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

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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.(1)

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.(2) 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".[3]

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".**(4)

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. (5)

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;(6)

— 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,(7)

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 evolvement 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';(8)

— 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 20th 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[9] and 49 states[10] 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[11] 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.[12]

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 aandelepoel-rekening by die makelaars Irish & Menell groot hoeveelhede aandele verkoop tydens die 'kunsmatige lopie' 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-realisable stock from Macmed, which had little value. 'The result was that Macmed reflected realised 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 Harmoney 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 discomforted 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.

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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.(1)

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

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

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".(3)

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(4).

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 11th 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 offset 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".(5)

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

2.8 From the 11th 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 14th and 15th centuries.(6).

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.(7)

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.[8]

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.[9] 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 17th 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". (10)

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.(11)

2.15 During the 17th and 18th 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 17th 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".(12)

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".[13]

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"**[14]**,** 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'**[15] (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.[16]

2.22 The **South Seas Company** competed for capital with many other companies and (some say) in an attempt to assist it,[17] 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').[18]

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.[19]

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;"[(20)]

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 **18th 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 19th 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)".(21)

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.(22)

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')".[23]

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.[24]

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 l908, 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 7th EC Company Law Directive on Consolidated Accounts, and the 8th 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".[(26)]

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".[27]

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. .....[(28)]

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".[29]

NOTES

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

2. **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 (4th 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 3rd 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., Delport P.A. :** 'Corporate Law', 2nd 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 12th 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 5th 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".(1)

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".(2)

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., incompleted 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".[(3)]

3.9 **Chatfield** describes the developments from the advent of the double-entry bookkeeping system to the 19th 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".[(4)]

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,[(5)] 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.[6]

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.(7)

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".(8)

3.20 At the end of the 19th 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".(9)

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 1st July, l908, 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 is 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".[(10)]

3.27 In the United States, by the end of the 19th 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.[(11)]

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".[(12)]

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".[13]

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'."[(14)]

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.[(15)]

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 accepting 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).

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.

Edey, H. C. and Panitpakdi, Prot : 'British Company Accounting and the Law 1844-1900', p. 359 – 362 and 367 – 375. ('Studies in the History of Accounting'. Littleton, A. C. and Yamey, B. S. Sweet & Maxwell Ltd, London. 1956).

Troberg, Pastus and Ekholm, Bo-Gorän : 'Objectives of Financial Reporting and Equity Theories. Are User Needs Different?' (Swedish School of Economics and Business Administration, Series C. Working Paper [1995]).

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 19th 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". (1)

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".(2)

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".(3)

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".[4]

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.[5]

4.11 During the latter part of the 19th 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".(6)

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".(7)

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'' 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 19th 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 evolvement 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

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

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

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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. (1)

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".[(2)]

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.

"Centralised Model	Usually undertaken by Central Bank
Quasi-Centralised Model	Financial regulation undertaken by a single .agency separate from the Central Bank (such as the Financial Services Authority ('FSA) in the UK).
Institutional Model	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).
Functional Model	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.[3]

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

5.8 **T**he **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 difference 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 Versekeringskamer**', '**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.(6)

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.(7)

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**.[8]

5.19 During the 20th 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[4] "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".

France	**The Commission des Opérations de Bourse** "The protection of investors whether their investments be in securities or other financial products involving public offerings. The adequacy of the information given to investors. The proper operation of the markets in financial instruments".
Germany	**The Bundesaufsichtsamt für den Wertpapierhandel** "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".
Iosco(5)	"2.3 (a) the protection of investors; (b) ensuring that markets are fair, efficient and transparent; and (c) the reduction of systemic risks".
Kansas	"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".

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 phases 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'.(1)

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".[(2)]

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 17th and 18th centuries (e.g., Sill, 1997)".[3]

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.[4]

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.(5)

6.9 The almost exponential growth of trading in derivative products is descibed 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 l960'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 sof 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 telecommuniction and information revolution.

Even with these successes, leadership and innovation, the futures industry faces many challenges as it moves toward the 21st 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".(6)

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.[7]

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".(8)

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 depositary 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 l950'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 l960'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 contact;

(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".[9]

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;[(10)]

— 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 and 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 **Meulenberg, M. T. G.** : 'The Financial Industry's Challenge of Developing Commodity Derivatives', p. 1.
(University of Ilinois. May 1999.)

4. **Ibid.** p.8.

5. **Ibid.** p.4.

6. **OFOR** : 'Futures Markets in the 21st 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

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 sor 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; 0r

(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 arangements 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.(1)

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".(2)

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"(3)

7.9 In its comments on the **Clerp 6 Consultation Paper**(4) **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".(5)

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".(6)

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.[7]

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;[8]

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.[9]

7.20 Section 173 empowers the Commission to inspect the affairs of intermediaries and their associated entities.[10]

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".[11]

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.(12)

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.(13)

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.(14)

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.(15)

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.cov.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".[9]

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

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 sit performs those function 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).

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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).

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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).

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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 (sections263 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).

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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).

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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 propio*, 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 fights, 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 fisted 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 (I) 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 concemed 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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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

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CHAPTER 8 SECURITIES REGULATION — THE PRIMARY MARKET—DISCLOSURE AND THE MERIT REVIEW

8.1 In England, the regulation of securities was preceded by the regulation of markets. The common law offences of engrossing (buying in a quantity of corn etc. to sell again at a high price), forestalling (raising the price of certain goods by holding up supplies etc.) and regrating (buying corn or other grain in any market so as to raise the price, and then selling it again in the same place) were rendered statutory offences in 1363.(1)

Investor protection started during the 16th century with bankruptcy laws(2) which sought to protect creditors, followed in the 17th century by laws which attempted to eliminate dishonest brokers(3). In 1720 the 'Bubble Act' outlawed unincorporated joint stock companies (4) and in 1734 trading in futures and options and short sales were prohibited(5). The Joint Stock Companies Act of 1844 required the filing at the Registry Office of prospectuses and documents such as advertisements which were addressed to the public and related to the formation of companies. It also required the filing of annual balance sheets and auditors' reports and prohibited the purchase and sale of shares of the company by its directors except with the consent of the shareholders at a general meeting.

8.2 Later reforms in securities regulation in the United Kingdom were mainly scandal-driven and except for developments during the last decade which led to the establishment of the Financial Services Authority (the FSA), the United Kingdom could certainly not have served as a model for other jurisdictions.

> "Almost every significant reform of the law or its administration in Britain has occurred as a direct result of the concern felt after a major scandal which has either dramatically illustrated the incompetence of the existing law or a significant lacuna in regulation. Sadly this has meant that experimentation and refinement of the law and regulatory devices have been pragmatic and have generally only been viable when

they can be conveniently attached to `the coat-tails of some measure that is justified by public outrage".[6]

8.3 During the 20th century and after a period in its history when fraud and corruption permeated all levels of society including the presidency, the judiciary, financiers, brokers and the like, the United States of America became the world leader in the field of securities regulation and supervision. Each state has its own securities law and in addition there are a number of federal laws, such as those which created the present Securities and Exchange Commission (the SEC).

8.4 During that unfortunate period in its history, the dishonesty which was endemic in the American economy is virtually beyond belief. Fortunes were made and lost in fraudulent and speculative ventures in gold mines, oil wells and railways. The stock market was often manipulated to 'corner' markets and the 'robber barons' ruled supreme.

8.5 Some of the methods used by the 'robber barons' are described by Edward Chancellor, and serve to illustrate the background to and the necessity for the far-reaching powers of regulators and supervisors which the American legislators bestowed upon State regulators and the SEC.

> "The promoters of the mining companies harnessed the mood of the day with age-old ploys. First, a claim in some unknown place was purchased for a pittance in cash or a quantity of shares and specimens of ore were submitted to an assay and certificated by a mineralogist. Then, a wealthy and respectable merchant, joined by other notables, was brought onto the board in return for a free distribution of shares. The capital of the company would be inflated to many times its value. For instance, the property of the Titan Ledge and Black Mountain Gold, Silver and Copper Company was bought for a thousand dollars and later capitalised at a million dollars. A broker was hired and advertisements placed in the papers announcing a 'limited' subscription. On street corners, boys were employed to hand out prospectuses with lavish descriptions of the company's prospects. Scouts, known as 'bubble-blowers', were hired to lure the bigger investors. Several companies were brought under the control of the same directors, who used the capital raised for one company to pay the unearned dividends of another.
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> .....

The great stock operators did not trifle with the transient mining and petroleum bubbles. Their attention was focused almost exclusively on the market for railroad stocks, where manipulation was a fine art and consequently the investment returns more certain. The great aim of the operator was to achieve one of the railroad corners which recurred with unprecedented frequency throughout the period. Among the most notorious corners were those in Harlem (1863 and 1864), Michigan Southern (1863 and 1866), Prairie du Chien (1865), Erie (1866, 1867, and 1868) and Chicago and Northwestern (1867 and 1872). The profits could be enormous : Henry Keep's pool in the Chicago and Northwestern Railroad in 1867 netted over $2 million. These operations were not without danger, as corners could be broken by 'watering' existing stock with new issues or by repatriating stock held in Europe. Therein lay the excitement of the game.

A pool operator would start by simulating weakness in a particular stock in order to shake out those holders on small margins and entice others to sell the stock short (this was known as the 'partridge trick'). The pool even lent from its own stockholding to facilitate short sales. Disreputable brokers provided 'wash sales', which set misleading prices. In a market hungry for 'points' or tips, false rumours were rife. Broken speculators, known as 'pointers', 'singed cats', or 'ropers-in', were commissioned to put out specious stories and solicit short sales. False rumours became so common that many acted contrary to what they were advised in the market, a practice known as 'coppering'. Once the stock had been oversold, the operator would catch out the short-sellers and force up the price (this was known as the 'scoop game'). A corrupt press was a useful tool in the hands of a stock manipulator. The notorious operator Jay Gould (of whom more later) controlled several newspaper editors, who in exchange for share tips would print whatever story he told them. After his death, the *New York Times* remarked:

> Mr. Gould's editors were known to the public as stool pigeons. It was their function to entice the incautious investor or speculator within reach of his ammunition; to 'hammer' securities that he wished to acquire, and to exalt by artful misrepresentation the quotations of those he desired to 'unload'.

Away from the stock exchange, other ways were found to manipulate securities. Influence over the board of directors was the most common and effective method, as Daniel Drew had shown with the Erie Railroad. Drew was frequently a bear, even in the stock of his own company, since his ability to issue new Erie shares made it almost impossible for other operators to corner him. 'Railway directors,' wrote James Medbery, 'are the heavy artillery of the stock market, and no corner can attain

Napoleonic victory without them'. Directors manipulated dividends to suit their speculative activities (sometimes paying them out of capital), broadcast false rumours (in 1869, the directors of the Pacific Mail circulated stories of an impending dividend increase in order to unload their shares), passed expected dividends, and issued unauthorised stock. Occasionally, speculating directors went even further. When Jim Fisk was a director of the Erie Railroad, he sold short the stock of the United States Express Company, which had a contract with the Erie, and then cancelled the contract. Once the express company's share price had fallen, Fisk covered his shorts, bought more shares, and then reinstated the contract. This technique was refined later in the century by the notorious gambler and speculator John 'Bet-a-Million' Gates, who shut down his Chicago steel plant during a period of prosperity and put thousands out of work, claiming that the business was not making money. Like Fisk beforehand, Gates had sold the stock short and after making a killing in market, he reopened his factories.

The behaviour of speculating directors corrupted the relationship between directors and shareholders (especially the British shareholders, who, on the other side of the Atlantic, were unable to influence events and were led like lambs to the slaughter). It appeared to justify Adam Smith's claim that joint-stock companies were beset by 'negligence and profusion' since the personal interests of directors differed from those of their shareholders. In his *Theory of Business Enterprise,* Thorstein Veblen contended that it was the custom of American directors to mislead the stock market in order to profit from successive over- and undervaluations of stock. Jay Gould, who once described the Erie Railroad as his 'plaything', was accused by Matthew Josephson of pursuing

> a deliberate policy of mismanagement, 'as a matter of principle', deriving his gains from the discrepancies between the real value of the affair and its supposed or transient value in the securities markets. In good times, he would give an appearance of gauntness and misery to his enterprises; in bad times he would pretend affluence".(7)

8.6 In recent years a number of jurisdictions have drawn upon the American experience for the regulation of their own securities and financial markets. Taking into account the diversity and complexity of the American financial markets and the ingenuity of its white collar criminals, this seems to be a commendable course, and the development of the American securities laws will be sketched in some detail.

8.7 In the United States the first securities act ('Blue Sky Law') was passed in the state of Kansas in 1911. By 1933, 47 of the then 48 states had securities laws. Following upon the stock market crash in 1929, the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted. The latter created the Securities and Exchange Commission (the SEC) as an independent agency of the United States Government.[8]

> "After the adoption of that first act (by Kansas in 1911), the idea of securities regulation began to spread. By 1913, twenty-three other jurisdictions had adopted securities acts. By the beginning of the depression in 1929, virtually all the states had some form of securities act. However, as some of the schemes of the 1920's illustrated, state securities regulation, with its limited jurisdiction, was not the total answer. The stock market crash of 1929 precipitated a movement to create a federal securities agency that could deal with schemes involving interstate commerce. This movement culminated in the passage of the Securities Act of 1933, and the Securities and Exchange Act of 1934. Thus, state securities regulation predated federal securities regulation by some twenty-two years. This fact is important in understanding both the scope of the federal securities acts and the interface between state and federal acts.
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> The state securities acts are generally known to those who deal with them as 'blue sky laws'. This name apparently comes from a comment by the United States Supreme Court in one of the early cases upholding the constitutionality of the early state acts that these statutes were passed to control schemes which had no more substance than so many feet of the blue sky. **(Hall** v **Geiger-Jones Co.**, 242 U.S. 539 [1917]**)**
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> Professor Loss, *Loss & Cowett* at 7, indicates that the term may have originated much earlier and may have been in common usage in Kansas at the time of the passage of the Kansas Act in 1911. He also quotes from a 1916 article which is often credited with coining the term. Mulvey, 'Blue Sky Law', 36 Can. L. Times 37 (1916):
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> > 'A definition of 'Blue Sky Law' is necessary. The State of Kansas, most wonderfully prolific and rich in farming products, has a large proportion of agriculturists not versed in ordinary business methods. The State was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that *they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky*

merchants, and the legislation intended to prevent their frauds was called Blue Sky Law' "[9]

8.8 In his lectures on 'The Protection of Investors' delivered during September 1962, Professor Loss of the Harvard Law School and former member of the SEC, sketched the Federal Controls which then existed in the United States:

"The Securities Act of 1933, the first in the series of SEC statutes, requires, with certain exceptions, the federal registration of all new issues which are offered to the public by use of the mails or any instrumentality of interstate or foreign commerce. The registration requirement also applies to secondary distribution of outstanding securities by persons who are in a relationship of control with the issuer. And a prospectus containing the basic information in the registration statement must be given to each buyer.

The Act includes a civil liability provision which, like sections 80 and 76 of the South African Companies Act, was largely modelled on the British Companies Act. But it also contains administrative machinery which is not found in Great Britain. The prospectus and various other documents, which are collectively called the registration statement, are carefully examined by the SEC. The Commission has no power to pass on the merits of securities, and it is a criminal offence to represent that it does. But it may issue a so-called stop order, subject to judicial review in a federal appellate court, upon a finding that the registration statement is materially incomplete or misleading. Since this administrative power exists, it seldom has to be exercised. An informal procedure has been developed whereby the registration statement is examined by a group of financial analysts, accountants, lawyers and engineers on the Commission's staff and then amended to repair any deficiencies which are thus found. This detailed examination, if it frequently proves annoying to registrants and their lawyers, is essentially welcomed by the financial and legal communities as a cheap form of insurance against what might otherwise be disastrous civil judgments.

It is this examination, moreover, which distinguishes the American system from that in either England or South Africa, or apparently anywhere else except for Japan and the *Commission Bencaire* in Belgium. The Jenkins report goes only a small way in suggesting that the Registrar of Companies be empowered (subject to judicial review) to refuse to accept for registration any prospectus offering shares or debentures for which a quotation on a prescribed stock exchange is not being sought 'if it either does not set out the information required by the Act or does so in a manner likely to create a false impression on the mind of an unwary or inexperienced investor. We do not

expect the Registrar to do more than reject prospectuses which, on the face of them, appear to him to be cast in a misleading form. He would not be expected to check the accuracy of the contents'. In the hands of a strong Registrar, this 'false impression' language might conceivably be the seed of an examination process almost as detailed as in America. But the Jenkins report itself suggests otherwise, without analysis of the 'false impression' phrase, and at this writing it is anybody's guess how the proposed amendment will operate in practice if it is adopted.

The Securities Act of 1933 was the first, but by no means the last, of the federal statutes. Almost annually for the next seven years Congress added a new statute, until now there are seven under which the SEC functions.

The Securities Exchange Act of 1934, the second statute in the series, is concerned with trading in securities already issued rather than the process of capital formation. Every stock exchange must be registered with the commission, which has certain supervisory functions with respect to their rules. Every security which is listed for trading on a stock exchange must likewise be registered. Annual or other periodic reports must be filed to keep registration data current. The Commission has a quasi-legislative power to adopt rules to regulate the solicitation of proxies. Directors, officers and beneficial owners of 10 per cent or more of any class of listed equity security must file monthly reports of their holdings, and must surrender to the corporation any profits they make from trading in their corporation's securities within any period of less than six months.

These several provisions apply only to securities listed on exchanges. So far as the over-the-counter market is concerned, the securities themselves are not registered unless they are the subject of a distribution which falls within the 1933 statute. But brokers and dealers in the over-the-counter market must themselves be registered and file annual financial statements. Moreover, the Commission has very broad powers to define fraudulent practices by rules; to enforce the statute and its regulations by investigation, injunction and criminal prosecution; to control various stock exchange practices such as short selling, stabilization, floor trading, and the hypothecation of customers' securities; and to suspend or expel stock exchange members, as well as to revoke the registration of over-the-counter brokers and dealers, for illegal conduct. And all this regulation is supplemented on an ethical plane by the National Association of Securities Dealers, an organization of over-the-counter brokers and dealers which has semi-official status.

The 1934 statute also attempts to control the amount of the nation's credit which is channelled into the securities markets by authorizing the Board of Governors of the Federal Reserve System to promulgate margin rules, which are enforced by the Commission. In this respect, the South African system of margin regulation under the Stock Exchanges Control Act, with its 50 per cent initial margin requirement except when both broker and customer are members of a South African stock exchange or a foreign exchange recognized by the Minister of Finance for the purpose, perhaps comes as close as any to the American scheme. There are traces in the American statute and its legislative history of three separate philosophies here, which are not altogether consistent: (1) prevention of the 'excessive use of credit for the purchase or carrying of securities'; (2) protection of the margin purchaser 'by making it impossible for him to buy securities on too thin a margin'; and (3) prevention of undue market fluctuations and stabilization of the economy generally. The Board of Governors of the Federal Reserve System has emphasized the first of these three philosophies in its administration of the margin provisions. Nevertheless, severe market movements have usually been followed sooner or later by increases or decreases in the margin requirement. The market break of late March, 1962, was followed in early July by a decrease in the margin requirement from 70 to 50 per cent.

These statutes of 1933 and 1934, which have been several times amended, are the two basic laws governing securities generally. The later statutes are more specialized.

The next year, 1935, brought the Public Utility Holding Company Act, which was an outgrowth of the holding company abuses in the area of electric and gas utilities. It took the SEC a quarter of a century to complete the Herculean task of integrating these holding company systems geographically and simplifying their corporate structures. The integrated and simplified holding company systems which have survived this process are subjected to stringent controls which go far beyond the disclosure philosophy of the 1933 statute.

In 1938 Congress amended the Bankruptcy Act to adopt a revised procedure whereby insolvent corporations may be reorganized instead of being liquidated. This statute gives the Commission no administrative authority in the usual sense. Instead it embodies a novel experiment in administrative – judicial co-operation by making the Commission the impartial and expert adviser to the federal courts in reorganization proceedings. The South African reader will notice a general resemblance to the judicial management under his Companies Act, although the South African courts receive no administrative help from the Government.

The next statute in the SEC series came in 1939 with the Trust Indenture Act. Its purpose is to assure that indentures under bond or debenture issues will have independent trustees to protect and enforce the rights of debenture holders. The mechanics of this statute are keyed in with the registration procedure under the Securities Act of 1933. Every debenture or other debt security which is offered to the public by use of the mails or the channels of interstate or foreign commerce must be issued under an indenture which has been qualified by the Commission. And no indenture may be qualified unless it provides for a corporate trustee which satisfies the exacting statutory definition of independence and in other respects meets the statutory requirements.

The last two Acts were passed in 1940. These are the Investment Company Act, which covers fifty-eight pages in the statute book and is the most complex of the entire series, and the Investment Advisers Act, a simple little statute which requires the registration of investment advisers and was little more than a continuing census until it was substantially tightened up in 1960".[(10)]

8.9 In his three-volume treatise on the securities laws of the United States, Professor Long points out that from the outset the focus of the blue sky statutes was on protecting its citizens from 'bad' investments.

"As a result, the early acts were clearly *parens patrie or public welfare*-type statutes. They were *parens patrie* statutes, in that the state, like a parent, was primarily interested in protecting its investors from their own ignorance and greed.

Since the turn of the century, both the state and federal governments have passed, under the police power, a myriad of public welfare statutes, such as the pure food and drug acts, aimed at protecting the physical health and well being of American citizens. The states, through merit regulation in the securities area, attempted to apply this same protective concept to the financial health and well being of its citizens. It is equally destructive of a citizen's well being to allow him to be stripped of his financial security, as it is to allow him to destroy his own physical health through the use of drugs or impure food.

To confirm the validity of this proposition, one need only look at the example of the *Lincoln Federal* and *Charles Keating*[(11)] case. Keating and his savings and loan swindled thousands of elderly people of their life savings. In so doing, he not only stole their dignity, but condemned many to a life of eating cat food and worrying about

whether they will become a burden upon their families or society in general. These fears are very real in that many have a life expectancy of ten years or more.

This merit regulation was accomplished by the state securities agency weeding out those offerings which were not 'fair, just, or equitable' to the investor or which were not 'based upon sound business principles'. Such offerings were simply denied registration and, therefore, could not be lawfully sold in the state. Under these merit statutes, while disclosure to investors of information about the securities and the company offering them was a consideration, it was clearly secondary to preventing the sale of securities considered undesirable in the eyes of the administrator. Most state securities acts, both early and modern, do not attempt to further define the 'fair, just, and equitable' standard. This was left to administrative interpretation on a case-by-case basis or through administrative rule".[(12)]

8.10 In contrast to the 'merit regulation' statutes, the main focus of the Securities Act of 1933 (the Federal act) was and still is on full disclosure in, amongst others, the statutory prospectus.

