (1) or (2) commit an offence.
- (4) In this section-
- (a) a reference to a transaction includes an offer and an invitation (however expressed) ; and
  - (b) a reference to entering into or carrying out a transaction shall, in the case of an offer or an invitation referred to in paragraph (a), be construed as a reference to making the offer or the invitation (as the case may be).

#### **Division 4 Other offences**

##### **292. Offence involving fraudulent or deceptive devices, etc. in transactions in securities, futures contracts or leveraged foreign exchange trading**

- (1) A person shall not, directly or indirectly, in a transaction involving securities, futures contracts or leveraged foreign exchange trading-
- (a) employ any device, scheme or artifice with intent to defraud or deceive; or

- (b) engage in any act, practice or course of business which is fraudulent or deceptive, or would operate as a fraud or deception.
- (2) A person who contravenes subsection (1) commits an offence.
- (3) In this section, a reference to a transaction includes an offer and an invitation (however expressed).

**293. Offence of disclosure of false or misleading information inducing others to enter into leveraged foreign exchange contracts**

- (1) A person shall not, in Hong Kong or elsewhere, disclose, circulate or disseminate, or authorize or be concerned in the disclosure, circulation or dissemination of, information that is likely to induce another person to enter into a leveraged foreign exchange contract in Hong Kong, if —
  - (a) the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact; and
  - (b) the person knows that, or is reckless or negligent as to whether, the information is false or misleading as to a material fact, or is false or misleading through the omission of a material fact.
- (2) Subject to subsections (3) to (5), a person who contravenes subsection (1) commits an offence.
- (3) Where a person is charged with an offence under subsection (2) in respect of a contravention of subsection (1) taking place in relation to any disclosure, circulation or dissemination of information, it is a defence to the charge for the person to prove that —
  - (a) he carried on a business the principal purpose of which was to provide the service of issuing or reproducing materials provided to him by others;
  - (b) the information was issued or reproduced by him in the ordinary course of that business;

- (c) the contents of the information were wholly devised by a customer of his or by a person acting on behalf of a customer of his;
  - (d) the nature of the service which he provided in relation to the information was such that he did not select, modify or otherwise exercise control over the contents of the information prior to its issue or reproduction; and
  - (e) at the time he issued or reproduced the information, he did not know that it was false or misleading as to a material fact or was false or misleading through the omission of a material fact.
- (4) Where a person is charged with an offence under subsection (2) in respect of a contravention of subsection (1) taking place in relation to any disclosure, circulation or dissemination of information, it is a defence to the charge for the person to prove that —
- (a) he carried on a business the normal conduct of which involved the re-transmission of information to other persons within an information system or from one information system to another information system (wherever situated), whether directly or by facilitating the establishment of links between such other persons and third parties;
  - (b) the information was re-transmitted by him to other persons in the ordinary course of such re-transmission of information;
  - (c) the contents of the information were devised by another person and he did not modify or otherwise exercise control over its contents prior to its re-transmission;
  - (d) the re-transmission of the information by him —
    - (i) was accompanied by a message to the effect; or
    - (ii) was effected following acknowledgment by the persons to whom it was re-transmitted of their understanding,that he did not devise the contents of the information and that he neither took responsibility for it nor endorsed its accuracy; and
  - (e) at the time he re-transmitted the information —

- (i) he did not know that it was false or misleading as to a material fact or was false or misleading through the omission of a material fact; or
  - (ii) he knew that it was false or misleading as to a material fact or was false or misleading through the omission of a material fact, but in the circumstances of the case he could not reasonably be expected to prevent the re-transmission.
  
- (5) Where a person is charged with an offence under subsection (2) in respect of a contravention of subsection (1) taking place in relation to any disclosure, circulation or dissemination of information, it is a defence to the charge for the person to prove that —
  - (a) he was a broadcaster;
  - (b) the information was broadcast live by him as a broadcaster;
  - (c) he did not modify the contents of the information prior to its broadcast;
  - (d) he has, in relation to the broadcast, acted in accordance with the terms and conditions of the licence (if any) by which he became entitled to broadcast and with any code of practice or guidelines (however described) issued under or pursuant to the Telecommunications Ordinance (Cap. 106) or the Broadcasting Ordinance (48 of 2000) and applicable to him as a broadcaster; and
  - (e) at the time of the broadcast —
    - (i) he did not know that the information was false or misleading as to a material fact or was false or misleading through the omission of a material fact; or
    - (ii) he knew that the information was false or misleading as to a material fact or was false or misleading through the omission of a material fact, but in the circumstances of the case he could not reasonably be expected to prevent the broadcast.