8.11 However, Professor Long points out that full disclosure in a prospectus does not protect the ordinary investor. In his view few of the investors who actually read prospectuses are able to form intelligent investment decisions based thereon because the prospectus has largely become a formalistic legal document used by the issuer to lay a foundation for its defence to any future allegations that full disclosure had not been made.

"The ultimate goal of the Securities Act is, of course, investor protection. Effective disclosure is merely a means. The entire legislative scheme can be frustrated by technical compliance with the requirements of the Securities and Exchange Commission's Form S-1 for preparation of registration statements in the absence of any real intent to communicate. It is for this reason that the SEC, through its rule making power, has consistently required 'clearly understandable' prospectuses. The Wheat Report at 78.

Unfortunately, the results have not always reflected these efforts. '[Even] when an investor [is] presented with an accurate prospectus prior to his purchase, the presentation in most instances [tends] to discourage reading by all but the most knowledgeable and tenacious'. Knauss, A Reappraisal of the Role of Disclosure, 62 Mich. L. Rev. 607, 618-619 (1964). These documents are often drafted so as to be comprehensible to only a minute part of the investing public.

In at least some instances what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilize turgid prose to enshroud the occasional critical revelation in a morass of dull, and — to all but the sophisticates — useless financial and historical data. In the face of such obfuscatory tactics the common or even the moderately well informed investor is almost as much at the mercy of the issuer as was his pre-SEC parent. He cannot by reading the prospectus discern the merit of the offering".[13]

8.12 Some states, such as the State of New York and the District of Columbia, largely rely upon anti-fraud statutes such as Article 21-A (Fraudulent Practices in Securities) and Article 23-A (Fraudulent Practices in Respect to Stocks) of the General Business Law of New York. The latter also prohibits chain distributor schemes (pyramid sales).[14]

8.13 According to Professor Long, experience has shown that anti-fraud statutes alone cannot protect investors because effective prosecution is lacking, and the reality is that in most cases the entire investment has been lost by the time a fraudster is arrested,

"Administrative or injunctive actions are simply not effective against professional criminals or scam artists who are continually offering fraudulent securities. These professionals may be offering commodity option contracts this year. Next year it might be oil and gas lease lotteries. The year after it might be interests in FCC cellular telephone or wireless cable license lotteries or build-outs of licenses won. These people tend to move from hot investment area to hot investment area, taking their customer lists with them. Further, these professional criminals are often in contact with each other and exchange ideas for new scams and investor 'sucker' lists. They also will sell their investor lists to other third parties. As a result, the same investors are often victimized several times, either in different schemes or different parts of the same scheme.

These people normally ignore summary cease and desist orders issued by state securities agencies. If the agency on its own motion sets the order for hearing or seeks an injunction, they will normally do either of two things. They will offer to enter into a consent order and rescind the investments made in that particular state. Or they will fight the action, using every delaying tactic possible. In either case, they gain time to continue their scam until it fails of its own weight, at which time they move on to the next scheme or company. The costs of fighting these actions, including exorbitant attorney's fees and paying any assessed fines or required rescissions, are merely costs of doing business.

The only way to stop these schemes and the people who perpetrate them is criminal prosecution. Yet, few criminal cases are ever brought. As a result, the chances of prosecution are extremely low, about three percent. For example, Glenn Turner[15] of 'Dare to Be Great' and 'Koscot Cosmetics' fame, operated at least four or five similar pyramid schemes before being convicted in Arizona. Further, the chances of spending any substantial 'hard' jail time are even lower, somewhere in the neighborhood of one percent. Michael Milken, the junk bond king, allegedly made over a billion dollars, but was sentenced to only a couple of years in jail. This reflects the attitude prevalent in the federal, and some state, courts that white collar criminals, who steal by their wits and fountain pens, should not do much 'hard' time. Charles Keating[16], convicted of defrauding hundreds of senior citizens of their life savings, received a relatively light sentence when compared with the average armed robber who steals under $100 and receives a twenty-five year sentence.

The second reason that after-the-fact fraud regulation only does not work is because in most cases the entire investment is lost. In a few cases, the investment money has actually been spent for the purposes it was raised for in an effort to try to make the project work. However, in most cases, the promoter has simply converted the money to his own use and either dissipated it through high living or secreted it in a foreign numbered bank account. In either case, the investors are unlikely to recover even a small percentage of their investment. After-the-fact fraud regulation is another example of closing the barn door after the horse has departed. What is needed is a system of regulation which has a chance of stopping the fraud before the loss occurs.

To verify this point, it is only necessary to compare the estimated losses to the success of agency recovery activities. Estimates on the amount of loss in the United States to fraudulent securities schemes each year range from $330 million to over $40 billion. The SEC has engaged in the last several years in a vigorous disgorgement program. While the program has been quite successful, the amount of disgorgement ordered is only a small fraction of the actual loss sustained. Further, the amount of money actually recovered for investors is only a small percentage of that ordered by the courts".[17]

8.14 Professor Long is also of the view, and convincingly so, that investor protection is best achieved by full disclosure with the addition of antifraud measures and a merit review.

"The full disclosure plus fraud statute is a great improvement over a fraud only statute. It provides the investor with some prophylactic protection *before* the offer or sale is

made, not *after*. Hopefully, such protection will prevent many frauds from taking place so there will be less need for the liability provisions after the sale. Further, the theory of providing the investor with full and accurate information, but not interfering with his ultimate investment decision, as is done in merit regulation statutes, is more in keeping with the American idea of freedom of choice.

However, this simple truth is that disclosure plus antifraud regulation doesn't work. Only when merit review is also added does the public have full investor protection.[18]

8.15 In the United States, regulation by means of merit review (the concept of 'fair, just and equitable') is largely restricted to seven regulatory areas.

— Marketing costs and selling expenses which are generally limited either by statutes or rules which specifically limit the percentage such expenses may comprise (usually between 10 and 30 per cent) and which enables the regulators to determine what an excessive or unreasonable amount would be. As an example, Section 306(a)(2)(F) of the Uniform Act provides that registration may be denied if 'the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation.

— Options and warrants which are issued to underwriters, insiders and promoters to provide additional compensation at no expense to the issuer.

"The evil that merit regulation of this area is attempting to control is quite simple. The investors, purchasing under the registration statement, will have their investment diluted if the options are exercised. The extent of this dilution is the difference between the option price and the market price of the securities when the option is exercised.

In the case of the issuer's promoters and insiders, this additional compensation represents further payment for the promoters' and insiders' efforts in organizing and running the issuer to the time of the registration. In the case of the underwriters or unaffiliated institutional investors making a contemporaneous loan to the issuer, the options are additional inducement to underwrite the offering or to make the loan. Usually such options are in lieu of a higher underwriting fee or interest rate on the loan. Finally, options are often issued to existing shareholders in various types of acquisitions and reorganizations. Here the purpose is to sweeten the exchange package to induce the shareholder to agree to the acquisition or other reorganization,

Because of the dilution effect caused by the issuance of options, many states, as part of their merit regulatory scheme, provide restrictions on the amount, type, and permissible holders of options and warrants. The statutory authority for such restrictions are based upon language similar to that of Section 306(a)(2)(F) of the Uniform Act. This section provides that registration may be denied if 'the offering has been or would be made with.....unreasonable amounts or kinds of options".

— Cheap stock issued to underwriters, insiders and promoters. Once again, placing limits on the issuance of cheap stock prevents the excessive dilution of the public's investment.

— The offering price. Restrictions are placed on the offering price where there is no established market for the security. The offering prices are required to relate to book value, earnings history and for industry price/earnings multiples and require the price to be no lower than say $2 in any event or no more than 25 times earnings. These restrictions are placed to protect the public from the marketing ability of the underwriter or promoter.

— Voting rights. It is deemed to be unfair and thus a ground for refusing registration if the class of securities being offered has voting rights unequal to those of other classes. Equal voting rights are necessary to ensure basic fairness to the investing public whose funds are being used to capitalize an entity. (c*f* the iniquitous South African N-vote shares).

— Promoters' investments. Some states require promoters to contribute assets in the form of cash or other tangible assets equal to approximately 10 to 15 percent of the equity to be offered to the public. This is justified on the basis that it is a fairly easy way to test the promoter's faith in the issuing entity.

— Interest and dividend coverage. States which apply this merit standard will often require that companies wishing to issue preferred stock or debt securities meet certain interest and dividend coverage tests. This is widely regarded as the most effective method to protect the public.

"The desirability of requiring that certain issuers demonstrate the ability to meet promised dividend or interest payments is founded on simple fairness and would appear beyond question. This is quite possibly the reason that of all the merit standards discussed, interest and dividend coverage restrictions are the least criticized and have proved to provide the highest level of investor protection" [(19)]

8.16 Some examples of merit review provisions in the United States and in other jurisdictions are

Arizona "1. (When) The application for registration, prospectus, any financial statement, or any document or exhibit filed with the application, or any amendment or supplement thereto, is incomplete, inaccurate or misleading, or the information contained therein is insufficient for a true appraisal of the securities.

3. (When) The sale of the securities works or would tend to work a fraud or deceit upon the purchasers thereof, or is or would be unfair or inequitable to the purchasers".
(Title 44 – 1921)

Arkansas "(2) (If)

(A) The registration statement is incomplete in any material respect or contains any statement which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact;

(D) The issuer's enterprise or method of business includes or would include activities which are illegal where performed;

(E) (i) The offering has worked or tended to work a fraud upon purchasers or would so operate; or

(ii) Any aspect of the offering is substantially unfair, unjust, inequitable, or oppressive;

(F) The offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, unreasonable amounts of promoters' profits or participation, or unreasonable amounts of kinds of options".

California "25410. (a) (1) The commissioner may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any qualification of an underwritten offering of securities under Section 25111, 25112 or 25131 or may suspend or revoke any permit issued under Section 25113 or 25122 if he or she finds (A) that the order is in the public interest and (B) that the proposed plan of business of

the issuer or the proposed issuance or sale of securities is not fair, just, or equitable, or that the issuer does not intend to transact its business fairly and honestly, or that the securities proposed to be issued or the method to be used in issuing them will tend to work a fraud upon the purchaser thereof".

India

"10.1.1. No public or rights issue of debt instruments including convertible instruments) in respect of their maturity or conversion period shall be made unless credit rating from a credit rating agency has been obtained and disclosed in the offer document

10.1.2 For a public / rights issue of debt security of issue greater than or equal to Rs.100 crores (±R150million) two ratings from two differing credit rating agencies shall be obtained.

10.1.3 Where credit rating is obtained from more than one credit rating agencies, all the credit rating/s, including the unaccepted credit ratings, shall be disclosed.

10.1.4 All the credit ratings obtained during the three (3) years preceding the public or rights issue of debt instrument (including convertible instruments) for any listed security of the issuer company shall be disclosed in the offer document.

10.9Additional Disclosures in respect of debentures

The offer document shall contain:-

e. The existing and future equity and long term debt ratio.

f. Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures.

g. That the certificate from a financial institution or bankers about their having no objection for a second or pari passu charge being created in favour of the trustees to the proposed debenture issues has been obtained"

Kansas

"(12)(a) The commissioner may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if he finds that such an order would be in the public interest, and that:

(1) The issuer's plan of business is unfair, inequitable, dishonest or fraudulent;

(2) the issuer's or registrant's literature or advertising is misleading and calculated to deceive the purchaser or investor;

(3) the securities offered or to be offered, or issued or to be issued, in payment for property, patents, formulae, goodwill, promotion or intangible assets, are in excess of the reasonable value thereof, or the offering has been, or would be, made with unreasonable amounts of options;

(4) the enterprise or business of the issuer, promoter or guarantor is unlawful;

(8) there has been a failure to keep and maintain sufficient records to permit of an audit satisfactorily disclosing to the commissioner the true situation or condition of such issuer"

Latvia

"(9) The Commission (the Securities Market Commission shall have the right to

4. terminate or refuse authorization for putting securities into circulation, if the interests of investors, or of other participants in the securities market, are materially affected;

The Commission will not register securities for putting into public circulation if:

19(2) information contained in the documents submitted for registration is not accurate or truthful, or if it does not meet the requirements of this Law and other laws".

Oklahoma

"§.306 (a) The Administrator may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if the Administrator finds that:

1. the order is in the public interest; and

2. (A) the registration statement as of its effective date or as of any earlier date in the case of an order denying effectiveness, or any report under Section 305(i) of this title is incomplete in any material respect or contains any

statement which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact;

(D) the issuer's enterprise or method of business includes or would include activities which are illegal where performed;

(E) the offering has worked or tended to work a fraud upon purchasers or would so operate;

(F) the offering has been or would be made or is being made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options, profits, compensation, or remuneration paid directly or indirectly to any officer, director, employee, contractor or agent".

Ontario

"61(2) The Director shall not issue a receipt for a prospectus if it appears to the Director that,

(a) the prospectus or any document required to be filed therewith,

(i) fails to comply in any substantial respect with any of the requirements of this Part or the regulations,

(ii) contains any statement, promise, estimate or forecast that is misleading, false or deceptive, or

(iii) contains a misrepresentation;

(b) an unconscionable consideration has been paid or given or is intended to be paid or given for promotional purposes or for the acquisition of property;

(c) the proceeds from the sale of the securities to which the prospectus relates that are to be paid into the treasury of the issuer, together with other resources of the issuer, are insufficient to accomplish the purpose of the issue stated in the prospectus;

(d) having regard to the financial condition of the issuer or an officer, director, promoter, or a person or company or combination of persons or companies holding sufficient of the securities of the issuer to affect materially the control of the issuer, the issuer cannot reasonably be

expected to be financially responsible in the conduct of its business;

(e) the past conduct of the issuer or an officer, director, promoter, or a person or company or combination of persons or companies holding sufficient of the securities of the issuer to affect materially the control of the issuer affords reasonable grounds for belief that the business of the issuer will not be conducted with integrity and in the best interests of its security holders;

(h) in the case of a prospectus filed by a finance company, as defined in the regulations,

(i) the plan of distribution of the securities offered is not acceptable,

(ii) the securities offered are not secured in such manner, on such terms and by such means as are required by the regulations, or

(iii) such finance company does not meet such financial and other requirements and conditions as are specified in the regulations".

Pakistan

"22(4) The Commission when exercising its powers under the 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;

(d) The interest of public investors, existing or potential, in the company or body corporate;

(f) The general public interest.

USA

Proposed Revised Uniform Securities Act

"(306)(a) The [Administrator] may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, a registration statement if the [Administrator] finds that the order is in the public interest and that:

(4) the issuer's enterprise or method of business includes or would include activities that are illegal where performed;

(5) the offering has worked or tended to work a fraud upon purchasers or would so operate; [alternative subparagraph (5): the offering is being made on terms that are unfair, unjust, or inequitable;]

(6) the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options;"

Utah "61-1-12(1) Upon approval by a majority of the Securities Advisory Board, the director may issue a stop order that denies effectiveness to, or suspends or revokes the effectiveness of, any securities registration statement and may impose a fine if he finds that the order is in the public interest and that:

(a) the registration statement, as of its effective date, is incomplete in any material respect, or contains any statement that was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact".

8.17 The need for restrictions on the advertisement, issue or sale of securities without prior approval by a securities regulator is self-evident. Also self-evident is the need for measures to ensure that the extent of disclosure is such that the regulator is able to conduct a suitable merit review.

As pointed out[20], if such measures had been in place in South Africa, the disastrous Masterbond, Supreme Bond and Owen Wiggins debenture bond schemes would not have occurred.

8.18 In addition, as in the State of New York[21], pyramid sales or chain distribution schemes must be prohibited. At present, and by R76 Notice 1135 of 1999, certain 'multiplication' schemes, 'chain letter' schemes and 'pyramid promotional' schemes are declared harmful business practices and hence unlawful. Unfortunately, the wording of the notice is virtually unintelligible.[22] It should be withdrawn and replaced by wording similar to that of the New York statute. Investment contracts should also be included in the definition of 'regulated securities' or 'financial products'.

8.19 It is recommended that the South African Securities Regulator be enjoined and authorised to

(a) call for such disclosure of information by the applicant for the registration of securities as it may deem fit;

(b) refuse the registration of securities if it appears to the Regulator that

1. the prospectus or any document required to be filed with the application for registration,

(i) fails to comply in any substantial respect with any of the requirements set,

(ii) contains any statement, promise, estimate or forecast that is misleading, false or deceptive.

2. the proceeds from the sale of the securities to which the prospectus or other documents relate together with other resources of the issuer, will be insufficient to accomplish the stated purpose of the issue;

3. having regard to the financial condition of the issuer or of an officer, director, promoter, or of a person or company or combination of persons or companies holding sufficient of the securities of the issuer to materially affect the control of the issuer, the issuer cannot reasonably be expected to be financially responsible in the conduct of its business;

4. the past conduct of the issuer or an officer, director, promoter, or a person or company or combination of persons or companies holding sufficient of the securities of the issuer to materially affect the control of the issuer affords reasonable grounds for belief that the business of the issuer will not be conducted with integrity and in the best interests of its security holders;

5. **the issuer's enterprise or method of business includes or would include activities that are illegal where performed;**

6. **the offering is being made on terms that are unfair, unjust, or inequitable;**

7. **the issuer's plan of business is unfair, inequitable, dishonest or fraudulent;**

8. **the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options;**

9. **the consideration offered or to be offered in payment for property, patents, formulae, goodwill, promotion or intangible assets, are in excess of the reasonable value thereof;**

10. **the viability of the issuing company or body corporate is suspect;**

11. **there has been a failure to keep and maintain sufficient records to permit an audit satisfactorily disclosing the true situation or condition of the issuer;**

12. **in respect of a proposed issue of debentures and having regard, *inter alia*, to**

    (a) **the existing and future equity and long term debt ratio of the issuer, and the**

    (b) **servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures,**

    (c) **any other factor;**

it is uncertain whether the issuer will be able to meet its obligations.

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NOTES

1. **Gilligan, Dr George P.** : 'The Origins of UK Financial Services Regulation'. and see Statutes of the Realm (1363), 37 Edw. III C.8.

2. **34 & 35 H.8 C 4** (1542/3).
   13 Elis. C 4 (1570).
   1 Jac. C 15 (1603).

3. **1 Jac. C 21** (1603) 'An Act against Brokers'.
   8 & 9 Gul. III C 32 (1697) 'An Act to Restrain the Number and ill practice of Brokers and Stock Jobbers'.

4. **6 G I. C 18** (1720).

5. **7 G II. C 8** (1734) 'An Act to prevent the infamous Practice of Stock-jobbing'.

6. **Rider, Prof. Barry A.K. :** 'The Control of Insider Trading – Smoke and Mirrors!' Journal of Financial Crime Vol 7 No. 3 p. 227. (Institute of Advanced Legal Studies – Henry Stuart Publications, London, January 2000.).

7. **Chancellor, Edward :** 'Devil Take the Hindmost – A History of Financial Speculation', p. 167 – 173. (Macmillan, London, 1999).

8. **The Banking and Finance Commission of Belgium** has a similar history:

   "The Banking Commission was created in the wake of the Great Depression. At that time, banks and savings institutions ware allowed, in their capacity as 'mixed banks', to hold shares in financial as well as industrial and commercial companies, without any legal limitation. The crisis in the 1930s led to major

losses on shares and loans, thus creating serious solvency and liquidity problems for the credit institutions concerned.

In order to restore confidence in the banking system, the government took the draconian measure of prohibiting mixed banks in Royal Decree 2 of 22 August 1934.

As a result, mixed banks were required to split their activities into two separate entities: firstly, a 'deposit-taking bank' which was not allowed to hold any shares in industrial or commercial companies, and secondly, a 'holding company' which was free to acquire and manage such shares.

A few months later, Royal Decree 42 of 15 December 1934 imposed on private savings institutions a strict regulatory system, the supervision of which was entrusted to the Office central de la petite eargne/Central Bureau voor de Kleine Spaarders, created a few days earlier.

The economic and monetary climate worsened in the ensuing months. Increased distrust of the Belgian franc caused massive withdrawals of deposits and a dramatic flight of capital out of the country, with the real risk of the whole banking system being crippled.

The new government which took office in March 1935 carried out an important reform by adopting the Royal Decree 185 of 9 July 1935 on the supervision of banks and the rules governing the issue of securities. Title I of that Decree — which remained enforced until the Law of 22 March 1993 — set out the regulatory system for banks.

Since holding companies and their subsidiaries were the main issuers of shares and bonds, it was also decided that the information to be provided to investors for public issues of securities would be supervised, whereby the government also hoped to restore the creditworthiness of listed companies and of the stock exchange in general, which had been badly affected in the aftermath of the Great Crash. Today, these matters are still governed by Title II of Royal Decree 185, although that original text has been amended several times since.

At the same time, a new institution was created: the Banking Commission. It was charged with the supervision of compliance with the provisions of both titles of Royal Decree 185.

Over the years, the tasks of the Commission have gradually been extended. In 1990, the legislator changed the name of the Banking Commission to the 'Banking and Finance Commission' as an acknowledgement of its increased responsibilities'.

9. **Long, Joseph C :** Blue Sky Law – Vol. 12 1.02 [1].

10. **Published** in the SA Law Journal Vol. LXXX (1963) p 53.

11. **People** v **Keating** — 19 Cal. Rptr. 2d 899 (1993) in which the Court described the methods used to encourage the public to buy unsecured debenture bonds, namely a higher rate of interest and seemingly excellent security.

"Meanwhile, Fidel, as president of Lincoln, began to develop concerns about ACC's ability to withstand a requirement to repay the debt service on the bonds. His concerns stemmed from a third quarter loss recorded by ACC and bad media the parent holding company was receiving. In November 1988, the one-year bonds began to mature and Keating instructed Fidel to inspire the bond representatives to send letters to these bondholders encouraging a rollover to another bond. Keating further instructed Fidel to continue to pursue additional new bond sales.

In late December 1988 or the first week of January 1989, Keating held a meeting in Irvine, which included both bond representatives and Lincoln employees, to announce the sale of Lincoln to the Spencer Scott Group. He indicated that, after the sale, ACC would have even greater opportunities, and encouraged the bond sales to continue. Immediately thereafter, Keating had all of the bond representatives flown to Phoenix for a day at ACC corporate headquarters and a tour of the facility, speeches by Keating and Wischer, and lunch at the Phoenician Resort Hotel. Fidel testified that, after this trip, the bond representatives went back to business as usual, quite enthusiastically" — (a typical Masterbond scenario).

12. **Long, Joseph C.**. ibid, 1-68-69.

13. **Fed. Sec. L. Rep. (CCH) P93**, 163 FEIT V. LEASCO DATA PROCESSING EQUIP. CORP., 332 F. Supp. 544 (E.D. NY 1971). per Judge Weinstein.

14. "§ 359-fff. Chain distributor schemes prohibited.

1. It shall be illegal and prohibited for any person, partnership, corporation, trust or association, or any agent or employee thereof, to promote, offer or grant participation in a chain distributor scheme.

2. As used herein a 'chain distributor scheme' is a sales device whereby a person, upon condition that he make an investment, is granted a license or right to solicit or recruit for profit or economic gain one or more additional persons who are also granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. A limitation as to the number of persons who may participate, or the presence of additional conditions affecting eligibility for such license or right to recruit or solicit or the receipt of profits therefrom, does not change the identity of the scheme as a chain distributor scheme. As used herein, 'investment' means any acquisition, for a consideration other than personal services, of property, tangible or intangible, and includes without limitation, franchises, business opportunities and services, and any other means, medium, form or channel for the transferring of funds, whether or not related to the production or distribution of goods or services. It does not include sales demonstration equipment and materials furnished at cost for use in making sales and not for resale.

3. A chain distributor scheme shall constitute a security within the meaning of this article and shall be subject to all of the provisions of this article".

15. **The Glenn Turner** type of scheme was a typical pyramid or chain distributor scheme. In **Sec** v **Glenn W. Turner Enters., Inc.,** 474 F.2d 476 (9th Cir.), the Court described the scheme as follows:

"I. The Adventures and the $1000 Plan — the facade.

The five courses offered by Dare ostensibly involve two elements. In return for his money, the purchaser is privileged to attend seminar sessions and receives tapes, records, and other material, all aimed at improving self-motivation and sales ability. He also receives, if he purchases either Adventure III or IV or the $1,000 Plan, the opportunity to help to sell the courses to others; if successful he receives part of the purchase price as his

commission. There is no doubt that this latter aspect of the purchase is in all respects the significant one.

II. The Adventures and the Plan in operation.

It is apparent from the record that what is sold is not of the usual 'business motivation' type of courses. Rather, the purchaser is really buying the possibility of deriving money from the sale of the plans by Dare to individuals whom the purchaser has brought to Dare. The promotional aspects of the plan, such as seminars, films, and records, are aimed at interesting others *[F.2d 479]* in the Plans. Their value for any other purpose, is, to put it mildly, minimal.

Once an individual has purchased a Plan, he turns his efforts toward bringing others into the organization, for which he will receive a part of what they pay. His task is to bring prospective purchasers to 'Adventure Meetings'.

A. **The Meetings.**

These meetings are like an old time revival meeting, but directed toward the joys of making easy money rather than salvation. Their purpose is to convince prospective purchasers, or 'prospects', that Dare is a sure route to great riches. At the meetings are employees, officers, and speakers from Dare, as well as purchasers (now 'salesmen') and their prospects. The Dare people, not the purchaser-'salesmen', run the meetings and do the selling. They exude great enthusiasm, cheering and chanting; there is exuberant handshaking, standing on chairs, shouting, and 'moneyhumming'. The Dare people dress in expensive, modern clothes; they display large sums of cash, flaunting it to those present, and even at times throwing it about; they drive new and expensive automobiles, which are conspicuously parked in large numbers outside the meeting place. Dare speakers describe, usually in a frenzied manner, the wealth that awaits the prospects if they will purchase one of the plans. Films are shown, usually involving the 'rags-to-riches' story of Dare founder Glenn W. Turner. The goal of all of this is to persuade the prospect to purchase a plan, especially Adventure IV, so that he may become a 'salesman', and thus grow wealthy as part of the Dare organization. It is intimated that as Glenn W. Turner Enterprises, Inc. expands, high positions in the organization, as well as lucrative opportunities to purchase stock, will be available. After the meeting, pressure is applied to the prospect by Dare people, in an effort to

induce him to purchase one of the Adventures or the plan. The sale is sometimes closed by the purchaser who brought the prospect to the meeting, but primarily, by Dare salesmen, specialists in the 'hard sell'.

The format of the meeting is preordained. A script created by Dare is strictly adhered to. The format applies even to the sale, there being a standard procedure for inducing the prospect to sign his name to the agreement and to part with his money. While no express guarantee of success is made at the meetings, and the statement is made that the purchaser must expect to work, the impression which is fostered is of the near inevitability of success to be achieved by anyone who purchases a plan and follows Dare's instructions.

Dare also arranges, in addition to the Adventure Meetings, 'GO Tours', or 'Golden Opportunity Tours'. Prospects are taken by plane or bus to one of Dare's regional centres where further meetings and sales efforts are undertaken. A significant effort is made during the trip itself to sell the plans to prospects. Much the same atmosphere as at the meetings pervades the trip — exuberant shouting, chanting, handshaking, relating of success stories, and lavish displays of cash.

In a scheme such as this, the possibility that a market will become 'saturated' is a real one. Saturation has in fact occurred in some markets, but this is not mentioned at the meetings. Few, if any, purchasers of these plans have achieved any success remotely approaching that described by defendants and their agents".

16. **See** note 11 above.

17. **Long, Joseph C.**, ibid, 1.78 - 1.80.

18. **Long, Joseph C,** ibid, 1 – 81.

19. **Long, Joseph C..,**ibid, 1.92 – 1.105.

U.S. Securities and Exchange Commission. Report on the Uniformity of State Requirements for Offerings that are not 'Covered Securities'. (October 11, 1997.).

"a. Merit review

As noted previously, in addition to reviewing offerings for adequate disclosure of all material information, approximately 40 states undertake a 'merit review' of the filing. A merit review of a filing involves a substantive review of the issuer and the offering and is intended to 'prevent promotion of fraudulent or inequitable issues'. Common merit review provisions relate to the following matters:

- **'Cheap stock' -** limiting sales of stock to insiders and promoters that are proximate to the offering at a significantly discounted price.
- **Loans to and other affiliate transactions -** requiring all insider loans to be repaid before the public offering; other material transactions must be on similar terms available from unaffiliated third parties and be ratified by a majority of the independent directors;
- **Debt securities -** requiring cash flow in the past fiscal year that is sufficient to cover fixed charges, meet debt obligations as they become due and service the debt being offered; requiring a trust indenture meeting the requirements of the Trust Indenture Act of 1939; requiring the establishment of a sinking fund or other redemption requirements;
- **Impoundment of proceeds -** subjecting the proceeds from any offering especially best efforts and minimum/maximum offering(s) to impound;
- **Options and warrants -** limiting stock underlying such securities, at the time of the public offering to, for example, 15 percent of the outstanding common stock; dictating terms of exercisability to not less than 85 percent of fair market value of the underlying common stock on the date of grant; and limiting underwriters compensatory issuances;
- **Preferred stock -** requiring net income in the past fiscal year that is sufficient to cover fixed charges, preferred stock dividends and redemption requirements of the preferred stock being offered; and requiring the establishment of redemption provisions;
- **Promoters' equity investment -** with respect to development stage companies, requiring the promoters' equity interest to be more than 10 percent of the aggregate public offering;

- **Promotional shares -** requiring the escrow of shares or the reduction of the offering price where equity securities of a development stage company have been issued to promoters for a value less than 85 percent of the proposed public offering price;
- **Selling expenses and selling security holders -** limiting expenses to a percentage of the offering amount; requiring selling security holders to pay a pro rata share of the additional expenses due to the inclusion of their shares in the public offering;
- **Unequal voting rights -** prohibiting these, unless accompanied by preferential dividend or liquidation provisions;
- **Capitalization requirements -** prohibiting the issuance of any security except common equity the issuer is 'unseasoned'; and
- **Specifying offering price -** requiring such prices to relate to book value, earnings history and/or industry price/earnings multiples where there is no established market for the security; requiring the price to be no lower than, e.g., $2 in any event, or no more than 25 times earnings; and forbidding certain types of offerings such as ones with a planned 'step-up' pricing mechanism.

b. Model merit review standards

NASAA is an association of securities administrators from each of the fifty states, the District of Columbia, Puerto Rico, Guam, Mexico, and several Canadian provinces. NASAA has published Statements of Policy that contain model merit standards of general applicability. NASAA also has published Statements of Policy that contain model merit standards that relate to specific investments".

A similar merit review in South Africa would have precluded the Masterbond, Supreme and Owen Wiggins groups from selling debentures and would have prevented losses which exceeded one billion rand.

20. **See** note 19 above.

21. **See** note 14 above.

22. **The** draftsmanship of the Notice is so poor that no useful purpose will be served by reciting the text.

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CHAPTER 9 - DISCLOSURE AND THE SECONDARY MARKET

9.1 In South Africa (as in many other jurisdictions) securities regulation has traditionally focused on new offerings of securities and mainly by means of the compulsory disclosure of the affairs of the company in a prospectus or in similar documents.

9.2 One of the requirements regarding the contents of a prospectus relates to the future prospects of the company. A matter which must be stated is (Schedule 3)

> '(i) The opinion of the directors, stating the grounds therefor, as to the prospects of the business of the company and of its subsidiary and of any subsidiary or business undertaking to be acquired'.

9.3 While securities legislation remains focused on the primary market and the prospectus, most investment activity occurs in the secondary market.

As examples of the investment activity in the secondary market, available statistics indicate that in Canada the secondary market is approximately 25 times larger and in the United States approximately 35 times larger than the primary market.(1)

9.4 In South Africa, compulsory disclosure of the affairs of a public company after the initial issues of shares is limited to the contents of its financial statements. Some additional disclosure is required by the listing requirements of the stock exchange.(2)

9.5 The Companies Act provides for

— duly audited annual financial statements which must be made out before the annual general meeting of the company which has to be held not more than 9 months after the end of the financial year (sec. 286 and 179);

— unaudited provisional annual financial statements within 3 months of the financial year-end if the annual statements had not been issued within this period (sec. 304);

— half-yearly interim reports within 3 months after the expiration of the first six months of the company's financial year (sec. 303).

9.6 These periods were introduced in 1973 and since that date the advance in technology relating to computerized accounting systems and the internet has been ignored.

9.7 There is a growing realization that financial statements as presently prepared have serious deficiencies and often offer very little assistance to investors when issued. More often than not the contents are irrelevant and misleading because

— the statements reflect historical positions which often have no relevance to the future;

— the statements, often published many months after year-end, are normally out of date;

— no direct statements as to the future prospects of the company are required from the directors or from the external auditors;

9.8 The views of some commentators about financial statements as reported by the Jenkins Committee[3] are

> "The **American Accounting Association Committee on Accounting and Auditing Measurement**, 1989-1990, concluded that '.....the most general criticism to be leveled at **financial statements in their present form is that they are seriously *incomplete*'.**
>
> **U.K. accountancy bodies** issued several documents challenging current business reporting.
>
> ***Making Corporate Reports Valuable* (1988)**. 'The present model for corporate reporting is not satisfactory.....**Present-day financial statement packages seldom given any indication of the overall objectives of the entity**; and even crucial information about its management and ownership is provided only on a limited scale'.
>
> ***Financial Reporting. The Way Forward* (1990)**: 'What is principally wrong with present financial statements is that **they do no reflect the economic reality of a company's progress and position** .....Present-day financial statements are deficient in that **they concentrate on .....past events rather than the future'.**

The Future of Financial Reports **(1991)**: 'There is increasing support for the view that the **existing financial reporting package is not adequate to meet the needs of users. The balance sheet and profit and loss account have evolved from the limited requirements of reporting in the developing industrial economy of the nineteenth century, and extensive tinkering has not been sufficient to bring them in line with the requirements of the late twentieth century market economy.**....The contents of financial reports should be user driven.....' "

9.9 Mr **John Whitney**, the Executive Director of the **Columbian Business School's Deming Centre** (at the **1997 World Congress of Accountants**) summarised one of the problems associated with financial statements and the traditional audit as

"Timeliness

We are all painfully aware of the time it takes to complete an audit. By the time the audit is finished and the financial statements are printed, two things will have happened: people will have lost interest and the world will have changed. Moreover, financial statements are lagging indicators".

9.10 More recently, the American Securities and Exchange Commission issued a consultation paper known as the 'Aircraft Carrier Report' in which it expressed the view that information provided ninety days after a fiscal year end, is stale.

"Since 1970, annual reports have been due 90 days after a reporting company's fiscal year end. Quarterly reports, since they were first required in 1946, have always been due within 45 days after the end of a quarter. Many companies file, or ostensibly could file, their periodic reports before they are due.

In this age of computers, instantaneous communications and electronic filing, we believe it is possible for reporting companies to file their annual and quarterly Exchange Act reports sooner than they are currently due. Public companies, as a group, have had decades of experience in preparing Exchange Act periodic reports within 90 and 45 days.

As the proposed registration system makes clear, the securities markets move faster than they did before. Commentators have long remarked that because the due dates for quarterly reports are so lengthy, the information required by Form 10-Q or 10-QSB is stale by the time the reports are available. Annual information — when provided 90

days after a fiscal year end — is also viewed as stale. We believe investors and the market would realize immediate and ongoing benefits if domestic reporting companies filed their annual and quarterly reports earlier than currently due. We also believe earlier due dates would provide investors with more timely disclosure as well as shorten the period during which periodic results would be available to only certain investors".(4)

9.11 Electronic communication offers the potential for rapid and less costly dissemination of information.

"Electronic lodgment has advantages for both the regulator and investors. It is potentially cheaper for the regulator to process, maintain, track and retrieve lodged information. It also provides the opportunity for efficient and effective dissemination of filed information to members of the public who have access to the means to receive it. Moreover, depending on the system adopted, electronically lodged information may be more useful to investors than the same information provided in paper format, since many electronic formats have the potential to be searched and for information (for example, the financial statements) to be imported into spreadsheets for the purpose of analysis".(5)

9.12 The Canadian Securities Administrators have issued a 'Concept Proposal for an Integrated Disclosure System' in which a system of continuous disclosure of information to all market participants is proposed.

"The objective of the CSA is to foster fair and efficient capital markets in a changing market environment in a way that facilitates capital formation without compromising the protection of investors. More specifically, the CSA seek to:

- facilitate prompt and flexible access by business to capital;
- enhance the ability of investors to make informed investment decisions using more useful and reliable information from securities issuers; and
- achieve a better match of regulatory effort to existing and prospective market conditions.

The key to achieving these objectives, in view of the the CSA, lies in integrating and upgrading the quality of information made available on a continuous basis to all market participants.

> The proposed 'integrated disclosure system' (the 'IDS') would integrate the information required to be provided by reporting issuers to investors in both the primary and secondary securities markets in a common continuous disclosure base. The foundation of the IDS would be an upgraded 'IDS disclosure base' that offers the public timely access to information relating to an issuer and its business, comparable to the information currently provided in a propsectus. The IDS disclosure base, with its comprehensive and timely information available to all investors, would represent an important advance in investor protection.
>
> With its IDS disclosure base in place, a participating issuer would be able to respond immediately to opportunities in the primary market by using an abbreviated securities offering document that incorporates by reference the issuer's IDS disclosure base and undergoes streamlined regulatory screening".[(6)]

9.13 Continuous disclosure of events which might have an impact on the value of the shares of a company is normally regulated by the listing requirements of stock exchanges.

9.14 The New Zealand Stock Exchange requires the release of all 'relevant information', which is defined as

> "[A]t any time information received or generated and held by an Issuer about its undertaking, activities, business environment, prospects, financial position or financial performance which is not reasonably available to an informed investor in the market in a form substantially as useable as the form in which it is available to the Issuer, and which upon disclosure to the market would, or would likely to, affect materially the market price of any of the Issuer's Quoted Securities".

It is also stated that

> ".... It shall not be a sufficient reason to withhold Relevant Information, that release of it may adversely affect the market price of any of the Issuer's Quoted Securities, or its ability to attract and retain debt financing on favourable terms".

9.15 The continuous disclosure of relevant information, the definition of relevancy and the exclusion of certain information from immediate disclosure are debated worldwide.[(7)]

9.16 While the listing requirements in South Africa are set and supervised by a private entity, the JSE Securities Exchange SA, no useful purpose will be served by a lengthy discussion about the continuous disclosure of relevant information.

The JSE seems to lack the ability or the necessary will to set listing requirements which could adequately protect investors.[8]

As recommended in Chapter 7, the Securities Exchange should be controlled by the Securities Regulator.

9.17 As pointed out, the South African Companies Act requires public companies to issue half-yearly and annual financial statements.

The advent of computerized accountancy systems has made daily disclosure possible. There is no practical reason why all listed public companies should not be required to issue quarterly financial statements.

9.18 The existing time periods allowed for the issue of financial statements have their roots in the old accounting systems based on manual bookkeeping.

There can be no practical reason why companies should not be able to issue quarterly statements within 30 days of the end of the quarter and annual financial statements within 45 days after the end of the financial year.

9.19 An impediment to the prompt issue of financial statements is the often widespread use of journal entries (often long after year-end) to manipulate financial data.

> "Currently the information presented in financial statements is too often only collated after year end and subsequently adjusted by an array of sometimes random closing and correcting entries to reflect preplanned sets of information. What is being achieved is a belated manipulated collation of data, for release after the so-called year end audit".[9]

9.20 As in Ontario and as suggested by the SEC, quarterly statements of all listed companies should be subject to review by the external auditor.

9.21 It is recommended that all public companies should be required to publish

— **quarterly reports within 30 days after the end of each of the first three quarters of the financial year;**

— **annual financial statements within 45 days after the end of the financial year.**

9.22 It is further recommended that all listed public companies should be required to have their quarterly reports reviewed by the external auditor.

.....

NOTES

1. **Concept Proposal for an Integrated Disclosure System** (Canadian Securities Administrators. January 2000) p. 3.

2. **Some** of the disclosures required by the listing requirements in South Africa are

"3.43 An issuer must, without delay, subject to the approval by the Listings Division, release an announcement giving details of:

(a) circumstances or events that have or are likely to have a material effect on the financial results, the financial position or cash flow of the issuer and/or information necessary to enable holders of the issuer's listed securities and the public to avoid the creation of a false market in its listed securities; and

(b) any new developments in its sphere of activity which are not public knowledge and which may by virtue of the effect of those developments on its assets and liabilities or financial position or in the general couse of its business, lead to material movements in the ruling price of its listed securities.

Save where otherwise expressly provided, the requirements of this paragraph are in addition to any specific requirements regarding notification contained in the Listings Requirements.

3.76 Information required by and provided in confidence to, and for the purposes of, a government department, the South African Reserve Bank, the SRP, the Financial Services Board or any other statutory or regulatory body or authority need not be published.

3.19 Interim reports shall be distributed to all shareholders as early as possible after the expiration of the first six month period of a financial year, but not later than three months after that date. Where the financial period covers 15 months or longer, interim reports shall be distributed in respect of the first and second six of this period. In the case of companies which report to shareholders on a quarterly basis, the quarterly reports shall be distributed to all shareholders as soon as possible after the expiration of each quarter, provided that where the quarterly report is in respect of the second quarter, such report shall be distributed within three months after the expiration of such period.

Requirement for review by auditors

3.24 The following provisions apply in respect of unaudited interim reports, and unaudited provisional reports:

(a) subject to (b), unaudited interim reports are not required to be reviewed by a listed company's auditors;

(b) unaudited interim reports shall be reviewed by a listed company's auditors if the company's auditors have qualified or disclaimed their opinion, or produced an adverse opinion, on the company's latest annual financial statements, unless the Committee otherwise decides;

(c) unaudited provisional reports shall be reviewed by a listed company's auditors;

(d) unaudited quarterly reports are not required to be reviewed by a listed company's auditors, unless otherwise requested by the Committee;

(e) when conducting a review of an unaudited interim or provisional report, the auditor shall follow the guidelines issued by the South African Institute of Chartered Accountants;

(f) if an interim provisional report has been reviewed by an auditor, this and the name of the auditor shall be stated in the published interim or provisional report, if such report is modified, details of the nature of such modification shall also be stated therein. If the report of the auditor is not included in the published interim or provisional report, it shall state that the report of the auditor is available for inspection at the company's registered office; and

(g) if during the course of a review of a provisional report, the auditor becomes aware of any unresolved matter which could result in a qualified disclaimer of or an adverse audit opinion on the annual financial statements for the period under review, that fact shall be stated.

Annual financial statements

3.25 Every listed company shall, within six months after the end of each financial year and at least twenty-one clear days before the date of the annual general meeting, distribute to all shareholders; submit to the Listings Division in accordance with paragraph 16.21; and make available to the South African Press Association:

(a) a notice of annual general meeting; and

(b) the annual financial statements for the relevant financial year which financial statements will have been reported upon by the company's auditors".

3. **Jenkins Committee Report**. "Improving Business Reporting: A Customer Focus". Report of the Special Committee of AICPA on Financial Reporting (1993).

4. **Aircract Carrier Report.**

5. **Boros, Dr Elizabeth :** 'The Online Corporation's Electronic Corporate Communications' (Centre for Corporate Law and Securities Regulation. University of Melbourne. December 1999) p.26.

6. **Canadian Securities Administration.** "Concept Proposal for an Integrated Disclosure System" (Jan. 2000) Part 2.

7. **Oesterle, Prof. Dale Arthur.** : 'The Inexorable March Towards a Continuous Disclosure Requirement For Publicly Traded Corporations : Are We There Yet?' (Cardozo Law Review Vol. 20) p 136.

8. **See** the recent retraction by the JSE of a perfectly normal requirement that the benefits of directors should be disclosed **(Cape Times Business Report : 23 February 2001):**

"JSE postpones requirement to disclose directors' fees

Johannesburg – In a move that is regarded as a blow to corporate governance, the JSE Securities Exchange (JSE) has decided to postpone implementation of its listing requirement relating to the disclosure of directors' emoluments.

The decision was taken largely in response to the possible threat of legal action around the issue of retrospective legislation.

Russel Loubser, the president of the JSE, said the additional time would allow companies to 'manage and communicate' the implications of the disclosure.

He also warned that companies should not attempt to change the relationship between themselves and their directors in order to avoid compliance with the requirement.

The requirement, which included disclosure of individual directors' remuneration, should have been effective for companies with a financial year ending after October 1 last year. It will now only become applicable in respect of financial years commencing on, or after, March 1 this year.

This means that shareholders will only get access to the information from annual reports that are published from about May 2002 onwards instead of next month.

John Burke, who is the head of the JSE's listings department, denied that the decision to postpone implementation was because of pressure from black

business leaders who feared that the publication of such data would make them targets for unwelcome activity.

'We discussed the issue with leading black businessmen and women and they expressed unhappiness with the perception that blacks were seen as an impediment to a change that they regard as necessary,' he said.

Others claimed that the toughest opposition came from a relatively small number of high-profile and powerful white business leaders. This opposition was only voiced after the new listings requirements took effect. There was little dissension expressed during the consultation period".

See also the comments by Ann Crotty in **Business Report, Sunday Argus** 25 February 2001:

"Johannesburg — The international reputation of the JSE Securities Exchange suffered a blow this week when it announced it was postponing implementation of the new requirement relating to disclosure of directors' remuneration until March next year. The postponement means the JSE will be several years behind the major international bourses.

John Burke, the head of the JSE listings department, urged companies to disclose details of their directors' remuneration this year and not wait until they were obliged to.

On Friday Burke and Russell Loubser, the chief executive of the JSE, announced they had reluctantly given into pressure from the directors of a 'minority of companies' and decided to postpone the implementation of the new disclosure requirement from last October to March next year.

This means stakeholders in corporate South Africa will only get access to useful information on directors' remuneration from about May next year, when the end-March 2001 [sic] annual reports are released.