- (6) In this section, "issue", in relation to any material (including any information), includes publishing, circulating, distributing or otherwise disseminating the material, whether —
- (a) by any visit in person;
  - (b) in a newspaper, magazine, journal or other publication;
  - (c) by the display of posters or notices;
  - (d) by means of circulars, brochures, pamphlets or handbills;
  - (e) by an exhibition of photographs or cinematograph films;
  - (f) by way of sound or television broadcasting;
  - (g) by computer or other electronic device; or
  - (h) by any other means, whether mechanically, electronically, magnetically, optically, manually or by any other medium, or by way of production or transmission of light, image or sound or any other medium,

and also includes causing or authorizing the material to be issued.

**294. Offence of falsely representing dealings in futures contracts on behalf of others, etc.**

- (1) A person shall not represent to another person that he has on behalf of the other person dealt in, or facilitated or arranged for any dealing in, a futures contract traded on a recognized futures market or by means of authorized automated trading services, when in fact he has not so dealt in, or facilitated or arranged for the dealing in, the futures contract.
- (2) A person shall not represent to another person that he has dealt in, or facilitated or arranged for any dealing in, a contract or other instrument substantially resembling a futures contract on behalf of the other person in accordance with the rules of a futures market outside Hong Kong, when in fact he has not so dealt in, or facilitated or arranged for the dealing in, the contract or other instrument.

- (3) Subject to subsection (4), a person who contravenes subsection (1) or (2) commits an offence.
- (4) Where a person is charged with an offence under subsection (3) in respect of a contravention of subsection (1) or (2) by reason of the making of a representation, it is a defence to the charge for the person to prove that up to (and including) the time of the making of the representation he acted in good faith and did not know, and could not in the circumstances of the case reasonably have known, that in fact he has not —
- (a) in the case of a contravention of subsection (1), dealt in, or facilitated or arranged for the dealing in, the futures contract referred to in that subsection in the manner described in that subsection; or
- (b) in the case of a contravention of subsection (2), dealt in, or facilitated or arranged for the dealing in, the contract or other instrument referred to in that subsection in the manner described in that subsection.

## **Division 5      Miscellaneous**

### **295.    Penalties**

- (1) A person who commits an offence under this Part is liable —
- (a) on conviction on indictment to a fine of 510,000,000 and to imprisonment for 10 years; or
- (b) on summary conviction to a fine of 51,000,000 and to imprisonment for 3 years.
- (2) Where a person is convicted of an offence under this Part, the court before which the person is so convicted may, in addition to any penalty specified in subsection (1), make one, or more than one, of the following orders in respect of the person —

- (a) an order that the person shall not, without the leave of the court, be or continue to be a director, liquidator, or receiver or manager of the property or business, of a listed corporation or any other specified corporation or in any way, whether directly or indirectly, be concerned or take part in the management of a listed corporation or any other specified corporation for the period (not exceeding 5 years) specified in the order;
  - (b) an order that the person shall not, without the leave of the court, in Hong Kong, directly or indirectly, in any way acquire, dispose of or otherwise deal in any securities, futures contract or leveraged foreign exchange contract, or an interest in any securities, futures contract, leveraged foreign exchange contract or collective investment scheme for the period (not exceeding 5 years) specified in the order;
  - (c) an order that any body which may take disciplinary action against the person as one of its members be recommended to take disciplinary action against him.
- (3) When making any order in respect of a person under subsection (2), the court may take into account any conduct by the person which-
- (a) previously resulted in the person being convicted of an offence in Hong Kong;
  - (b) previously resulted in the person being identified by the Market Misconduct Tribunal as having engaged in any market misconduct pursuant to section 244(3) (b); or
  - (c) at any time before the commencement of Part XIII resulted in the person being identified as an insider dealer in a determination under section 16(3), or in a written report prepared and issued under section 22(1), of the repealed Securities (Insider Dealing) Ordinance.
- (4) Where the court makes an order under subsection (2)(a), the court may specify a corporation by name or by reference to a relationship with any other corporation.

- (5) Where the court makes an order under subsection (2)(a), the order shall be filed by the court with the Registrar of Companies, as soon as reasonably practicable after it is made.
- (6) Where the court makes an order under subsection (2)(b), the Commission may notify any licensed or exempt person of the order in such manner as it considers appropriate.
- (7) A person commits an offence if he refuses or fails to comply with an order made under subsection (2)(a) or (b) and is liable —
  - (a) on conviction on indictment to a fine of 51,000,000 and to imprisonment for 2 years; or
  - (b) on summary conviction to a fine at level 6 and to imprisonment for 6 months.