Ironically, South African shareholders in London-listed companies such as SAB, Billiton, Old Mutual, Dimension Data and Anglo American have access to detailed information on their directors' remuneration. To date none of the executives of these companies, who spend a considerable amount of

time in South Africa, have reported any consequent disruptions to their corporate or personal lives.

The lobbying to block implementation began after October 1 last year, which was the original date of implementation. This was despite corporate executives and members of the public having access to the consultation draft of the new listings requirements as early as August last year. There was very little discussion of the requirements relating to disclosure of directors' remuneration during this consultation period.

'We followed the due process, which included a period of consultation, but it was only after October 1 that the objections started,' said Loubser.

This indicates that key members of corporate South Africa either do not take the JSE seriously, or believe they have enough power to change the rules after the fact".

9. **Wenzelburger, Norman R :** 'The Failure of the Audit Function in Managing Risk' (September 2000).

.....

CHAPTER 10 - REGULATION AND SUPERVISION OF INTERMEDIARIES

10.1 As pointed out, 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, shares of listed companies and the like. When unable to depend upon their own resources, they are invited to place their futures in the hands of professional advisers or so-called 'intermediaries'.

10.2 In South Africa these 'intermediaries' are usually unregulated and no qualifications, no skills and no adherence to codes of ethics are required by law when they ply their trade.

10.3 In response to the Consultative Paper 'Regulation of Retail Investment Services in South Africa' issued by the Policy Board of Financial Services and Regulations (12 July 1996), the Commission stated that **intermediaries** (brokers, agents, financial advisers, etc.)

— **are normally indispensable links in the chain when fraud is being perpetrated on the public;**

— **are virtually never prosecuted and are hardly ever in the position to satisfy claims based on their negligent, reckless or even fraudulent conduct;**

— **are often motivated by greed when they target the elderly and trusting members of society;** [(1)]

— **that no qualifications, no skills and no adherence to codes of ethics are required from them;**

— **that there are approximately 20 000 – 30 000 persons, loosely described as 'brokers', active in South Africa;** and

— **that according to evidence presented in the High Court in the matter of Durr** v **Absa Bank and Myles Stuart, the typical South African 'broker'**

(i) **cannot distinguish between a prospectus and marketing material containing information;**

(ii) **does not know what the legal requirements of a**

prospectus are;

(iii) **cannot read and understand financial statements;**

(iv) **is not able to assess the institutional risk attaching to a particular company or group of companies,** and

(v) **would not make enquiries as to the nature of the security underlying secured debentures.**

10.4 In the vast majority of the well regulated economies of the world it is recognized that regulation, supervision and licensing of all financial advisers and intermediaries are necessary

— to provide protection to investors from unfair, improper and fraudulent practices; and

— to foster fair and efficient capital markets and confidence therein. (2)

10.5 In these economies, licensing only occurs after the applicants have satisfied the regulators, whether by way of examination or by other means, that they are suitably qualified to perform their functions.

10.6 The **Australian Securities Commission** stated

'While no form of regulation can completely protect investors from fraudulent or dishonest players, the ASC believes that regulation can promote efficiency and raise the quality of the advisory process by addressing some market imperfections'.

'Extensive regulation of advisers would not be necessary if competitive market forces could remove incompetent and dishonest advisers quickly and before any substantial losses occur. However, in the absence of all the information and understanding necessary for consumers to make informed choices, competition may not produce optimal outcomes'.

'The most significant problems include inadequate consumer information and an imbalance of knowledge between advisers and investors; difficulties in ascertaining

the quality of an advisory service at the point of purchase because of the long term nature of financial contracts, the tendency of investors to use imperfect substitutes for reliable information; issues relating to conflicts of interest between investor and intermediary; the complexities of financial markets and technicalities of some financial products'.

'The objective of regulation in this context should be to promote investor confidence and market efficiency through : investor education; cost-efficient regulation; encouraging the industry to set and improve market standards; maintaining a significant role in enforcement and surveillance of the industry and promoting effective complaints resolution mechanisms. In the context of a relative fragmented and young market for advisory services and a relative inexperienced investing community, it is considered appropriate for the ASC to maintain a licensing role. Regulation which imposes requirements on advisers before they can enter the industry is considered justified having regard to the needs of retail investors who rely largely on assumptions as to the competence and integrity of advisers rather than undertake this assessment themselves'."[(3)]

If the above is a true reflection of the Australian market, regulation which imposes requirements on advisers before they are allowed to enter the industry would be even more essential in the South African market.

10.7 To illustrate the recognition by many of the well-regulated economies of the need to regulate, supervise and license all financial advisers and intermediaries, reference will be made to legislation or proposed legislation in Hong Kong, Singapore, the United Kingdom and the United States.

10.8 In the Consultation Paper on the Review of the Licensing Regime issued by the **Hong Kong Government** (June 1999), the necessity for a licensing regime in respect of all intermediaries with barriers to entry which would exclude the incompetent or unfit is stressed.

"4.1 The International Organization of Securities Commission (IOSCO) has adopted three core objectives of securities regulation. These are:

— The protection of investors.

— Ensuring that markets are fair, efficient and transparent.

— The reduction of systemic risk.

4.2 In achieving these objectives, IOSCO recommends the need for a 'licensing' (rather than 'registration', 'certification' or 'negative licensing') regime. The right to provide financial services should be conditional upon practitioners satisfying a licensing authority of their ability to meet certain predetermined criteria. Principle 21 of the IOSCO Objectives and Principles provide: 'Regulation should provide for minimum entry standards for market intermediaries'.

4.3 Hong Kong faces increasing competition from our neighbours in the region and, due largely to advances in technology and communications, competition from further afield. The financial markets are an important part of the Hong Kong economy. The presence in Hong Kong of a pool of competent licensed intermediaries is vital to the growth and development of the local markets. To maintain Hong Kong's position as a leading financial centre, the licensing regime must provide:

— minimum barriers to entry that exclude the incompetent and those unfit to enjoy a position of trust as a financial intermediary;

— equal and fair access to all suitably qualified applicants for a licence;

— entry criteria that have regard to the business plan of the applicant and do not permit the provision of services outside the applicants' area of competence;

— entry criteria that are clear and certain in their application;

— entry criteria that set initial and ongoing capital and other prudential requirements;

— entry criteria that set standards for internal organisation and operational conduct that aim to protect the interests of clients and under which management of the intermediary accept primary responsibility for these matters;

— a transparent licensing process in which key information on licensed persons is publicly available, including the category of licence held,

the scope of authorized activities, the identity of senior management and those authorized to act in the name of the intermediary;

— a process requiring a comprehensive assessment of the applicant and all who are in a position to control or materially influence the carrying on of regulated activities by the applicant;

— protection of the interests of investors, recognising that the initial entry barrier cannot be set too high and that investor protection is complemented by the availability of information, facilitating informed choices by investors and availability to the Commission of inspection, investigatory and disciplinary powers in respect of the intermediary;

— power for the Commission to withdraw or restrict a licence or to sanction the licencee whenever the entry criteria are not fulfilled or other misconduct occurs; and

— a requirement that changes of control over, or material influence of an intermediary should be made known to the Commission and be subject to approval in order to allow for a review of the licensed person's suitability".

10.9 The **Monetary Authority of Singapore** licenses dealers in securities, investment advisers and investment representatives (sections 24 – 26 of Act 15 of 1986). It grants or renews a licence if it has no reason to believe that the applicant will not perform its duties efficiently, honestly and fairly (sec. 30).

10.10 In the **United States** the National Conference of Commissioners on Uniform State Laws published the Uniform Securities Act in 1956.
The 1956 Act has been adopted in whole or in part in 37 jurisdictions.[4]

10.11 In 1985 an updated version, the Uniform Securities Act (1985), was published. It provides for the licensing of broker-dealers, sales representatives and investment advisers (sections 201 – 205), and for the examination, oral or written, of an applicant or a class of applicants for licensing, and of a class of persons who will represent an investment adviser in performing an act that requires licensing as an investment adviser. (Section 207)[5]

10.12 Generally speaking, the individual States in the United States require all intermediaries to be licensed and they are only licensed after having satisfied the authorities of their competence.

10.13 The **Alabama Securities Act** is used as an example.[6] It defines intermediaries (agents, dealers, brokers, investment advisers, investment adviser representatives and salesmen) as follows -
(Sec. 8-6 2):

> "**Agent**.
> Any individual other than a dealer who represents a dealer or issuer in effecting or attempting to effect sales of securities, but such term does not include an individual who represents an issuer in:
>
> a. Effecting transactions in a security exempted by subdivisions (1), (2), (3), (4), (9) or (10) of Section 8-6-10;
>
> b. Effecting transactions exempted by Section 8-6-11; or
>
> c. Effecting transactions with existing employees, partners, or directors of the issuer if no commission or other remuneration is paid or given directly or indirectly for soliciting any person in this state. A partner, officer, or director of a dealer or issuer is an agent if he otherwise comes within this definition.
>
> **Dealer.**
> Any person engaged in the business of effecting transactions in securities for the account of others or for his own account. Such term does not include:
>
> a. An agent, issuer, bank, savings institution, savings and loan association, credit union, or trust company, or
>
> b. A person who has no place of business in this state if he effects transactions in this state exclusively with or through the issuers of the securities involved in the transactions and other dealers.
>
> **Broker**.
> A dealer, as hereinabove defined.

Investment adviser.

a. Any person, who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities. 'Investment adviser' also includes financial planners and other persons who, as an integral component of other financially related services, provide the foregoing investment advisory services to others for compensation and as part of a business or who hold themselves out as providing the foregoing investment advisory services to others for compensation.

'Investment adviser' does not include: (a. An investment adviser representative.....)

Investment adviser representative.

Any partner, officer, director of (or a person occupying a similar status or performing similar functions) or other individual employed by or associated with an investment adviser, except clerical or ministerial personnel, who:

a. Makes any recommendation or otherwise renders advice regarding securities,

b. Manages accounts or portfolios of clients,

c. Determines which recommendation or advice regarding securities should be given,

d. Solicits, offers, or negotiates for the sale of or sells investment advisory services, unless the solicitation, offering, or selling activities are solely incidental to his or her profession and such person is a dealer or salesman registered under Section 8-6-3 and the person would not be an investment adviser representative except for the performance of activities described in subdivision (18)d. of this section, or

e. Supervises employees who perform any of the foregoing.

Salesman.

An agent, as hereinabove defined.

10.14 Section 8-6-3 of the **Alabama Securities Act** prohibits the transaction of business as an investment adviser or investment adviser representative unless registered as such. Registration is not possible without having passed an examination (8-6-3-f).

"Section 8-6-3 : Registration and bonds of dealers and salesmen.

(a) It is unlawful for any person to transact business in this state as a dealer or agent for securities unless he is registered under this article. It is unlawful for any dealer or issuer to employ an agent unless the agent is registered.

(b) It is unlawful for any person to transact business in this state as an investment adviser or as an investment adviser representative unless:

(1) He is so registered under this article.
(2) .....
(3) .....

(c) It is unlawful for any investment adviser required to be registered to employ an investment adviser representative unless the investment adviser representative is registered under this article. The registration of an investment adviser representative is not effective during any period when he is not employed by an investment adviser registered under this article. When an investment adviser representative begins or terminates employment with an investment adviser, the investment adviser shall promptly notify the commission.

(d) A dealer, agent, investment adviser, or investment adviser representative may apply for registration by filing with the securities commission, or its designee, an application, together with a consent to service of process pursuant to Section 8-6-12 and payment of the fee prescribed in subsection (h) of this section. The application shall contain whatever information the commission requires concerning such matters as:

(1) The applicant's form and place of organization;

(2) The applicant's proposed method of doing business;

(3) The qualifications and business history of the applicant and, in the case of a dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the dealer or investment adviser;

(4) Any injunction or administrative order or conviction of a misdemeanor involving moral turpitude, a security or any aspect of the securities business, any conviction of a felony;

(5) The applicant's financial condition and history; and

(6) Any information to be furnished or disseminated to any client or prospective client, if the applicant is an investment adviser.

(e) The commission shall by rule or order require all or any class of applicants to post surety bonds, or cash, in an amount not less than &dollar, 50 000, and shall determine their conditions.

(f) .....The commission shall require as conditions of registration that:

(1) All or any class of applicants and, in the case of a corporation or partnership, the officers or partners, pass an examination, either written or oral, the form, content, and conduct of which the commission shall prescribe by rule or order.

(2) A dealer shall have and maintain a minimum net capital as the commission shall prescribe by rule or order. The commission may by rule establish minimum financial requirements for investment advisers, which may include different requirements for those investment advisers who maintain custody of clients' funds or securities or who have discretionary authority over same and those investment advisers who do not.

(3) Every registration expires December 31 unless renewed as hereinafter provided.

(g) .....

(h) .....

(i) Every registered dealer and investment adviser shall make and keep such accounts and other records as the securities commission by rule prescribes. All records so required shall be preserved for five years unless the commission prescribes otherwise for particular types of records. The commission may require that certain information be furnished or disseminated by a registrant as necessary or appropriate in the public interest or for the protection of investors and advisory clients. To the extent determined by the commission in its discretion, information furnished to clients or prospective clients of an investment adviser pursuant to the Investment Advisers Act of 1940 and the rules thereunder may be used in whole or partial satisfaction of this requirement. All the records of any registrant are subject at any time or from time to time to such reasonable periodic, special, or other examinations by representatives of the commission, within or without this state, as the commission deems necessary or appropriate in the public interest or for the protection of investors".[7]

10.15 The usual examination for an investment adviser representative is known as the 'Series 65 Exam' which has been designed to qualify candidates as investment adviser representatives. This is the examination referred to in the Georgia Securities Act [8] which was developed by the North American Securities Administration Inc. (NASAA). NASAA is the organisation of the Securities Administrators of Canada, Mexico, 50 States of the USA and of the District of Columbia and Puerto Rico.

10.16 The 'Modified' Series 65 Examination replaced the old Series 65 and became effective on January 1, 2000. The required study outline is set out in the notes hereto.[9]

10.17 In the **United Kingdom** the Financial Services and Markets Act 2000 prohibits the carrying on of a regulated activity unless authorised thereto by the Financial Services Authority (sec. 17). Regulated activities include the giving or offering of investment advice (sec. 20 and schedule 2).

The FSA may refuse an application for registration if it appears to it desirable in the interest of consumers or potential consumers

(sec. 42 (3)) after having been provided with such information as it reasonably considers necessary (sec. 49).

The stated intention of the FSA is the assessment of the competence and capability of the applicant to carry out the function which he will be performing.[10]

10.18 In response to the Consultative Paper issued by the South African Policy Board of Financial Services and Regulation during July 1996, the Commission made the following key recommendations:

- **No person should be allowed to give investment advice for reward unless licensed so to do so by a competent and independent supervisor.**

- **Before being licensed, such a person should satisfy the supervisor that he or she is a fit and proper person and qualified to advise on investment in a particular field or fields before registration.**

- **The licence should state in which particular field such person is allowed to give advice.**

- **Any unlicensed person and any employer of such a person should be personally liable for the immediate repayment of any investment made as a result of the activities of such a person if and when called upon to do so by the investor.**

- **Any person who gives investment advice for reward without being licensed to do so or contrary to the terms of the licence or not in accordance with prescribed rules of conduct, should be guilty of a criminal offence carrying heavy penalties, such as, say, imprisonment up to 10 years or a fine of up to one million rand or both.**

- **Alternative civil remedies should be made available to investors who have claims against any regulated person or entity. The proceedings should be expeditious and inexpensive and the claims adjudicated upon by tribunals whose members have particular expertise.**

10.19 During April 1999 the Financial Services Board issued a Draft Financial Advisers Bill for comment. The draft bill specifically excluded representatives or 'agents' from regulation and supervision by the regulator.

10.20 In its response thereto the Commission restated its views on the regulation and supervision of intermediaries and also referred extensively to legislation in other jurisdictions.[11]

10.21 A Revised Draft 'Financial Advisory and Intermediary Services Bill 2000' was issued during June 2000.

10.22 The Financial Services Board still refuses to accept the responsibilities which regulators in modern economies regard as cornerstones of investor protection, namely

- the registration of all financial advisers, whether employers, employees or the thousands of 'agents' and only after having been satisfied of their competence,
- the regulation and supervision of virtually all financial products;[12]
- the independence of the regulator.

10.23 In its final form the proposed bill has completely abandoned the concept of an independent regulator.

In terms of section 5 of the Bill an 'Advisory Committee on Financial Service Providers' will be created which will consist of a chairperson and **other members representative of product suppliers, financial service providers** [own emphasis] and clients.

10.24 The very entities which created the necessity to regulate and supervise, and the very entities against which the public have to be protected, will thus be appointed to advise the registrar

- which financial products should be exempted from the provisions of the Act (section 2);

- which advisory activity should be excluded from the provisions of the Act (section 3(a)(v);

- which intermediary services should be exempted from the provisions of the Act (section 3(b)(iii).

(An intermediary service is defined as meaning

"any act other than the furnishing of advice, performed by a person —

(a) the result of which is that a client may enter into, offers to enter into or enters into any transaction in respect of a financial product with a product supplier; or

(b) with a view to —

(i) managing, administering, keeping in safe custody, maintaining or servicing a financial product purchased by a client from a product supplier or in which the client has invested;

(ii) collecting or accounting for premiums or other moneys payable by the client to a product supplier in respect of such financial product; or

(iii) receiving, submitting or processing of claims of a client against any such product supplier; ".)

- advise the registrar as to the submission of reports and the manner and matters to be reported upon by a compliance officer (section 17(4));

- advise the Board as to which person should be appointed as an Ombudsman (section 21(1));

- advise the Board and Minister whether to remove the Ombudsman from office (section 21(4));

- advise the Board in the making of rules (section 26) –

"... including different rules in respect of different categories of complaints or Ombudsman investigations, regarding –

(a) (i) any matter which is required or permitted under this Act to be regulated by rule;

(ii) the category of persons qualifying as complainants;

(iii) the type of complaint justiciable by the Ombudsman, including a complaint relating to a financial service rendered by a person not authorised as a financial services provider or a representative of such provider;

(iv) the rights of complainants in connection with complaints, including the manner of lodging of a complaint to the authorised financial services provider or representative involved;

(v) the rights and duties of any such provider or representative on receipt of any complaint, particularly in connection with the furnishing of replies to the complainant;

(vi) the rights of a complainant to submit a complaint to the Ombudsman where the complainant is not satisfied with any reply received from the provider or representative concerned;

(vii) the circumstances under which a complaint may be dismissed without consideration of its merits;

(viii) the power of the Ombudsman to fix a time limit for any aspect of the proceedings and to extend a time limit;

(b) the payment to the Office by the authorised financial services provider or representative involved in any complaint lodged with the Ombudsman of case fees in respect of the consideration of a complaint by the Ombudsman".

- advise the board as to the imposition of special levies on authorised financial providers for the purposes of funding the office of the Ombudsman (section 26(3));

- advise the registrar whether a particular business practice should be declared undesirable for all or a particular category of authorised financial service providers, or for any specific provider (section 34(1));

- advise the Minister relating to the making of any regulation (section 35(1).

10.25 A remarkable abandonment of any semblance of the independence of the regulator is provided by section 15(1):

"15 (1) The registrar shall in consultation with the Advisory Committee and with such other representatives of the financial services industry and client and consumer bodies determined by the Advisory Committee, draft a code of conduct for authorised financial services providers which, if approved by that Committee, shall be published by notice in

> the *Gazette*, and which shall on any such publication become binding on all authorised financial services providers and representatives referred to therein".

10.26 This section means that the registrar will be obliged to consult with

- the Advisory Committee; and
- representatives of the financial services industry and client and consumer bodies **determined by the Advisory Committee** (own emphasis); and
- that these entities will have to approve the contents of any proposed rule of conduct before such rule can be published and become binding.

10.27 The effect of this section is that the very entities whose conduct has to be regulated will have the authority to veto any rule which might seek to curb their excesses.

10.28 While the contents of section 15 can be described as 'a remarkable abandonment of any semblance of the independence of the regulator', the contents of section 6 defies description.

10.29 Section 6 must certainly be unique in legislation which purportedly seeks to curb the excesses of the financial services industries.

10.30 The essence of section 6 is that, if enacted in its present form, it will create a mechanism whereby each and every function of the Minister and of the Registrar can be delegated to

'a body of persons which represents a category of authorised financial service providers.'

This will enable the financial service providers to control virtually all the facets of the hawking and selling of financial products.

10.31 Virtual control by the financial service providers would follow if the powers to delegate which has been introduced into the Bill are used. It

- enables the Minister to delegate any power conferred upon him by the Act to, *inter alia*, the Registrar (section 6(1));

- enables the Financial Services Board to delegate any power conferred upon it by the Act to, *inter alia*, the Registrar (section 6(2)(a));

- enables the Registrar to delegate any power conferred upon him by the Act, including any power which has been delegated to him, to, *inter alia*, any body recognized by the Financial Services Board for that purpose (section 6(3)(a)(iii));

- enable the Financial Services Board, for the purposes of the delegation of such powers to it, to recognize any body of persons which represents a category of authorised financial service providers or representatives (section 6(4)(a)).

10.32 In addition to these criticisms, the final draft of the proposed Bill is decidedly less friendly towards the long-suffering public than previous drafts.

Provisions seeking to protect the public, such as those relating to 'cold calling' and 'cooling-off' periods, have disappeared without any explanation.

10.33 The Commission is of the view that at best the contents of the proposed Bill do not provide adequate protection to the public, and at worst the contents constitute a cynical attempt to allow control of financial intermediaries to be handed over to the financial services industry.

10.34 It is recommended that the proposed Bill should be rejected and redrafted with a specific instruction to the draftsperson that the contents of the Bill should be focused on the protection of the public and on the protection of the financial markets.

10.35 It is further recommended that

- **No person should be allowed to give investment advice for reward unless licensed so to do so by a competent and independent supervisor.**

- **Before being licensed, such a person should satisfy the supervisor that he or she is a fit and proper person and qualified to advise on investment in a particular field or fields before registration.**

- **The licence should state in which particular field such person is allowed to give advice.**

- **Any unlicensed person and any employer of such a person should be personally liable for the immediate repayment of any investment made as a result of the activities of such a person if and when called upon to do so by the investor.**

- **Any person who gives investment advice for reward without being licensed to do so or contrary to the terms of the licence or not in accordance with prescribed rules of conduct, should be guilty of a criminal offence carrying heavy penalties, such as, say, imprisonment up to 10 years or a fine of up to one million rand or both.**

.....

NOTES

1. **See also** - Under the heading **'Big commission debate hots up'**, Bruce Cameron wrote the following (Personal Finance, The Argus, September 30, 2000):

"The widespread switch from defined benefit to defined contribution pension funds has forced many members to take responsibility for the investment of their retirement savings at retirement. This has brought about a war between various financial services sectors for the billions at stake. The war is being won and lost on the commissions and other incentives, such as luxury foreign holidays, on offer to those selling financial products.

Life assurers have been losing out because they cannot match the higher commissions paid by other sectors to intermediaries because life assurance is the only sector with regulated commissions.

.....

The commission war has become so acute and absurd that wrap fund managers, who pull together underlying investments, and whose funds are the main investment vehicle used for living annuities, are now paying higher annual commissions to the people who sell the investments than they receive for their investment expertise. The intermediaries are paid for doing very little.

.....

However, it is in the lump sum business that most mis-selling by intermediaries has taken place in recent years. Much of the mis-selling has been based on ever higher commissions being paid to intermediaries by the non-assurance sector of the financial services industry for lump sum investments, most of which are pension pay-outs from retirement funds.

Despite evidence of the mis-selling of lump sum investments, particularly living annuities, published over a number of months in Personal Finance, Gerhard Joubert, chief executive of the LOA, says: 'I am not aware of the alleged mis-selling of living annuities and would appreciate receiving information about specific cases'."

2. **See** e.g. **Securities Act of Ontario :** Section 1.1

3. **Australian Securities Commission**, Licensing Review (August 1995).

4. **Long, Joseph C :** Blue Sky Law Vol. 12 B. App. D.I.- 3. (The West Group 1999).

5. **Ibid :** App. D. I. Par 11.

See also sections 401(d)(2), 403(a)(1) – (6) and 405(a) (A-K) of the Proposed Revised Uniform Securities Act as follows (Jan. 2000):

"401(d)(2) Except as provided in §402, the [Administrator] may register any investment adviser representative of a federal covered investment adviser who has a place of business within the State. The registration of such an investment adviser representative is not effective during any period when the investment adviser representative is not employed by or associated with the federal covered investment adviser. When an investment adviser representative begins or terminates employment by or association with a federal covered investment adviser, or begins or terminates activities which make him or her an investment adviser representative, the investment adviser representative or federal covered investment adviser shall promptly notify the [Administrator].

403(a) **[REGISTRATION PROCEDURE FOR BROKER-DEALERS, AGENTS, INVESTMENT ADVISERS, AND INVESTMENT ADVISER REPRESENTATIVES]**

A broker-dealer, agent, investment adviser, or investment adviser representative may obtain an [initial or renewal] registration by filing with the [Administrator] or his or her designee an application together with a consent to service of process complying with §510. Each application shall contain whatever information the [Administrator] by rule requires concerning such matters as

(1) the applicant's form and place of organization;

(2) the applicant's proposed method of doing business;

(3) the qualifications and business history of the applicant; in the case of the broker-dealer or investment adviser, the qualifications and business history of each partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser;

(4) any injunction or administrative order or conviction of a felony of the applicant or any person specified in §403(a)(3);

(5) the applicant's financial condition and history; and

(6) `if the applicant is an investment adviser, any information concerning the investment adviser to be furnished or disseminated to any client or prospective client.

405 **[DENIAL, REVOCATION, SUSPENSION CANCELLATION, AND WITHDRAWAL OF REGISTRATION].**

(a) The [Administrator] shall by order deny, suspend or revoke any registration, or bar or censure any registrant agent or investment adviser representative from employment by or association with a registered broker-dealer, investment adviser, or federal covered investment adviser, or bar or censure any officer, director, partner or person occupying a similar status or performing similar functions for a registered broker-dealer or investment adviser, from employment by or association with a registered broker-dealer or registered investment adviser, or restrict or limit a registrant as to any function or activity of the business for which registration is required in this state, if the [Administrator] finds (1) that the order is in the public interest and (2) that the applicant or registrant

(A) has filed an application for registration which as of its effective date, or as of any date after filing in the case of an order denying effectiveness, was incomplete in any material respect or contained any statement which was, in light of the circumstances under which it was made, false or misleading with respect to any material fact;

(B) has willfully violated or willfully failed to comply with any provision of this Act or a predecessor act or any rule or order under this Act or a predecessor act, or any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the

Investment Company Act of 1940, or the Commodity Exchange Act within the past ten years;

(C) has been convicted, within the past ten years, of any felony or any misdemeanor involving a security or any aspect of the securities business;

(D) is permanently or temporarily enjoined by any court of competent jurisdiction from engaging in or continuing any conduct or practice involving any aspect of the securities business;

(E) is the subject of an order entered within the past five years by the securities administrator of any other state or by the Securities and Exchange Commission denying, revoking, or suspending registration as a broker-dealer, agent, investment adviser, or investment adviser representative, or the substantial equivalent of those terms as defined in this Act, or is the subject of an order entered within the past five years by the [Administrator] of any State or by the Securities and Exchange Commission with a registered broker-dealer or registered investment adviser, or the substantive equivalent of these terms or is the subject of an order of the Securities and Exchange Commission suspending or expelling him from a national securities exchange or national securities association registered under the Securities Exchange Act of 1934, or is the subject of a United States Post Office fraud order; but (i) the [Administrator] may not institute a revocation or suspension proceeding under this paragraph more than one year from the date of the order relied on, and (ii) [the Administrator may not enter an order under this paragraph on the basis of an order under another state act unless that order was based on facts which would currently constitute a ground for an order under this Subsection;

(F) is the subject of an adjudication or determination, after notice and opportunity for hearing, within the past ten years by securities or commodities agency or administrator of

another state or a court of competent jurisdiction that the person has willfully violated the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the Investment Company Act of 1940, or the Commodity Exchange Act, or the securities or commodities law of any other state;

(G) is insolvent, either in the sense that the person's liabilities exceed the person's assets or in the sense that the person cannot meet the person's obligations as they mature; but the [Administrator] may not enter an order against a broker-dealer or investment adviser under this paragraph without a finding of insolvency as to the broker-dealer or investment adviser;

(H) is not qualified on the basis of such factors as training, experience, and knowledge of the securities business, except as otherwise provided in §405(b);

(I) has failed reasonably to supervise the person's agents or employees if the person is a broker-dealer, or the person's investment adviser representatives or employees if the person is an investment adviser, to ensure their compliance with this Act, if such agents, investment advisers representatives or employees are subject to the person's supervision and have committed a violation of the Act;

(J) [after notice,] has failed to pay the proper filing fee;

(K) has willfully violated the law of a foreign jurisdiction governing or regulating any aspect of the business of securities or banking or, within the past five years, has been the subject of an action of a securities regulator of a foreign jurisdiction denying, revoking or suspending the right to engage in the business of securities as a broker-dealer, agent, investment adviser or investment adviser representative, or is the subject of an action of any securities exchange or self-regulatory organization operating under the authority of the securities regulator of a foreign

jurisdiction suspending or expelling such person from membership in such exchange or self-regulatory organization; or

(b) The following provisions govern the application of 405(a)(2)(H):

(1) The [Administrator] may not enter an order against a broker-dealer on the basis of the lack of qualification of any person other than (A) the investment adviser if the person is an individual or (B) an agent of the broker-dealer.

(2) The [Administrator] may not enter an order against any investment adviser on the basis of the lack of qualification of any person other than (A) the investment adviser if the person is an individual or (B) an investment adviser representative.

(3) The [Administrator] may not enter an order solely on the basis of lack of experience if the applicant or registrant is qualified by training or knowledge or both.

(4) The [Administrator] shall consider that an agent representative who will work under the supervision of a registered broker-dealer need not have the same qualifications as a broker-dealer and that an investment adviser representative who will work under the supervision of a registered investment adviser need not have the same qualifications as an investment adviser.

(5) The [Administrator] shall consider that an investment adviser is not necessarily qualified solely on the basis of experience as a broker-dealer or agent. When the [Administrator] finds that an applicant for [initial or renewal] registration as a broker-dealer is not qualified as an investment adviser, the [Administrator] may by order condition the applicant's registration as a broker-dealer upon her or his not transacting business in this state as an investment adviser.

(6) The [Administrator] may by rule provide for an examination, including an examination developed or approved by an organization of securities administrators, which examination may be written or oral or both, to be taken by any class of or all applicants. The [Administrator] may by rule or order waive the examination requirement as to a person or class of persons if the [Administrator] determines that the examination is not necessary for the protection of investment adviser clients".

6. **See also** as further examples the **Insurance Code of California** and the **Texas Securities Act.**

Insurance Code of California:

"1621. An insurance agent is a person authorised by and on behalf of an insurer to transact all classes of insurance, except life insurance. The term 'insurance agent' as used in this chapter does not include a life agent as defined in this article.

1622. A life agent is a person authorised by and on behalf of a life, disability, or life and disability insurer to transfer life, disability, or life and disability insurance.

1623. An insurance broker is a person who, for compensation and on behalf of another person, transacts insurance other than life with, but not on behalf of, an insurer.

1624. An insurance solicitor is a natural person employed to aid an insurance agent or insurance broker in transacting insurance other than life.

1625. A fire casualty licensee is a person authorised to act as an insurance agent, broker, or solicitor, and a fire and casualty broker-agent license is a license so to act.

1626. A life licensee is a person authorized by and on behalf of a life, disability, or life and disability insurer to transfer life, disability, or life and disability insurance, and a life agent license is a license so to act.

1627. A license is a permit to act in the capacity specified therein. A person licensed is the holder of the license. The commissioner may deny an application for any license issued pursuant to this chapter **if**:

(a) The applicant is not properly qualified to perform the duties of a person holding a license applied for.

1676. Except as set forth in Sections 1675 and 1679, the commissioner shall not issue a permanent license pursuant to this chapter to an applicant therefor unless such applicant has within the 12-month period next preceding the date of issue of the license taken and passed the qualifying examination for such license.

1677. Every qualifying examination for a license under this chapter shall be in writing and shall be of sufficient scope to satisfy the commissioner that the applicant has sufficient knowledge of and is reasonably familiar with the insurance laws of this State and with the provisions, terms and conditions of the insurance which may be transacted pursuant to the license sought, and has a general and fair understanding of the obligations and duties of the holder of such license"

Texas Securities Act. Art. 581 – 13.D

The Commissioner shall require as a condition of registration for all registrations granted after the effective date of this Subsection D that the applicant (and, in the case of a corporation or partnership, the officers, directors or partners to be licensed by the applicant) pass successfully a written examination to determine the applicant's qualifications and competency to engage in the business of dealing in and selling securities as a dealer or as a salesman, or rendering services as an investment adviser. This condition may be waived as to any applicant or class of applicants by action of the State Securities Board".

7. **Also compare** (not an exhaustive list):

Alaska Securities Act :	Chapter 45.55.
Arizona Securities Act :	Chapter 44-1962.
Connecticut Uniform Securities Act :	Sec. 36b – 15.
District of Columbia :	A. Sec. 35 – 1324.
Delaware Securities Act :	Sec. 7316.

Georgia Securities Act :	Sec. 590-4-8-02.
Illinois Securities Law of 1953 :	Sec. 8.
Iowa Securities Act :	Sec. 502.301 - 304.
Missouri Securities Act :	Sec. 409.204.
Missouri Code of State Regulations :	15 CSR 30-51-020.
Pennsylvania Securities Act of 1972 :	Sec. 301 - 303.
Texas Securities Act :	Sec 12 - 13.
Utah Uniform Securities Act :	Sec. 61-1-3.

8. **See also** the examination requirements set out in section 590-4-8-07 of the Georgia Securities Act.

"590-4-8-07 Examinations.

The following provisions shall govern investment adviser and investment adviser representative examination requirements:

(a) unless waived pursuant to subparagraph (b), (c), or (d) of this rule, each investment adviser representative and investment adviser must show proof of passage of the NASD Series 65 Uniform Investment Adviser State Law Examination; and one of the following general examinations or combinations of general examinations:

1. Any part of the examination for Chartered Financial Analysts administered by the Institute of Chartered Financial Analysts of Charlottesville, Virginia; or

2. Part one of the examination for the Chartered Financial Consultant Examination designation administered by the American College of Bryn Mawr, Pennsylvania; or

3. Part one of the examination for the Certified Financial Planner designation administered by the International Board of Standards and Practices for Certified Financial Planners, Inc., of Englewood, Colorado; or

4. The National Association of Securities Dealers, Inc., Series 7 General Securities Registered Representative Examination or the National

Association of Securities Dealers, Inc., Series 2 Nonmember Examination; or

5. The National Association of Securities Dealers, Inc., Series 6 Investment Company Products/Variable Contracts Representative Examination; and the National Association of Securities Dealers, Inc., Series 22 Direct Participations Programs Representative Examination; or

6. The examination for the Accredited Financial Planning Specialist designation administered by the American Institute of Certified Public Accountants; or

7. The examination required for admission to The Registry of the Financial Planning Practitioners administered by the International Association for Financial Planning, Inc., of Atlanta, Georgia.

(b) With respect to investment advisers, the examination requirement in subparagraph (a) of this rule is waived for any applicant, who, prior to October 2, 1989, shows proof satisfactory to the Commissioner that such applicant was engaged in business activities on April 7, 1988, which activities would have required registration as an investment adviser, had the amendments to the Act which became effective on April 1, 1989, been in effect on April 7, 1988.

(c) With respect to investment adviser representatives, the examination requirement in subparagraph (a) of this rule is waived for any applicant who, prior to the date which is six months after the date on which the Central Registration Depository, described in Section 10-5-10(g) of the Act, is fully operational with respect to the registration of investment adviser representatives, shows proof satisfactory to the Commissioner that such applicant was engaged in business activities on April 7, 1988, which activities would have required registration as an investment adviser representative, had the amendments to the Act which became effective on April 1, 1989, been in effect on April 7, 1988.

(d) An investment adviser or investment adviser representative who wishes to rely on passage of any examination other than those enumerated in subparagraph (a) above or who wishes to request a waiver of the examination

requirements of this rule must submit a written request for consideration, identifying the examination in question, its content, and the agency administering the examination, and the reason why a waiver should be granted by the Commissioner. Acceptance of such examination results or the waiver of the examination is solely within the Commissioner's discretion. An investment adviser or investment adviser representative who wishes to request an extension of time in which to show proof of compliance with subparagraph (a) above must submit a written request for consideration, identifying the extenuating circumstances which necessitate such a request. The granting or denial of such a request for extension of time is solely within the Commissioner's discretion.

(e) An investment adviser who is not an individual shall meet the examination requirement imposed by this rule by showing proof of compliance on a continuing basis with the provisions of subparagraph (a), (b), (c), or (d) of this rule by any one of its investment adviser representatives who is currently engaged in the management of the investment adviser's business in the State of Georgia, including the supervision or conduct of such business or the training of investment advisory representatives or employees for any of those functions."

9. **The study outline** reads as follows:

"NASAA Uniform Investment Adviser Law (Series 65) Exam Specifications

CONTENT AREA

I. Economics and Analysis

A. Understand basic economic concepts

1. Inflation/deflation
   a. Definitions
   b. Causes of inflation/deflation
2. Interest rates and yield curves
   a. Graphs
   b. Definitions
   c. Interest rate = cost of money
3. Basic economic indicators

a. GDP
b. Employment indicators
c. Trade deficit
d. Balance of payments
e. CPI

B. Identify components of business's financial statements to determine investment merits

1. Income statement
   a. Revenues
   b. Cost of goods sold
   c. Pre-tax margins
   d. Cash flow
2. Balance sheet
   a. Assets
   b. Liabilities
   c. Working capital
   d. Owner's equity
   e. Footnotes

C. Demonstrate understanding of quantitative methods to evaluate investments

1. Time value of money
2. Expected return
3. Net present value
4. Internal rate of return
5. Inflation-adjusted return (real return)
6. After-tax return/yield
7. Risk-adjusted return
8. Total return
9. Holding period return
10. Yield-to-maturity
11. Yield-to-call
12. Current yield
13. Risk measurement (e.g., Beta, standard deviation, duration)

14. Valuation ratios (e.g., P/E, price-to-book)
15. Benchmark portfolios
16. Annualized return

D. Identify risks (i.e. definitions, impact on the market, companies, and personal investments)

1. Business
2. Market
3. Interest rate
4. Inflation
5. Regulatory (e.g., tax law changes)
6. Liquidity
7. Opportunity cost

II Investment Vehicles

A. Evaluate cash and cash equivalents

1. Types and characteristics of cash and cash equivalents
    a. Certificates
    b. Money market funds
    c. Treasury bills
2. Benefits/risks of owning cash and cash equivalents

B. Evaluate fixed income securities

1. Types of characteristics of fixed income securities
    a. U.S. government and agency securities
    b. Mortgage-backed securities
    c. Corporate bonds (i.e., investment grade and high yield)
    d. Convertible bonds
    e. Municipal bonds
    f. Zero-coupon bonds
2. Benefits/risks of owning fixed income securities

C. Evaluate equity securities

1. Types and characteristics of equity securities
   a. Common stock (e.g., voting rights, etc.)
   b. Preferred stock
   c. Convertible preferred stock
2. Methods used to determine the value of equity securities (e.g., technical and fundamental analyses, dividend discount)
3. Benefits/risks of owning equity securities

D. Evaluate investment company securities

1. Types and characteristics of investment companies
   a. Open-end investment companies (mutual funds)
   b. Closed-end investment companies
   c. Classes of shareholders, expense ratios, sales load, breakpoints, 12b-1 fees
2. Benefits/risks of owning investment company securities

E. Recognize derivative securities and their benefits/risks

F. Understand unique aspects of international investing

1. Emerging vs. developed markets
2. American Depository Receipts (ADRs)
3. Currency influences (concept of risk)

G. Understand real estate partnerships and investment trusts (REITs) and variable annuities

1. Definitions
2. Benefits/risks

III. Investment Recommendations and Strategies

A. Determine and analyze the financial profile of the client to develop a suitable investment policy and strategy

1. Type of client

a. Individual
b. Sole proprietorship
c. General partnership
d. Limited partnership (including family limited partnership)
e. Limited liability company
f. C corporation
g. S corporation
h. Trust
i. Estate

2. Financial goals
3. Current financial status (e.g., cash flow, balance sheet)
4. Capital needs (e.g., current, retirement, death, disability)
5. Current investments and strategies
6. Time horizon
7. Non-financial investment considerations (e.g., values, attitudes, experience, demographic characteristics)
8. Risk tolerance
9. Tax situation

B. Understand portfolio management strategies, styles, and techniques (fixed income equities)

1. Portfolio management styles and strategies
   a. Strategic and tactical asset allocation (e.g., style, asset class, rebalancing)
   b. Active vs. passive
   c. Growth vs. value
   d. Market capitalization (micro, small, mid, large)
   e. Buy/hold
   f. Indexing
   g. Diversification
2. Funding techniques
   a. Dollar-cost averaging
   b. Income reinvestment (e.g., dividend, interest, cap gain)

C. Recognize fundamental taxation issues

1. Individual income tax (e.g., capital gains, tax basis, retirement distribution, alternative minimum tax)
2. Corporate, trust, and estate income tax
3. Estate and gift tax

D. Recognize types of retirement plans and related issues

1. Retirement plans
    a. Individual Retirement Arrangements (IRA)
    b. 403(b) plans
    c. Qualified retirement plans (e.g., pension and profit sharing, 401(k))
    d. Nonqualified ERISA issues
2. Important ERISA issues
    a. Fiduciary responsibility (e.g., 404(c))
    b. Investment policy statement
    c. Prohibited transactions

E. Define the fundamental terms and concepts of trading securities

1. Terminology (e.g., bids, offers, quotes)
2. Role of broker-dealers, specialists, market-makers
3. Types of orders (e.g., market, limit, stop, short sale)
4. Types of accounts (e.g., cash, margin, option)
5. Commissions, markups, spread

F. Calculate performance

1. Calculate performance
    a. Total return (i.e., yield plus growth)
    b. Inflation-adjusted return
    c. After-tax return/yield
    d. Current yield

IV. Ethics and Legal Guidelines

A. Understand relevant aspects of securities acts and other rules and regulations in order to comply as an investment adviser representative

1. Investment Company Act of 1940
2. Investment Advisers Act of 1940
3. Securities Act of 1933 and Securities Exchange Act of 1934 (as applicable to investment adviser issues)
4. SEC Release No. IA-1092 (applicability of the Investment Advisers Act to financial planners and others)
5. State securities laws (i.e., Blue Sky)
6. NASAA rules prohibiting dishonest and unethical business practices
7. Limitations on permissible practice (i.e., technical licensing requirements)

B. Demonstrate ability to apply ethical practices

1. Fiduciary responsibility
2. Conflict of interest
3. Prudent Investor standards
4. Limitations on advice and activities (i.e., when to consult other professionals)"

10. Financial Services Authority : 'The Regulation of Approved Persons' (July 1999.).

11. Some Comments on the **first draft of the proposed Bill:**

"1.1 The provisions of the Bill **seek to perpetuate**

- a **fragmented supervisory system**;
- a **system where numerous financial products such as 'standardised' insurance policies will be totally or partially exempted from the provisions of the Act**;
- a **system which allows untested an unregulated 'representatives' to prey on the public**.

This is contrary to modern thought.

2. Major Deficiencies

2.1 As pointed out, securities legislation should be focused on the protection of investors and the financial markets.

Unfortunately **a large number of the proposed provisions** of the Bill **run counter to such aims and also run counter to the provisions of securities legislation in each and every other jurisdiction researched.**

2.2 Of **major concern** are the following:

- **it would allow the 'authorised financial advisers' to let loose on the public** '**representatives**' who **would be completely unregulated and not examined, registered or licensed** (**section 6**);

2.3 If a Bill such as the present is enacted, **the supervising authority must be prepared to firmly grasp the twin nettles of proper licensing and adequate supervision**.

In **the absence of proper licensing control by means of written or oral examinations or by other required minimum standards of efficiency, reasonable grounds for licensing intermediaries cannot exist.**

If reasonable grounds for belief in the ability and efficiency of applicants do not exist, licensing will not only be a farce but, in fact, a fraud on the public.

2.4 **Minimum standards** of competency for both the financial advisers and their representatives **assessed by examination or other means** and **licensing in respect of particular financial products**, are **the norms in securities legislation in other countries.**

2.5 **Another major concern is that despite the enormous losses suffered by the public as a result of lapsed or cancelled long-term insurance policies,**

the Bill seeks to exclude some, if not all, of these products from its more onerous provisions. Thus

- **'standardized' life insurance policies** could be exempted from **all** the provisions of the Bill [**Section 1 (2)**];

- if the product sold is a '**standardized**' **life or funeral policy** or an **investment in a collective investment scheme**, the provisions relating to **unsolicited calls** and the **cooling-off periods** will not apply [S**ection 9(ii)** & **(iv)**].

2.6 A further **major concern** is that it is a **hybrid bill which seeks to protect** investors as well as **product suppliers, 'financial advisers', unqualified 'representatives' and negligent auditors**.

Instead of seeking to protect 'big business', **unauthorised advisers should be eradicated**, thus

- **no product supplier should be allowed to enter into an agreement to supply its products if the agreement had been facilitated by an unauthorised financial adviser**;

- **no product supplier should be allowed to supply its products without having been placed in possession of the document contemplated by section 10 (which summarises the advice given and the reasons why a product is considered suitable for the needs of the client) and without being satisfied that the contents correctly reflect the salient features of its product.**

- **no product supplier should be allowed to directly or indirectly reward any unauthorised financial adviser in any manner whatsoever or be allowed to be a party to any such reward by any other person**.