**296. Civil liability for contravention of this Part**

- (1) Subject to subsections (2) and (3), a person who contravenes any of the provisions of Divisions 2 to 4 shall, apart from any other liability he may incur (whether under section 295 or otherwise), be liable to pay compensation by way of damages to any other person for any pecuniary loss sustained by the other person as a result of the contravention, whether the loss arises from the other person having entered into a transaction or dealing at a price affected by the contravention, or otherwise.
- (2) No person shall be liable to pay compensation under subsection (1) unless it is fair, just and reasonable in the circumstances of the case that he should be so liable.
- (3) A defence under this Part to a charge for an offence in respect of a contravention of any of the provisions of Divisions 2 to 4 shall also be a defence in an action brought under subsection (1) in respect of the same contravention.
- (4) A person may bring an action under subsection (1) in respect of a contravention of any of the provisions of Divisions 2 to 4 even though the

person against whom the action is brought has not been charged with or convicted of an offence by reason of the contravention.

- (5) For the avoidance of doubt, where a court has jurisdiction to determine an action brought under subsection (1), it may, where it is, apart from this section, within its jurisdiction to do so, grant an injunction in addition to, or in substitution for, damages, on such terms and conditions as it considers appropriate.
- (6) Without prejudice to section 62 of the Evidence Ordinance (Cap. 8), in an action brought under subsection (1) —
- (a) a determination by the Market Misconduct Tribunal pursuant to section 244(3)(a) that market misconduct has taken place;
  - (b) a determination by the Market Misconduct Tribunal pursuant to section 244(3) (b) identifying a person (whether or not a party to the action) as having engaged in market misconduct,

shall, in so far the determination is still subsisting, be admissible in evidence for the purpose of proving, where to do so is relevant to any issue in the action —

- (i) in the case of a determination referred to in paragraph (a), that the market misconduct has taken place; or
  - (ii) in the case of a determination referred to in paragraph (b), that the person has engaged in market misconduct.
- (7) In an action brought under subsection (1) —
- (a) where there is a determination referred to in subsection (6)(a) or (b) —
    - (i) in the case of a determination referred to in subsection (6)(a), the market misconduct that is the subject of the determination shall, unless the contrary is proved, be taken to have taken place; or
    - (ii) in the case of a determination referred to in subsection (6)(b), the person that is the subject of the determination

shall, unless the contrary is proved, be taken to have engaged in market misconduct; and

(b) without prejudice to the reception of any other admissible evidence for the purpose of identifying the facts on which the determination was based, the contents of a report of the Market Misconduct Tribunal containing the determination and published under section 254(2)(b)(i), or the contents of a copy of a report of the Market Misconduct Tribunal containing the determination and made available under subsection (8), shall also be admissible in evidence for that purpose.

(8) Where in an action brought under subsection (1) —

(a) a determination referred to in subsection (6)(a) or (b) is admissible in evidence under subsection (6); and

(b) a report of the Market Misconduct Tribunal containing the determination has not been published under section 254(2)(b)(i), the court having jurisdiction to determine the action may, where it considers appropriate, require that a copy of the report be made available to the court to enable it to be used for the purposes of subsection (7)(b), whereupon

(i) the Market Misconduct Tribunal shall cause a copy of the report to be made available to the court to enable it to be used for the purposes of subsection (7)(b); and

(ii) the contents of the report shall be admissible for the purpose specified in subsection (7)(b).

(9) In this section, a reference to a transaction includes an offer and an invitation (however expressed).

(10) Nothing in this section affects, limits or diminishes any rights conferred on a person, or any liabilities a person may incur, under the common law or any other enactment.

**297. Transactions not to constitute offence**

- (1) Subject to subsections (2) and (3), the Commission may, where it considers it is in the public interest to do so, make rules to prescribe the circumstances in which any conduct that would otherwise constitute an offence under this Part (other than section 292 or 294) shall not be regarded as constituting such an offence.
- (2) Where the Commission proposes to make rules under subsection (1), it shall prepare and publish a draft of the rules, in such manner as it considers appropriate, for the purpose of inviting representations on the rules by the public.
- (3) After a draft of the rules which the Commission proposes to make under subsection (1) is published under subsection (2), the Commission may, after consultation with the Financial Secretary, modify the rules, taking into consideration any representation on the rules received as a result of the publication, in such manner as it considers appropriate, for the purpose of having the rules made under subsection (1).
- (4) Notwithstanding anything in this Part, where a person is charged with an offence under this Part (other than section 292 or 294) by reason of any conduct, it is a defence to the charge for the person to prove that the conduct is, according to the rules made under subsection (1), not to be regarded as constituting an offence.
- (5) Notwithstanding anything in this Part, where —
  - (a) a person is charged with an offence under section 287, 288 or 291 by reason of any conduct; and
  - (b) the person is charged on the basis that the conduct was carried out not in respect of securities or futures contracts traded on a relevant recognized market or by means of authorized automated trading services, but in respect of securities or futures contracts traded on a relevant overseas market,

the person shall not be convicted of the offence unless the prosecution proves that in any place in which such relevant overseas market is situated

the conduct would have constituted a criminal offence had it been carried out there.

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