2.7 Other striking examples of the attempt to protect vested interests at the expense of the investor are the rights reserved to the Executive Chairperson to exempt financial products, financial advisers and product suppliers from the provisions of the Bill.

The perpetuation of the system of additional rewards by means of indirect benefits (such as fully paid overseas holidays) without full disclosure to potential investors **can never promote the objectivity** of **authorised financial advisers**.

2.8 The provisions of s**ection 10(1)** should be combined with the provisions of **section 203A** of the **Securities Act of Massachusetts**, which reads as follows:

Chapter 110A : **Section 203A. Disclosure content**.

(a) Each investment adviser registered under this chapter shall disseminate to each client or prospective client a document disclosing material facts. Said document shall include information concerning:

(1) compensation arrangements between the client and the investment adviser,

(2) the nature of services offered,

(3) business practices,

(4) methods for obtaining information on disciplinary history and registration of the investment adviser and persons associated with the investment adviser,

(b) Each person registered under this section shall disclose to each client before a purchase or sale is effected on behalf of the client:

(1) the total amount of sales commissions or other fees that may reasonably be expected to be charged or deducted in connection with the purchase or sale;

(2) that the adviser will receive such amount or a portion of such amount, or, in the case of a transaction to be effected through a broker or a dealer that is a person associated or under a common control with the adviser, that the broker or dealer is affiliated with the adviser and will receive such amount or portion of such amount;

(3) the existence of any compensation arrangement with an issuer or other third party with respect to the recommended transaction.

Such initial disclosure shall be in writing if the purchase or sale was recommended in writing. The secretary may, by rule, permit a client to waive in writing the right to a disclosure".

The disclosure requirements envisaged by the **Australian Consultation Paper** are as follows:

> "**Product issuers will be required to disclose the following information in a financial product information statement** (FPIS) where that information is relevant to the particular product being offered:
>
> 1. Information to identify the product issuer;
> 2. Characteristics, features or nature of the product including the rights, terms, conditions and obligations attaching to the product;
> 3. **Expected benefits** which a consumer will receive;
> 4. **The risks** associated with the product;
> 5. **Details of all amounts payable in respect of the product (including any amounts by way of initial and ongoing fees, commissions** or **charges) and the point at which the amount is payable**;
> 6. Internal inquiry and complaints handling mechanisms and external alternative dispute resolution procedures;
> 7. Taxation considerations;
> 8. **Cooling off arrangements**;
> 9. The availability on client request of further information and the nature of the information;
> 10. The date or version of the FPIS or supplement;
> 11. Any other material information which is known to the issuer and which is not required to be disclosed under items — 10 above but which may reasonably influence a client's decision to acquire the product.

2.11 To alleviate the enormous problems caused by unscrupulous or incompetent investment advisers, the Commission recommended that any person who gives investment advice for reward without being registered or contrary to the terms of the licence or not in accordance with prescribed rules of conduct, should be guilty of a criminal offence carrying heavy penalties, such as say 10 years imprisonment or a fine of one million rand or both;

In this regard the **Business and Professions Code of California** [**Section 145(c)**] reads as follows:

> "145(c) The **criminal sanction for unlicensed activity should be swift, effective, appropriate, and create a strong incentive to obtain a license**".

Definition of Cooling-off Period

The concept of a 'cooling-off period' should not form part of a the definition clause. There should be a substantive clause in the Bill establishing a right to cancel within, say, 14 days after receipt of the documentation (*cf* section 64 and 64A of the Insurance Contracts Act 1984 of Australia) —

"SECT 64 'Cooling-off period' period: life insurance

(1) **An insured under a contract of life insurance** other than a blanket superannuation contract, or an RSA, **has a right, exercisable at any time before the expiration of 14 days after the insured receives the policy document, to cancel the contract**.

(2) Subject to subsection (6) and section 64B, **where an insured cancels the contract, the insurer is liable to repay an amount equal to the sum of all the amounts that have been paid to the insurer under the contract.**

(3) A reference in this section to a policy document does not include a reference to a replacement policy document issued as mentioned in subsection 221(3) of the *Life Insurance Act 1995.*

(4) If the policy document in relation to a contract of life insurance is sent to the insured by post, that policy document shall be deemed, for the purposes of subsection (1), to have been received by the insured at the time of which it would have been delivered in the ordinary course of post unless the insured proves that, through no fault of the insured, the insured did not received it.

(5) A reference in this section to a contract of life insurance does not include a reference to a contract of consumer credit insurance even though that contract extends to cover in the case of the death of the insured.

SECT 64A 'Cooling-off' period: consumer credit insurance

(1) An insured under a contract of consumer credit insurance may cancel this contract at any time within 14 days after the insured receives a notice referred to in subsection 71A(5) in respect of the contract.

(2) If an insured cancels a contract, the insurer must repay to the insured an amount equal to the sum of all the amounts that have been paid to the insurer under the contract.

(3) A notice referred to in subsection 71A(5) in relation to a contract of consumer credit insurance that is sent to the insured by post is to be taken, for the purposes of subsection (1), to have been received by the insured at the time at which it would have been delivered in the ordinary course of post unless the insured proves that, through no fault on the part of the insured, it was not so received".

13. The two major deficiencies in this section are —

- that **the auditor is not compelled** to report **irregularities such as fraud or theft immediately,** and

- that the auditor is only required to report irregularities which **in the opinion of the auditor** are **material**.

  This means a subjective approach by the auditor.

In its **First Report, the Commission** pointed to the ineffectual provisions of the Public Accountants' and Auditors' Act as follows:

> "**Section 20(5) of the Public Accountants' and Auditors' Act, No 80 of 1991,** requires the auditor of an undertaking to take certain steps —
>
> *'if he is satisfied'* or *'has reason to believe'*
>
> that in the conduct of the affairs of the undertaking
>
> *'a material irregularity'* has taken place or is taking place which *'has caused'* or *'is likely to cause'* financial loss to the undertaking or any of its members or creditors.
>
> **These provisions are lacking in clarity, are difficult to police, and the steps which the auditor has to take are time-consuming.**
>
> The phrases '*material irregularity*', '*is satisfied*', '*likely to cause loss*', '*has been satisfied*', '*adequate steps*', mean that in a given situation a particular auditor is required to form an opinion which might differ from the opinion of another auditor, given the same facts.
>
> Thus one auditor might be satisfied that a 'material' irregularity has taken place which is likely to cause financial loss, while another auditor might not share his view.

One auditor might be satisfied that adequate steps have been taken for the prevention of loss likely to be caused and another auditor might not agree.

If, say, serious theft or fraud is discovered, the auditor is first obliged to despatch a report in writing to the person in charge of the undertaking. If he does not receive a satisfactory reply within 30 days thereafter, then only is the matter reported to the Board which may then, in its discretion, report it to other authorities or interested persons.

The inevitable delay means that all the assets of a company could disappear before the relevant authority is eventually notified by the Board.

16.2 **An auditor should be required to report all irregularities whether they are, in his opinion, material or immaterial**.

The materiality of a particular irregularity, or the frequent occurrence of what normally would be regarded as immaterial irregularities, should be known to the particular supervisor, or shareholders or creditors of the entity concerned.

If all irregularities are required to be reported it would remove the element of subjectivity created by the undefined concept of 'materiality'".

In **Germany** if the **auditor discovers shortcomings which are relevant** or **shortcomings in respect of which uncertainty exist whether they are relevant or irrelevant**, the **Federal Supervisory Officer has to be informed immediately** (**section 3(2) of the Ordinance**).

In addition, **after the conclusion of the examination the auditor is required to file the report immediately.** This is a detailed report on the activities of the enterprise. A copy of the requirements is annexed.

In **Singapore section 70 of the Securities Act** reads as follows:

"**70.**— (1) Where in the performance of his duties as an auditor for a relevant person, an auditor becomes aware —

(a) of any matter which in his opinion may adversely affect the financial position of a relevant person to a material extent;

(b) of any matter which in his opinion may constitute a breach of any provision of this Act or a criminal offence involving a fraud or dishonesty;

(c) that irregularities that have a material effect upon the accounts have occurred, including irregularities that jeopardise the funds or property of the clients of a relevant person.

he shall immediately report the matter to the securities exchange where the relevant person is a member of that securities exchange **and the Authority** and in any other case to the Authority.

(2) An auditor shall not in the absence of malice on his part be liable to any action for defamation at the suit of any person in respect of any statements made in his report pursuant to subsection (1).

(3) The relevant authority may impose all or any of the following duties on an auditor in addition to those provided under this Part:

(a) a duty to submit such additional information in relation to his audit as the relevant authority consider necessary;

(b) a duty to enlarge or extend the scope of his audit of the business and affairs of the relevant person;

(c) a duty to carry out any other examination or establish any procedure in any particular case; and

(d) a duty to submit a report on any of the matters referred to in paragraphs (b) and (c).

and the relevant person shall remunerate the auditor in respect of the discharge by him of all or any of these additional duties.

Malaysia. Similarly in respect of other institutions, **the auditor is required to report irregularities immediately. Section 39(1)** reads as follows:

"39.(1) If an auditor, in the course of the performance of duties as an auditor of an exchange company, clearing house, a futures broker or a futures fund manager, is satisfied that —

(a) there has been a contravention of this Act;

(b) an offence in connection with the business of the exchange company, clearing house, futures broker or futures fund manager, as the case may be, **has been committed**;

(c) in the case of a futures broker or a futures fund managers, there has been **a contravention of the business rules of an exchange company or a clearing house** of which the futures broker or futures fund manager is an affiliate;

(d) an irregularity has occurred in the conduct of the business of an exchange company, clearing house, futures broker or futures fund manager in relation to futures contracts, **including any irregularity that jeopardises the funds, securities or property of any client of a futures broker or futures fund manager;** or

(e) the auditor is unable to confirm whether the assets of a futures broker or futures fund manager are sufficient to meet the claims of creditor of the broker or fund manager,

the auditor shall immediately report the matter to the Commission".

Subsection 1(d) relates to cooling-off periods, the 'unenforceability [**or**] otherwise' of agreements concluded as a result of unsolicited calls and the powers of the Court to enforce such agreements if

- the client was not materially influenced by the call (whatever that might mean;

- the call was made by a person unconnected with the person seeking to enforce the agreement (whatever that might mean); and

- the client was fully aware of the agreement (whatever that might mean); and

- of any risks connected therewith.

The presumed aim of this Bill is to protect investors and to ensure as far as possible that they invest wisely. Risk is only one of the factors, but a virtually risk free 32 day bank deposit would probably be totally unsuitable for the majority of investors.

Once again the investor is left to the time consuming and costly procedures of the Courts.

— Unsolicited calls should either be completely restricted as the hawking of securities is restricted in Australia, or if not, all agreements following upon unsolicited calls should be subject to cooling-off periods.

Sections 1077, 1078 (1) and **(2)** and **1081** of the **Corporations Law of Australia** read as follows:

"Sect 1077 - Division 6 – Hawking of Securities Interpretation

In this Division:

(a) a reference to a person going from place to place includes a reference to a person communicating with other persons at different places by the use of an eligible communications service; and

(b) a reference to the buying or purchase of securities includes a reference to acquiring securities by barter or exchange".

Sect. 1078 -

(1) A person shall not, whether by appointment or otherwise, go from place to place:

(a) issuing invitations to subscribe for or buy securities of a corporation; or

(b) offering securities of a corporation for subscription or purchase.

(2) Subsection (1) does not apply in relation to securities of a corporation where the Commission has on the application of the corporation, by writing published in the *Gazette*, exempted the corporation from the operation of that subsection.

Sect 1081 –

Prohibition on hawking securities of proposed corporation

A person shall not, whether by appointment or otherwise, go from place to place:

(a) issuing invitations to subscribe for or buy securities of a corporation that is proposed to be formed; or

(b) offering securities of a corporation that is proposed to be formed for subscription or purchase".

12. **See also "Financial watchdogs are failing to bark"** - Bruce Cameron Saturday Argus 9.12.2000.

"When the Life Offices' Association (LOA) criticises the Financial Services Board (FSB) for toning down legislation that is meant to protect consumers, then it is time to become concerned about the activities of the board.

As can be expected, the criticisms by the life assurance companies are motivated mainly by a desire to protect their own interests rather than those of the consumer.

The LOA is objecting to banks' financial advisers being excluded from the ambit of the long-awaited Financial Advisory and Intermediary Services Bill (FAIS), which is intended to regulate financial advisers.

Although the LOA's criticisms are probably based on unfair competition rather [than] consumer interest, their complaints are entirely justified as there has been some gross mis-selling by bank brokers in order to meet sales targets. There is no reason why banks should be excluded from the legislation.

The LOA is also concerned about the implementation of the Life Assurance Policyholder Protection Rules, which fall under the Long and Short Term Insurance Acts. Considering that it took some 12 years to write those Acts into law, it is more than perturbing that these rules are not yet in place.

These two factors are of serious concern, particularly as the FAIS has been watered-down as it has passed through various revisions.

But the LOA's criticisms are only the tip of the iceberg.

Of greater concern is that the FSB is showing insufficient commitment to providing proper protection for consumers.

Our front page lead today is but one example of how financial institutions flout laws that are intended to protect South Africans.

While I have little sympathy with investors (and advisers) who, despite ample warning, persist in investing in financial products and through companies that are not registered in South Africa, the FSB has demonstrated that it is either inept or incapable of dealing with companies that play semantics with the law.

The FSB is not the only party to blame. South Africa's financial services industry has a bad reputation for non-compliance. Rather than follow the spirit of the law, many

companies — including some of the largest in the land — find ways to side-step regulations.

But the temptation to side-step the rules is exacerbated by the failure of the FSB to lay down equitable regulations for all participants in the financial services market, and to ensure that those regulations are taken seriously".

.....

CHAPTER 11 - THE RECORDS OF CORPORATIONS — ACCESS BY SHAREHOLDERS

11.1 Section 242 of the South African Companies Act. No. 61 of 1973, requires the keeping of minutes of the meetings of directors and managers of companies.

> "(1) The directors of a company shall cause minutes in one of the official languages of the Republic of all proceedings of meetings of directors or managers to be entered in one or more books to be kept for that purpose at the registered office of the company or at the office where such minutes are made up.
>
> (2) Any resolution of directors or managers of a company in the form of a written resolution signed by the directors or managers shall be deemed to be a minute of a meeting and shall be entered in the book or books provided for in subsection (1) and be noted by the next following meeting of directors or managers."

11.2 Section 284 of the Act requires the keeping of accounting records.

> "(1) Every company shall 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....."

11.3 In terms of section 284(3) directors have access to the books and accounting records.

"(3) The accounting records shall be kept at the registered office of the company or at such other place as the directors think fit and shall at all times be open to inspection by the directors and if such records are kept at a place outside the Republic, there shall be sent to and kept at a place in the Republic, and be at all times open to inspection by the directors, such financial statements and returns with respect to the business dealt with in those records as will disclose with reasonable accuracy the financial position of that business at intervals not exceeding twelve months, subject to section 285, and will enable the company's annual financial statements to be prepared in accordance with this Act."

11.4 In terms of section 281 the external auditor similarly has a right of access to the books and accounting records.

"An auditor of a company shall —

(a) have the right of access at all times to the accounting records and all books and documents of the company, and be entitled to require from the directors or officers of the company such information and explanations as he thinks necessary for the performance of his duties as auditor;

(b) in the case of an auditor of a holding company, have the right of access to all current and former financial statements of any subsidiary of such holding company and be entitled to require from the directors or officers of such holding company or subsidiary all such information and explanations in connection with any such statements and in connection with the accounting records, books and documents of the subsidiary as he may consider necessary; and

(c) be entitled to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which he attends on any part of the business of the meeting which concerns him as auditor."

11.5 In contrast thereto, the rights of access to and inspection of the books and accounting records of the company by its shareholders are basically restricted to

— the minutes of meetings of the company (meetings of shareholders) — section 206

— the register of members — section 113

— the register of directors and officers — section 215

— the register of interests in contracts of directors and officers — section 240

— the annual financial statement — section 302

— the half-yearly interim report — section 303

— the provisional annual financial statement — section 304

— whilst the company is in the process of being wound up, with the leave of the Court — section 360

> "360 (1) Any member or creditor of any company unable to pay its debts and being wound up by the Court or by a creditors' voluntary winding-up may apply to the Court for an order authorizing him to inspect any or all of the books and papers of that company, whether in possession of the company or the liquidator, and the Court may impose any condition it thinks fit in granting that authority".

11.6 Other stakeholders, such as holders of debentures, employees, creditors and the like, have even less access to its records.[(1)]

Shareholders and other stakeholders thus have no right to inspect the minutes of the meetings of directors and managers or the accounting records of the company.[(1)]

11.7 Behind this virtually impenetrable statutory veil of secrecy which exists in South Africa and in many other jurisdictions, dishonest, incompetent or astute directors, managers and controlling shareholders, sometimes aided and abetted by auditors and by imprecise accounting and auditing standards, play fast and loose with the fortunes of corporations, enrich themselves and mislead investors and other stakeholders by publishing false, misleading or inadequate financial statements.

11.8 Any proposed lifting of this veil is usually fiercely resisted by controlling shareholders and by directors and management on the grounds of

— privacy

— protection against competitors

— the impracticality of allowing numerous parties to have access to the records of the company.

11.9 In the **United Kingdom** the statutory veil of secrecy was drawn over the affairs of companies more than a century ago.

As pointed out , the Davey Committee recommended in 1896 that

> "(the) true financial position of the company should be honestly disclosed to shareholders not less than once a year but not for public use".[(2)]

11.10 The arguments in favour of secrecy were

— that competitors could benefit by the information disclosed;

— that the labour force would present pay demands to the management of highly profitable companies.

11.11 It was also stated that if information had to be made public, profit should be understated (potentially overstated in unprofitable companies) so that the disclosure would not harm the company.[(3)]

11.12 The recommendation by the Davey Committee that the true financial position should be honestly disclosed to shareholders but not to the public was adhered to in part only in that shareholders soon suffered the same fate.

11.13 In contrast hereto, in the **United States** and in countries such as **Anguilla, Belize**, the **British Virgin Islands** and the **Philippines**, it is accepted that shareholders have the right to inspect corporate books and records.

11.14 As will be shown, the right of shareholders to inspect the records of corporations incorporated in the **United States** are based on the factual assumptions

— that they are the owners of the corporation;

— that those in charge of the corporation are regarded as the shareholders' agents;

— that the shareholders have an interest and a right to be informed as to whether their agents discharge their duties competently and in good faith;

— that business prudence demands it.

11.15 In addition, it will be shown that the right to inspect is not limited or restricted by

— the size of the individual shareholding;

— the fact that the shareholder might be a business competitor.

11.16 In the **United States** at the beginning of the 20th century, the right of shareholders to have access to all the records of the corporation was stated to be as follows:

> "At common law any shareholder has a right to inspect any corporate records or papers whenever such inspection is reasonably necessary to protect his interests or guide his action as a member of the corporation. His right does not extend to inspection for other purposes. Nor does it extend beyond what is necessary to accomplish a definite and specific purpose.
>
> For the protection of his interests as a member of the corporation against a reasonable suspicion of fraud or mismanagement on the part of the corporate officials, he may demand access to such account books of the corporation and records of its corporate actions as bear upon the particular matter under Inquiry. For guidance in his conduct he is entitled to inspect also the articles and the by-laws of the corporation, the minutes of its general meetings, and the lists of its officers and members. He must exercise the right in a reasonable way, so as not to interfere unduly with business, or endanger the

safe-keeping of the records. He is entitled to employ accountants or attorneys to act with or for him in making the inspection.

The right of inspection is frequently regulated by by-laws, and in most states statutes require the keeping of certain corporate records and prescribe conditions to govern the right to inspect them. In most instances the statutory right of inspection expressly given is more extensive than the right at common law. But it is strictly interpreted by the courts, and unless expressly permitted for any purpose whatever, it is usually held to be impliedly restricted so as not to extend to examination for the purpose of injuring the corporate business or building up a rival."[(4)]

11.17 The present state of the law in the United States is summarized by **Fletcher** as follows:

"Inspection of corporate books and records, as that phrase is commonly used and understood, refers primarily to inspection by shareholders. Except as otherwise indicated, it is that inspection which this chapter treats.

The existence of a right, either under the common law or by virtue of constitutional or statutory provisions, in every shareholder to inspect the books and records of the corporation seems to be accepted without question throughout the states. A shareholder has a fundamental right to be intelligently informed about corporate affairs. However, the United States Supreme Court has held that inspection of corporate books and records is not a right which universally attaches to corporate shares.

The courts seem to agree that the basis for the shareholder's right is to be found in the ownership of shares in the corporation and the necessity of self protection. Thus, although the corporation and the shareholders are separate and distinct legal entities and legal title to the corporate property is vested in the corporation and not in the shareholders, the shareholders' right of inspection of the corporation's books and records rests upon the underlying ownership of the corporation's assets and property. The right to inspection is an incident of ownership of the corporate property, whether this ownership or interest is termed an equitable ownership, a beneficial interest, or a quasi-ownership.

In a sense, the right to inspection arises out of the fact that those in charge of the corporation are merely the shareholders' agents, concerning whose good faith in discharging their duties the shareholders have an interest and right to be informed.

While the books and papers of the corporation are necessarily in the hands of the corporate officers and agents, they are the common property of the shareholders who have the right to know what the corporation is doing. Shareholders have the same right as the members of an ordinary partnership to examine the books and records of the organization in order that they may protect their own interests.

Managers of some corporations deliberately keep the shareholders in ignorance or under misapprehension as to the true condition of affairs. Business prudence demands that the investor keep a watchful eye on the management and the condition of the business. Those in charge of the company may be guilty of gross incompetence or dishonesty for years and escape liability if the shareholders cannot inspect the records and obtain information.

The right of inspection is not ascribable to any supposed public status of the corporate books and records since, in the absence of special statutory provisions, they are not, in the strict sense, public records which are open as such to inspection by the public generally.

This basis of underlying ownership which characterizes the right of inspection by shareholders also distinguishes it from inspection by: directors; creditors or other persons to whom the right is given by statute or otherwise; or the state or federal governments under their supervisorial and visitorial powers and authority, which is discussed elsewhere in this work.

Inspection by a shareholder is not necessarily sought in aid of pending or contemplated litigation or to obtain evidence, although it may be sought for that purpose. It is distinguished from discovery and the various statutory proceedings to compel production and inspection of documentary evidence and the compulsory production of books and papers in court on subpoena *duces tecum*, all of which are ancillary or incidental to pending or contemplated litigation and have as their principal object the obtaining of evidence, as pointed out elsewhere.

The shareholder's statutory right of inspection is distinguishable from the right of discovery pursuant to a lawsuit against the corporation. Thus, even though the same corporate records may be discoverable in accordance with court procedural rules, the effect is not the same. There is authority for the principle that the purpose of statutory shareholder examination provisions is to provide an expeditious and ready means of inspection. Since discovery under rules of procedure may be delayed before the opposing party is required to respond, discovery of corporate records is not nearly as

speedy as inspection. Also, a failure to comply with discovery is not subject to the same sanctions as refusing an inspection demand. Accordingly, shareholders who demand inspection are not precluded from seeking judicial enforcement of their inspection rights merely because they have another suit pending against the corporation and could obtain the same records through the discovery process".[5]

11.18 The American **Corpus Juris Secundum** states it as follows:

"A stockholder has a right at common law to inspect and examine the books and records of the corporation at a proper time and place and for a proper purpose; and in many jurisdictions this right is further secured by statutory or constitutional provisions. Such statutes are salutary.

They are not intended to abridge the stockholder's common-law rights, but rather to enlarge and extend them by removing some of the common-law limitations. Accordingly, they should be liberally construed in favour of the stockholders, unless they are penal in nature; but even the rule of strict construction then applied does not compel courts to take an unreasonable view so as to defeat the object of the statute".[6]

11.19 In the vast majority of the States in the United States, in addition to their common law rights, individual State laws also entitle shareholders for a proper purpose (or for a proper purpose and in good faith, or for a purpose reasonably related to his interests as a shareholder), to inspect and copy the records of the corporation, including the minutes of the meetings of its board of directors and its committees, the records of actions taken by its board of directors and its financial records.[7]

11.20 A typical example of such a State law is **Title 13-A: Maine Business Corporation Act -**

§625. Books and records required to be kept by corporation

Each corporation shall keep accurate books and records of account, which shall be in written form or in any other form capable of being converted into written form within a reasonable time; and shall keep written minutes of the proceedings of its shareholders, board of directors.

§626. Right of shareholders to inspect corporate records

1. Except as otherwise indicated in this section, a 'shareholder', entitled to inspect the books of and records of a corporation as provided by this section shall mean:

   A. Any person who shall have been a holder of record of shares of any class, or of voting trust certificates representing such shares, for at least 6 months immediately preceding his demand for inspection; or

   B. Any person who shall be the holder of record of, or any person whose aggregate holdings of record shall equal, at least 10% of the outstanding shares of any class regardless of when they were acquired; or

   C. Any person or persons who hold voting trust certificates representing shares aggregating at least 10% of the outstanding shares of that class; or

   D. An attorney, accountant or other agent of any of the foregoing persons.

2. Any such shareholder shall have the right to inspect during normal business hours, for any proper purpose, the corporation's books and records of account, minutes of meetings, and a list or record of shareholders, and to copy them or make extracts therefrom".

11.21 Section 1601 of the Corporations Code of California (reputedly the fifth largest economy in the world) reads as follows-

"1601. (a) The accounting books and records and minutes of proceedings of the shareholders and the board and committees of the board of any domestic corporation, and of any foreign corporation keeping any such records in this state or having its principal executive office in this state, shall be open to inspection upon the written demand on the corporation of any shareholder or holder of a voting trust certificate at any reasonable time during usual business hours, for a purpose reasonably related to such holder's interests as a shareholder or as the holder of such voting trust certificate. The right of inspection created by this subdivision shall extend to the records of each subsidiary of a corporation subject to this subdivision.

(b) Such inspection by a shareholder or holder of a voting trust certificate may be made in person or by agent or attorney, and the right of inspection includes the right to copy and make extracts.

The right of the shareholders to inspect the corporate records may not be limited by the articles or bylaws."

11.22 The **Delaware Corporation Code** (the State most favoured for the registration of corporations) reads as follows (section 220)

"(a) As used in this section, 'stockholder' means a stockholder of record of stock in a stock corporation and also a member of a nonstock corporation as reflected on the records of the nonstock corporation. As used in this section, the term 'list of stockholders' includes lists of members in a nonstock corporation.

(b) Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies of extracts therefrom. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder. In every instance where an attorney or other agent shall be the person who seeks the right to inspection, the demand under oath shall be accompanied by a power of attorney or such other writing which authorizes the attorney or other agent to so act on behalf of the stockholder. The demand under oath shall be directed to the corporation at its registered office in this State or at its principal place of business.

(c) If the corporation, or an officer or agent thereof, refuses to permit an inspection sought by a stockholder or attorney or other agent acting for the stockholder pursuant to subsection (b) of this section or does not reply to the demand within 5 business days after the demand has been made, the stockholder may apply to the Court of Chancery for an order to compel such inspection. The Court of Chancery is hereby vested with exclusive jurisdiction to determine whether or not the person seeking inspection is entitled to the inspection sought. The Court may summarily order the corporation to permit the stockholder to inspect the corporation's stock ledger, an existing list of stockholders, and its other books and records, and to

make copies or extracts therefrom; or the Court may order the corporation to furnish to the stockholder a list of its stockholders as of a specific date on condition that the stockholder first pay to the corporation the reasonable cost of obtaining and furnishing such list and on such other conditions as the Court deems appropriate. Where the stockholder seeks to inspect the corporation's books and records, other than its stock ledger or list of stockholders, such stockholder shall first establish (1) that such stockholder has complied with this section respecting the form and manner of making demand for inspection of such documents; and (2) that the inspection such stockholder seeks is for a proper purpose. Where the stockholder seeks to inspect the corporation's stock ledger or list of stockholders and such stockholder has complied with this section respecting the form and manner of making demand for inspection of such documents, the burden of proof shall be upon the corporation to establish that the inspection such stockholders seeks is for an improper purpose. The Court may, in its discretion, prescribe any limitations or conditions with reference to the inspection, or award such other or further relief as the Court may deem just and proper. The Court may order books, documents and records, pertinent extracts therefrom, or duly authenticated copies thereof, to be brought within this State and kept on this State upon such terms and conditions as the order may prescribe".

11.23 In the **Philippines**, a similar provision was incorporated in its Corporation Act in 1906 by the then American occupational force.

Section 51 provided that

'The record of all business transactions of the corporation and the minutes of any meeting (referring to all meetings of directors, members or stockholders) should be open to the inspection of any director, member of stockholder of the corporation at reasonable hours'.

11.24 This provision has been retained in the present **Corporations Act of the Philippines** (section 74) whereby, acting in good faith and for a legitimate purpose -

".....The records of all business transactions of the corporation and the minutes of any meeting shall be open to inspection by any director, trustee, stockholder or member of

the corporation at reasonable hours on business days and he may demand, in writing, for a copy of excerpts from said records or minutes, at his expense".

11.25 Sections 66 and 67 of the **International Business Companies Ordinance of the British Virgin Islands** read as follows

"66(1) A company incorporated under this Ordinance shall keep such accounts and records as the directors consider necessary or desirable in order to reflect the financial position of the company.

(2) A company incorporated under this Ordinance shall keep:

(a) minutes of all meetings of:

(i) directors,
(ii) members,
(iii) committees of directors,
(iv) committees of officer, and
(v) committees of members; and

(b) copies of all resolutions consented to by:

(i) directors,
(ii) members
(iii) committees of directors,
(iv) committees of officer, and
(v) committees of members.

(3) The books, records and minutes required by this section shall be kept at the registered office of the company or at such other place as the directors determine.

67 (1) A member of a company incorporated under this Ordinance may, in person or by attorney and in furtherance of a proper purpose, request in writing specifying the purpose to inspect during normal business hours the share register of the company or the books, records, minutes and consents kept by the company and to make copies or extracts therefrom.

(2) For purposes of subsection (1), a proper purpose is a purpose reasonably related to the member's interest as a member.

(3) If a request under subsection (1) is submitted by an attorney for a member, the request must be accompanied by a power of attorney authorizing the attorney to act for the member.

(4) If a company, by a resolution of directors, determines that it is not in the best interest of the company or of any other member of the company to comply with a request under subsection (1), the company may refuse the request.

(5) Upon refusal by the company of a request under subsection (1), the member may before the expiration of a period of 90 days of his receiving notice of the refusal, apply to the court for an order to allow the inspection".[8]

11.26 In **Australia**, a member of a company may apply to a Court for an order authorizing an auditor or legal practitioner to inspect its records on the member's behalf (sections 319 and 320 of the Corporation Law).

"319(1) Where:

(a) a member of a company applies to the Court for an order authorizing a registered company auditor, or a duly qualified legal practitioner, acting on behalf of the member to inspect books of the company; and

(b) the Court is satisfied that the member is acting in good faith and that the inspection is to be made for a proper purpose:

the Court may:

(c) make an order authorizing a registered company auditor, or a duly qualified legal practitioner, acting on behalf of the member, at such time as is specified in the order, to inspect, and to make copies of, or take extracts from, specified books of the company; and

(d) make such order or orders (if any) as it thinks fit including without limiting the generality of the foregoing, an order relating to the use that may be made of the information disclosed to the member by the

registered company auditor or the duly qualified legal practitioner as a result of the inspection.

(2) The right of a member of a company to apply for an order under subsection (1) is in addition to and not in derogation of any right in relation to the inspection of books of a company that a member of a company has under any other law.

s320. Disclosure of Information. (Corporations Law)

A registered company auditor, or a duly qualified legal practitioner, who inspects books of a company pursuant to an order of the Court under section 319 shall not disclose information acquired in the course of the inspection to a person other than:

(a) the member of the company on whose application the order was made; or

(b) a staff member, or a member or acting member, of the Commission".[9]

11.27 While the South African shareholders are denied access to the records of companies of which they are the owners, in a number of jurisdictions, the trustees of holders of debentures have full access to such records.

Examples are **Australia, Argentina, India, Malaysia, Nauru, Papua New Guinea, Paraguay** and **Singapore**.

In these jurisdictions holders of debentures, who are nothing more than creditors of the issuing companies, have all information at their disposal while the owners of South African companies have to rely upon information made available to them by both honest and dishonest directors, officers and auditors.

11.28 The Commission issued a Consultation Paper entitled 'The Role of the Auditor – The Elimination of the Expectation Gap and the Appointment of Auditors by all Significant Interest Groups' in which the appointment of auditors by each significant stakeholder group of a company was proposed. Stakeholders were identified as shareholders, holders of debentures, other creditors, employees (trade unions) when conducting wage negotiations or when

disputing the necessity to retrench, participation bond investors, depositors in banks and members of pension funds.[10]

A predictable outcry followed.[11]

11.29 The Commission is of the view that corporate fraud would be significantly curtailed if shareholders have access to the records of their companies.

It is beyond dispute that dishonesty or negligence of external auditors of companies would virtually be eliminated if the records of the companies are subject to inspection by other experts at any time.

11.30 Deposit-taking institutions such as banks require some measure of secrecy to protect the interests of their clients.

The Commission is of the view that shareholders of such institutions should only be allowed to exercise their rights of access to the records by using the services of auditors.

11.31 To allay the fears of administrative mayhem which is often expressed by antagonists of access to corporate records, it is recommended that access by shareholders be restricted to

— **shareholders who individually or in the aggregate hold 5% or more of the issued share capital; and**

— **shareholders who wish to institute derivative or dissenter actions, or whose rights could be affected by mergers, sale of assets or take-overs.**

11.32 It is also recommended that in the event of a public company

— **not issuing its financial statements by due date; or**

— **issuing a financial statement without an unqualified auditor's report;**

all shareholders should have access to the records of the company.

11.33 It is further recommended that

(a) such shareholders may in person or by means of a legal representative, an accountant or an auditor have access to all the books and records of the company, including those of any subsidiaries;

(b) such access shall only be for a proper purpose reasonably related to such shareholder's interest as a shareholder;

(c) access to the books and records shall be at any reasonable time during usual business hours after a written request stating the purpose of such inspection;

(d) **access to the books and records of banks should only be by means of an auditor.**

.....

NOTES

1. **During the 19th century** in England and in South Africa the records of companies were available for inspection by shareholders appointed by the general body of shareholders.

   In addition, special interest groups such as the assured of assurance companies, holders of debentures and holders of preference shares could sometimes appoint their own auditors. Towards the end of the 19th century these rights were lost.

2. **See** Chapter 3.

3. **Troberg, Pastus and Ekholm, Bo-Gorän** : 'Objectives of Financial Reporting and Equity Theories. Are User Needs Different?' (Swedish School of Economics and Business Administration, Series C. Working Paper [1995]).

4. **Scrutton, T.E.** and **Bowstead, William.** 'The Commercial Laws of the World'. Vol. VIII. p. 40 (British Edition. Sweet and Maxwell Ltd.).

5. **Fletcher :** 'Cyclopedia of the Law of Private Corporations' Vol. 5A, par. 2213. (Clark, Boardman, Callaghan, New York.).

6. **Corpus Juris Secundum.** 'A Contemporary Statement of American Law' Vol. 18 p. 658 – 659 (West Publishing Co., St Paul, Minn.).

   Also see par. 331 – 334.

   "§331. In General

   Stockholders are entitled to information as to the business and affairs of the corporation.

   The stockholders of a corporation, including minority as well as majority holders, have a right to be informed as to the business and affairs of the company. However, this right is not unlimited.

A stockholder has a right to visit and inspect the corporate property.

§332. Inspection of Corporate Books and Records

At common law, as well as under statutory and constitutional provisions, stockholders ordinarily are entitled to inspect corporate books and records at a proper time and place and for a proper purpose.

A stockholder has a right at common law to inspect and examine the books and records of the corporation at a proper time and place and for a proper purpose; and in many jurisdictions this right is further secured by statutory or constitutional provisions. Such statutes are salutary.

They are not intended to abridge the stockholder's common-law rights, but rather to enlarge and extend them by removing some of the common-law limitations. Accordingly, they should be liberally construed in favour of the stockholders, unless they are penal in nature; but even the rule of strict construction then applied does not compel courts to take an unreasonable view so as to defeat the object of the statute.

The statutes permit multiple examinations of the same corporate books and records.

A statute authorizing a corporation to define, limit, and regulate the powers of its stockholders does not authorize it to deprive them of their right to inspect the company's books.

§333 Absolute or Qualified Right

a. In General

A shareholder's right to inspect corporate books and records is not absolute but is qualified, and the shareholder may exercise inspection rights only for proper purposes.

A shareholder's right to inspect corporate books and records is not absolute but is qualified. The paramount factor in determining whether a stockholder

is entitled to inspection of corporate books and records is the propriety of the stockholder's purpose in seeking such inspection; a stockholder may exercise inspection rights only for the proper purposes.

While the term 'proper purpose' has been held to mean that which is germane or reasonably related to a person's interest as a stockholder, the term is one which seeks to protect the interests of the corporation as well as the interests of the shareholder seeking the information, and it includes honest motive and good faith. It is not sufficient merely to allege a proper purpose. Rather, in each case, the facts must be examined.

Once a proper purpose has been established, any secondary purpose or ulterior motive of the stockholder becomes irrelevant. While the court may discount a secondary or ulterior purpose, at least where the stockholder-related purpose predominates over the ulterior purpose, the primary purpose must not be adverse to the best interests of the corporation. Moreover, the court may deny inspection where the shareholder is shown to have possession of all the information that is requested, or where the request is made out of sheer curiosity, unrelated to any legitimate interest of the stockholder, or where the sole purpose of the inspection is to harass the corporation.

Generally, stockholders are entitled to inspect books and records of the corporation to investigate the conduct of management, to determine the financial condition of the corporation, and to seek an account of the stewardship of the officers and directors. In particular, the valuation of one's shares, solicitation of proxies, election of directors, and a desire to learn the reasons for lack of dividends or insubstantial dividends have been held to be proper purposes for the inspection of corporate books and records.

A mere statement of purpose to investigate possible general mismanagement, without evidence of any possible corporate mismanagement or waste, does not entitle the shareholder to inspection, and an improper purpose exists where the demanding shareholder seeks to further his own interest in the corporation not as a shareholder but as a stockbroker. Also, a court may deny a shareholder the right to inspect corporate books if the shareholder has improperly used information secured through any prior examination of books and records of account.

b. Insufficient Grounds for Denial of Right

In general, adverseness to management and a desire to gain control of the corporation for economic benefit does not indicate an improper purpose for inspecting corporate books and records.

An unqualified statutory right of inspection cannot properly be denied on the ground that the stockholder is on unfriendly terms with the officers of the company or that he hopes to find something alarming which he intends to communicate to other stockholders, or that an inspection would cause inconvenience to the corporation or might involve it in difficulties.

Also, the stockholder's right of inspection is not affected by the fact that he manufactures articles similar to those manufactured by the corporation.

The right of a stockholder to inspect the books and records of the corporation may not be taken away by the substitution of some other method of informing him of the matters of which he desires to learn, and may not be denied to him merely because he has been given the privilege on other occasions, or because the corporation is willing to purchase his shares.

The absence of the custodian from the state cannot ordinarily defeat the right of inspection, if the records can be procured from the corporation itself.

c. Where Corporation Insolvent or in Liquidation

Generally, a stockholder's right to examine the corporate books and records is not extinguished because the corporation is in receivership or bankruptcy.

In such case, the question whether or not an inspection of its books shall be accorded to its stockholders is one resting in the discretion of the court, unhampered by any decisions touching such right of inspection while the corporation was still a going concern in the hands of its officers and directors, and ordinarily such discretion should be exercised by the court most liberally toward every individual stockholder who shows some reason other than mere idle curiosity which induces him to ask for the inspection.

The court will grant an inspection to a stockholder who in good faith asks therefor to enable him to determine whether or not a proposed plan of reorganization is desirable, with proper regulations as to time and circumstances, so as not to interfere with the exercise of the receiver's duties or the inspection of other stockholders; and it is not a sufficient answer that the proposed plan meets with the approval of the majority of the stockholders who have not received such information as asked for, or that it is commended by the receiver and promises to afford means for an early liquidation of the debts of the company.

However, an inspection will not be granted to a person who purchased stock in the corporation, for mere speculative purposes, after the appointment of a receiver.

§334 Books and Records Subject to Inspection

a. In General.

At common law, the right of inspection covers all the books and records of the corporation, and the term 'books and records of account', as used in the statutes pertaining to the right of a shareholder to inspect corporate records, includes all records to which the common law right of inspection might properly apply. Such statutes are not limited to 'relevant' books and records; the right of a stockholder extends to all books, papers, contracts, minutes or other instruments from which he can derive any information that will enable him to protect his interest, and which are necessary to make an intelligent and searching investigation. The fact that the information sought is of a confidential nature is not enough, in itself, to deny the right of examination.

Books of other corporations.

A stockholder is not entitled to inspect the books and papers of other corporations not shown to be in the possession of the corporation of which he is a stockholder.

However, the stockholders of one company have a right to inspect the books and records of subsidiary companies where the latter are so organized and controlled, and their affairs so conducted, as to make them adjuncts or instrumentalities of the parent company, and it has been held that

stockholders of a dissolved corporation seeking a proper share of its assets are entitled to examine the books of a successor corporation.

Small stockholders.

A holder of a small amount of stock has as much right to examine the books of a corporation as has the owner of a large amount. Indeed one of the purposes of the statutes is to protect small or minority stockholders and to facilitate the exercise of their right of access to the books of the corporation".

7. **Eg.** Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming. (Exceptions are, eg. Hawaii, the District of Columbia and New York State).

8. **See** also

Anguilla Sections 60 and 61 of the International Business Companies Ordinance, 1994.

Belize Sections 66 and 67 of the International Business Companies Act, 1990.

9. **See also New Jersey** Title 14A : 5 – 28 (4) –

"Nothing herein contained shall impair the power of any court, upon proof by a shareholder of proper purpose, irrespective of the period of time during which the shareholder shall have been a shareholder of record, and irrespective of the number of shares held by him, to compel the production for examination by such shareholder of the books and records of account, minutes, and record of shareholders of a corporation. The court may, in its discretion prescribe any limitations or conditions with reference to the

inspection, or award any other or further relief as the court may deem just and proper. The court may order books, documents and records, pertinent extracts therefrom, or duly authenticated copies thereof, to be brought within this State and kept in this State upon whatever terms and conditions as the order may prescribe. In any action for inspection the court may proceed summarily"

10. **The Consultation Paper** stated that

"1.7 The Commission has come to the conclusion that in addition to the proposed changes set out in paragraph 1.4 above, more effective steps could and should be taken to protect all the stakeholders in the modern corporation.

Stakeholders are persons such as shareholders, holders of debentures, employees (trade unions), suppliers and other trade creditors, members of pension funds, provident funds and a myriad of investment funds, lenders, bank depositors and the assured by insurance companies.

1.8 It is clear that the methods of financial accounting which have evolved into 'generally accepted accounting practice (principles or standards)' and the traditional audit and audit reports in respect thereof, often no longer serve the purpose of adequately informing and thus protecting the stakeholders in the modern corporations.

1.9 The shortcomings in the present methods of accounting and auditing are expounded upon in Chapter 2 hereof.

1.10 To achieve adequate protection for the stakeholders a fundamental and structural change to the audit function is required.

The change envisaged is the empowerment of all significant stakeholder interest groups by granting them the right to appoint their

own auditors to investigate and report on matters which particularly affect them.

1.11 The purpose of this Paper is to ensure the widest possible consultation with all interested parties regarding the views expressed herein and the practicality of achieving the proposed changes in the role of the auditor";

and proposed as follows –

"3.1 Many of the problems created by unfair or fraudulent conduct by market participants, by inadequate disclosure of information upon which users can make informed choices and by dishonest or inefficient auditors, could be eradicated by the appointment of auditors for and by each significant interest stakeholder group.

3.2 Significant interest groups would be groups such as No-vote shareholders, minority shareholders in a take-over bid situation, debenture holders, suppliers and other trade creditors, persons assured by insurance companies, members of pension and provident funds, employees, trade unions, bank depositors, etc.

3.3 Their auditors would also have access to the audit files of the main auditor of the entity. This would obviate duplication of work and fees and should also have a salutary effect on the main audit.

3.4 The value of such auditors for interest groups is obvious. Some examples are —

— employees (trade unions) will not be dependent upon financial information prepared by management when conducting wage negotiations or disputing the necessity to retrench;

— the debenture holders in the failed Masterbond companies such as Mykonos, Fancourt, Marina Martinique and a host of smaller companies will not have lost hundreds of millions of rand. Their auditors would have raised early warnings that monies were being used for other purposes and that the securities were inadequate;

— similarly, the investors in the failed Owen Wiggins companies would have received early warnings;

— participation bond investors in the Masterbond, Owen Wiggins and Supreme Bond schemes would not have lost their investments;

— **SA Rail Commuters Corporation** would not have lost R247 million deposited in Cape Investment Bank. The auditor of the depositors would have warned them that the insolvent bank was being propped up by the Reserve Bank;

— the depositors in Pretoria Bank would have been warned of its imminent liquidation and that it was riddled with maladministration, theft and fraud. This could have saved the taxpayer millions;

— members of pension funds which fail to produce the required annual returns could take steps to prevent or reduce the extent of the losses or the theft of their monies;

— the reports which emanate from the Registrar of Pension Funds regarding failure to produce annual returns could only be described as frightening;

— minority shareholders would not have to be left to the mercy of the majority shareholder in a take-over situation.

Recently a typical dispute such as between IBM SA and its minority shareholders was reported in the press as follows:

> 'The dispute between IBM SA and disgruntled minority shareholders has escalated with the shareholders launching a last-ditch bid to force the US-controlled company to disclose more about its financial condition.
>
> The shareholders, who are former IBM employees, have lodged a complaint with the Securities Regulation Panel claiming the company is worth more than it admits.

The minorities are hoping to thwart the computer company's efforts to buy back the 46% of shares it does not already own at R12 each.

The ex-employees are concerned that IBM SA's figures may have been manipulated to keep its share price in the doldrums. They allege the US parent overcharged its SA subsidiary for the secondment of foreign managers, and bumped up the wholesale price of its hardware and software to reduce the subsidiary's profit margin.

The complaint to the panel accuses IBM of withholding information crucial to determine the true value of the shares. A key request is that the panel instruct IBM SA to disclose its figures for the half-year to June 30 1998. These accounts are being prepared but are unlikely to be published before a vote on the buyback offer on August 5.

.....

IBM SA said yesterday it was not aware of any formal complaint. 'In terms of the offer made to minority shareholders and in terms of the scheme of arrangement, we believe we have conformed to all JSE requirements by making available all information that is appropriate and available', said a spokesman'.

An auditor, appointed by the minority shareholders, would have been able to report on the adequacy of the offer.

— Investors, such as the investors in '**Proplace**', would probably have not lost their investments.

The plight of these investors was reported in the **Saturday Argus**, **August 29, 1998** under the heading —

'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.

Proplace lured investors with promises of guaranteed returns of up to 16 percent with tax advantages through investments in endowment policies with the big assurance houses such as Old Mutual, Sanlam, Southern Life, Fedlife, and Norwich.

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 life savings into this scheme.' Says Cameron-Ellis who has described the Proplace scam as the 'biggest debacle since Masterbond' ".

3.5 If auditors are appointed by each significant interest group, some of the most pressing problems which confront the auditing profession and which are demonstrated by the 'expectation gap', could also be alleviated.

Problems such as

— the extent and scope of the main audit which often cannot cater for the particular needs of all significant interest groups;

— the non-independence or perceived non-independence of the main auditor who renders other services for the client;

— the liability for damages caused to a particular interest group by the dishonesty, negligence or lack of insight of the main auditor;

— the interpretation and application of generally accepted accounting standards to the accounts or the account items of an entity.

3.6 In addition, if auditors are appointed for each significant interest group, it would result in

— increased specialization in the profession;

— the employment of specialists by smaller firms;

— from a globalization point of view, the overall audit function could be fulfilled on a modular basis, especially where use is made of specialist correspondent auditors;

— the use of specialist auditors should lead to more uniformity in the presentation of account items, in the auditing thereof and in the auditors' reports thereon;

— specialist auditors would keep abreast with dynamic developments in their fields.

3.7 The Commission is of the view that if stakeholders are empowered by

— the right to appoint their own auditors; and

— appropriate class actions,

corporate fraud would be prevented to a large extent and, if not prevented, significantly curtailed".

11. **See** Chapter 13.

.....

CHAPTER 12 - DEBENTURES AND THE PROTECTION OF HOLDERS OF DEBENTURES

12.1 Section 116 of the South African Companies Act provides that a company if so authorised by its memorandum or by its articles, may create and issue secured or unsecured debentures.(1)

12.2 The South African Companies Act (section 1) defines a debenture as:

> " 'debenture' includes debenture stock, debenture bonds and any other securities of a company, whether constituting a charge on the assets of the company or not".(2)

12.3 An issue of debentures may be subject to a trust deed appointing a trustee for the debenture-holders. The trustee may not be a director or officer of the company issuing the debentures.(3)

12.4 In terms of subsections 302 (1) and (2) and section 303, debenture-holders are entitled to receive copies of the company's financial statements.(4)

12.5 No other noteworthy protection is afforded to debenture holders. No limit is placed on the value of debentures which may be issued and, if appointed, the trustee of the debenture holders has no independent right of access to the books and records of the borrowing company.

12.6 This enabled companies in the Masterbond Group such as Marina Martinique and Fancourt, each with an issued share capital of only R100, with no reserves and without adequate security, to issue debentures for amounts totalling more than R50 million each.

Weskus, another Masterbond company, also with an issued share capital of R100, with no reserves and virtually no security, issued debentures in an amount of R30 million.

12.7 A debenture is usually a document which creates, acknowledges or evidences the indebtedness of a company in respect of money accepted by it as a deposit or as a loan.

12.8 Although defined, the word 'debenture' has no precise meaning, it is the name of a genus, not of a species.[5]

12.9 The history of 'debentures' is sketched by Pennington as follows:

> "Companies have always been able to create legal and equitable mortgages of their property in the same form and with the same effect as mortgages by individuals. The distinctive security given by companies, however, is the debenture.
>
> Debentures are creatures of fairly recent growth. They appeared first during the 1860's in a form closely resembling the bonds which companies had previously issued in order to raise loans. Their principal difference from bonds was that, in addition to containing a covenant by the company to repay the loan, they charged the company's property or undertaking with the repayment, thus creating a security which later became identified as a floating charge. Gradually the form of debentures changed from that of the bond, but like bonds they were still arranged in two parts. The main part contained the company's covenant for payment of principal and interest and a legal mortgage of its fixed assets and a floating charge over its other property; the other part comprised the endorsed conditions which dealt with the detailed terms of the loan and conferred remedies on the lender for its recovery. The form of debenture is still used when a company borrows from one or a few lenders, in particular for securing short term bank loans and overdrafts.

By the end of the last century public companies found that their issues of debentures were subscribed for by so great a number of investors that it was inconvenient to employ the form of debenture currently in use. If the company mortgaged its assets to a thousand persons, it had to get a thousand consents when it wished to sell an asset which was specifically mortgaged, or to depart in the smallest degree from the terms of its debentures. The problem was solved by the introduction of the trust deed by which trustees were appointed to represent the interests of the debenture holders. The trustees were given a legal mortgage of the company's fixed assets and a floating charge over its other property, were empowered to consent on the debenture holders' behalf to minor departures by the company from the terms of the debentures, and were authorised to call meetings of debenture holders to decide whether the trustees should enforce the security given by the trust deed when a case arose for doing so, or whether the debenture holders should agree to a modification of their rights when the company was unable to meet its obligations in full. Debentures in the old form were still issued to the debenture holders, but they were always expressed to be subject to the provisions of the trust deed, and although they contained a covenant by the company with the holder to repay his loan, they often omitted to give him any security individually and left him to rely on the security given to the trustees by the trust deed.

Soon the trust deed underwent a change and assumed its present form. In a modern trust deed the company covenants with the trustees to repay the debenture loan to the subscribers. They, in turn, are given debenture stock certificates which evidence their right to a share in the total debenture debt equal to the amount they have individually subscribed, but there is no covenant by the company with them to repay the amounts they have advanced. Debenture stockholders, unlike debenture holders, are not creditors of the company. The trustees are the creditors for the whole debenture debt, and the stockholder is an equitable beneficiary of the trust on which they hold that debt. Consequently, his remedies are primarily against the trustees, but by suing them to compel them to exercise their remedies against the company, he can indirectly enforce the same remedies against it as a debenture holder can enforce directly.

The most recent development in debenture issues by the larger and some of the medium sized public companies has been the diminution of the security given by the trust deed. Legal mortgages are now rarely given except by property companies, and sometimes there is not even a floating charge. If no security at all is given and the debentures are to be dealt in on a stock exchange, they must be denominated "unsecured", and they are commonly known as unsecured loan stock or notes. It is usual for trust deeds covering such stock or notes to contain a "negative pledge" clause by which the company undertakes not to mortgage its property, or not to mortgage it for more than a specified

sum. This clause ensures that if the company becomes insolvent and has adhered to its undertaking, the loan stockholders will not find its assets consumed in paying secured creditors. The clause does not give the loan stockholders any priority over the company's other unsecured creditors, however, and so if the company does become insolvent, stockholders and other unsecured creditors alike will be paid an equal proportion of their debts".[6]

12.10 The meagre protection afforded to holders of debentures in South Africa is in stark contrast to the protection which their counterparts enjoy in many other jurisdictions.

12.11 A worldwide survey of companies and securities laws of other jurisdictions revealed seven basic measures to protect investors when corporations seek to borrow money from the public, namely:

— A merit review of the proposed issue by a regulator.

— The appointment of a reputable trustee to protect the holders of debentures.

— The right of access to the books and records of the issuer by the trustee.

— The obligation of the trustee to ensure the existence of sufficient security for the repayment of the debentures.

— The obligation of the external auditor of the issuer to report irregularities to the trustee.

— A periodical report of the affairs of the issuer by its directors.

— Capping the amount which may be borrowed.

12.12 The jurisdictions enumerated in the text and in the notes are not intended to be exhaustive lists. They are cited to illustrate that measures to protect holders of debentures are taken worldwide.[7]

12.13 A merit review by a regulator of the proposed issue of debentures including an assessment of the ability of the borrower to repay the loans, is required in many jurisdictions.[8]

A prime example is the disclosure requirements set by **India** in its 'Guidelines for Issue of Debt Instruments'.[9]

> "10.1.1. No public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period shall be made unless credit rating from a credit rating agency has been obtained and disclosed in the offer document.
>
> 10.8. The existing and future equity and long-term debt ratio.
> [and the] Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures".

12.14 Access to all the records of the borrowing corporation by the trustee for the holders of debentures is a requirement in some countries, such as **Australia**.

> "Section 1054. Contents of trust deed (Corporations Law)
>
> (1) A corporation shall not, in this jurisdiction, invite subscriptions for or the purchase of debentures or offer debentures for subscription or purchase unless the relevant trust deed
>
> (a) .....
>
> (b) contains covenants by the borrowing corporation as mentioned in subsection (3)
>
> (2) .....
>
> (3) The covenants referred to in paragraphs (1)(b) and (2)(b) are:
>
> (a) .....
>
> (b) a covenant that the borrowing corporation will:
>
> (i) make available for inspection by the trustee for the holders of debentures or any registered company auditor appointed by that trustee the whole of the financial or other records of the borrowing corporation; and

(ii) give to that trustee such information as that trustee requires with respect to all matters relating to the financial or other records of the borrowing corporation".[10]

12.15 The appointment of a reputable trustee for the holders of debentures is required in many countries. In **Australia** (section 1052) a trustee must be a body corporate being

"(c) a person constituted as the Public Trustee in any State or Territory;

(d) a body corporate authorised by law of a State or Territory to take in its own name a grant of probate of the will, or of letters of administration of the estate, of a dead person;

(e) a body corporate registered under the Life Insurance Act 1995;

(f) an Australian ADI;

(g) a body corporate (in this paragraph called the 'subsidiary') the whole of the issued shares of which are held beneficially by a body corporate or bodies corporate of a kind referred to in paragraph (d), (e) or (f) (in this paragraph called the 'holding company') if:

(i) the holding company is liable for all liabilities incurred or to be incurred by the subsidiary as trustee for the holders of the debentures; or

(ii) the holding company has subscribed for and beneficially holds shares in the subsidiary, being shares in respect of which there is a liability of not less than $500,000 that has not been called up and which, because of a special resolution of the members of the subsidiary, is not capable of being called

up except in the event, and for the purposes, of the winding up of the subsidiary; or

(h) a body corporate approved by the Commission for the purposes of this subsection".(11)

12.16 Restrictions on the total value of debentures are common. In **Korea** (section 470)

"(1) The total amount of debentures shall not exceed that of twice the stated capital and the reserve fund.

(2) If the net amount of the existing property of the company as shown by the last balance sheet does not reach to the total amount of the stated capital and the reserve fund, the total amount of debentures shall not exceed twice the net amount of such property".(12)

12.17 Some countries require the trustee to ensure that the assets of the borrower are sufficient to discharge the principal debt when it becomes due. The **Singapore** Companies Act provides as follows (section 101):

"s.101 Duties of trustees (Companies Act)

(1) A trustee for the holders of debentures:

(a) shall exercise reasonable diligence to ascertain whether or not the assets of the borrowing corporation and of each of its guarantor corporations which are or may be available whether by way of security or otherwise are sufficient or are likely to be or became sufficient to discharge the principal debt as and when it becomes due".(13)

12.18 The Companies Act of **Mauritius** requires the auditor of the borrowing company to assist the trustee for the holders of debentures.

"173. Duties of Auditors Towards Debenture Holders' Representatives

(1) The auditor of a borrowing company shall, within 7 days after furnishing the company with any balance sheet or profit and loss account or any report, certificate, or other document which he is required by this Act or by the agency deed to give to the company, send a copy by post to every debenture holder's representative.

(2) Where in the performance of his duties as auditor or borrowing company the auditor becomes aware of any matter which is in his opinion relevant to the exercise and performance of the powers and duties imposed by this Act or by any agency deed on any debenture holder's representative, he shall within 7 days after becoming aware of the matter send by post a report in writing on such matter to the borrowing company and a copy to the representative.

(3) The auditor of a borrowing company shall at the request of the debenture holders' representative, furnish to him such information or particulars relating to the borrowing company as are within his knowledge and which are in his opinion relevant to the exercise of performance of the powers or duties conferred or imposed on the representative by this Act or by the agency deed".

12.19 The Companies Act of **Singapore** (section 103(1)) requires a borrowing corporation to furnish a quarterly report of the state of its financial affairs to the trustee for the holders of debentures and to the Registrar.

"The report referred to in subsection (1) shall be signed by not less than 2 of the directors on behalf of all of them and shall set out in detail any matters adversely affecting the security or the interests of the holders of the debentures and, without affecting the generality of subsection (1), shall state:

(a) whether or not the limitations on the amount that the corporation may borrow have been exceeded;

(b) whether or not the borrowing corporation and each of its guarantor corporations have observed and performed all the covenants and provisions binding them respectively by or pursuant to the debentures or any trust deed;

(c) whether or not any event has happened which has caused or could cause the debentures or any provision of the relevant trust deed to become enforceable and, if so, particulars of that event;

(d) whether or not any circumstances affecting the borrowing corporation, its subsidiaries or its guarantor corporations or any of them have occurred which materially affect any security or charge included in or created by the debentures or any trust deed and, if so, particulars of those circumstances;

(e) whether or not there has been any substantial change in the nature of the business of the borrowing corporation or any of its subsidiaries or any of its guarantor corporations since the debentures were first issued to the public which has not previously been reported upon as required by this section and, if so, particulars of that change; and

(f) where the borrowing corporation has deposited money with or lent money to or assumed any liability of a corporation which pursuant to section 6 is deemed to be related to the borrowing corporation, particulars of

(i) the total amounts so deposited or loaned and the extent of any liability so assumed during the period covered by the report; and

(ii) the total amounts owing to the borrowing corporation in respect of money so deposited or loaned and the extent of any liability so assumed as at the end of the period covered by the report,

distinguishing between deposits loans and assumptions of liabilities which are secured and those which are unsecured, but not including any deposit with or loan to or any liability assumed on behalf of a corporation if that corporation has guaranteed the repayment of the debentures of the borrowing corporation and has secured the guarantee by a charge over its assets in favor of the trustee for the holders of the debentures of the borrowing corporation".(14)

12.20 These measures to protect investors from unscrupulous borrowers are fair and practical and should be incorporated into the South African Companies Act.

12.21 It is recommended that no company should be allowed to borrow money from the public, whether as loans or as deposits of whatever nature and whether as an agent or a principal unless

(a) it has satisfied the regulator that it would be able to repay such monies and any interest thereon, on due date;

(b) in terms of a trust deed a registered South African financial institution has been appointed as trustee for the investors;

(c) the trustee is required to exercise reasonable diligence to ascertain from time to time whether or not the assets of the borrowing company which are or may become available whether by way of security or otherwise are sufficient or are likely to be or become sufficient to discharge the principal debt as and when it becomes due;

(d) **the trustee has at all times access to all accounting and other records of the borrowing company and to all information held by its directors, officers and employees;**

(e) **it quarterly prepares and lodges with the trustee and the regulator a report signed by not less than two of the directors on behalf of all of them and which shall set out in detail any matters adversely affecting the security or the interests of the holders of the debentures and, without affecting the generality, which shall state:**

(i) **whether or not the limitations on the amount that the company may borrow have been exceeded;**

(ii) **whether or not the borrowing company and each of its guarantor companies have observed and performed all the covenants and provisions binding them respectively by or pursuant to the debentures or any trust deed;**

(iii) **whether or not any event has happened which has caused or could cause the debentures or any provision of the relevant trust deed to become enforceable and, if so, particulars of that event;**

(iv) **whether or not any circumstances affecting the borrowing company, its subsidiaries or its guarantor companies or any of them have occurred which materially affect any security or charge included in or created by the debentures or any trust deed and, if so, particulars of those circumstances;**

(v) **whether or not there has been any substantial change in the nature of the business of the borrowing company or**

any of its subsidiaries or any of its guarantor companies since the debentures were first issued to the public which has not previously been reported upon as required and, if so, particulars of that change; and

(vi) where the borrowing company has deposited money with or lent money to or assumed any liability of another entity or person, full particulars thereof, including

(aa) the total amounts so deposited or loaned and the extent of any liability so assumed during the period covered by the report; and

(bb) the total amounts owing to the borrowing company in respect of money so deposited or loaned and the extent of any liability so assumed as at the end of the period covered by the report,

distinguishing between deposits, loans and assumptions of liabilities which are secured and those which are unsecured, and the reasons for making such deposits or loans or the assumption of liability;

(f) the auditor of the borrowing company, or such other entity referred to in 12.21(e) above, is required

(i) to forthwith report to the trustee any matter of which he becomes aware and which could be relevant to the exercise and performance of the powers and duties imposed upon the trustee by the Companies Act or the trust deed;

(ii) to furnish on request to the trustee copies of all working papers and such information or particulars relating to the borrowing company as are within his knowledge or which he can obtain

and which could be relevant to the exercise and performance of the powers and duties imposed upon the trustee by the Companies Act or the trust deed;

(g) the amount which may be borrowed is restricted.

.....

NOTES

1. **Section 116. "Creation and issue of debentures.**—A company, if so authorized by its memorandum or by its articles, may create and issue secured or unsecured debentures".

2. The 'other securities of a company' is not defined. It is in fact illogical and contradictory. 'Securities' of a company are normally assets of the company. Debentures are liabilities. The definition was copied from an English Act and probably inserted without further thought.

3. **Section 122. "Director or officer not to be trustee for debenture-holders.** — No director or officer of a company shall be capable of being a trustee for the holders of debentures of that company".

4. **Section 302. "Duty of company to send annual financial statements to members and Registrar.**—(1) A copy of the annual financial statements of a company and the group annual financial statements, if any, shall not less than twenty-one days before the date of the annual general meeting of the company be sent to every member of the company and every holder of debentures of the company (whether or not such member or holder of debentures is entitled to receive notices of general meetings of the company) and to all persons other than members or holders of debentures of the company who are entitled to receive such notices.

   (2) The provisions of subsection (1) shall not be construed as requiring a copy of the said statements to be sent —

      (a) in the case of a company not having a share capital, to any member or holder of debentures of the company who is not entitled to receive notices of general meetings of the company;

      (b) to any member or holder of debentures of a company who is entitled to receive such notices and whose address is not known to the company;

      (c) to more than one of the joint holders of any shares or debentures of a company none of whom is entitled to receive such notices;

(d) in the case of joint holders of any such shares or debentures of whom some are and others are not entitled to receive such notices, to any such joint holder who is not so entitled.

Section 303. Half-yearly interim reports.—Every public company having a share capital, other than a wholly owned subsidiary, shall not later than three months after the expiration of the first period of six months of its financial year send to every member and holder of debentures of the company an interim report fairly presenting the business and operations of the company or, in the case of a holding company, of the company and its subsidiaries, during the said period of six months, and the results thereof".

5. **Pennington, Robert R. :** 'Company Law' 3rd Ed. p. 367. (Butterworths, London. 1973.)

"It is apparent that the commercial meaning of the term debenture covers many different forms of investment. The legal definition of a debenture is even wider. In one case, Chitty, J., said *(r) :-*

> 'In my opinion a debenture means a document which either creates a debt or acknowledges it, and any document which fulfils either of these conditions is a 'debenture'. I cannot find any precise legal definition of the term, it is not either in law or commerce a strictly technical term, or what is called a term of art'."

6. **Ibid :** p. 365 – 366.

7. **Translations** of companies laws are translations published in 'Commercial Laws of the World"**.** (Foreign Tax Law Publishers, Inc., Florida.).

8. **See generally Chapter 8** : "Securities Regulation – The Primary Market – Disclosure and the Merit Review".

9. **The Gazette of India Extraordinary :** 29.12.93. (Guidelines)

10.0 "A company offering Convertible/Non Convertible debt instruments through an offer document, shall comply with the following provisions in addition to the relevant provisions contained in other chapters of these guidelines.

10.1 Requirement of credit rating

10.1.1 No public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period shall be made unless credit rating from a credit rating agency has been obtained and disclosed in the offer document.

10.1.2 For a public / rights issue of debt security of issue greater than or equal to Rs. 100 crores two ratings from two different credit rating agencies shall be obtained.

10.1.3 Where credit rating is obtained from more than one credit rating agency, all the credit rating/s, including the unaccepted credit ratings, shall be disclosed.

10.1.4 All the credit ratings obtained during the three (3) years preceding the public or rights issue of debt instrument (including convertible instruments) for any listed security of the issuer company shall be disclosed in the offer document.

10.2 Requirement in respect of Debenture Trustee

10.2.1 In case of issue of debenture with maturity of more than 18 months, the issuer shall appoint a Debenture Trustee.

10.2.2 The names of the debenture trustees must be stated in the offer document.

10.2.3 A trust deed shall be executed by the issuer company in favour of the debenture trustees within six months of the closure of the issue.

10.2.4 Trustees to the debenture issue shall be vested with the requisite powers for protecting the interest of debenture holders including a right to appoint a nominee director on the Board of the company in consultation with institutional debenture holders.

10.2.5 The merchant banker shall, along with draft offer document, file with Board, certificates from their bankers that the assets on which security is to be created are free from any encumbrances and the necessary permissions to mortgage the assets have been obtained or a No Objection Certificate from the financial institutions or banks for a second or pari passu charge in cases where assets are encumbered.

10.2.6 The debenture trustee shall ensure compliance of the following:

a. Lead financial institution / investment institution shall monitor the progress in respect of debentures raised for project finance / modernisation / expansion / diversification / normal capital expenditure.

b. The lead bank for the Company shall monitor debentures raised for working capital funds.

c. Trustees shall obtain a certificate from the company's auditors:

i In respect of utilization of funds during the implementation period of projects.

ii. In the case of debentures for working capital, certificate shall be obtained at the end of each accounting year.

a. Debenture issues by companies belonging to the groups for financing replenishing funds or acquiring share holding in other companies shall not be permitted.

Explanation:

The expression 'replenishing of funds or acquiring shares in other companies' shall mean replenishment of funds or acquiring share holdings of other companies in the same group. In other words, the company shall not issue debentures for acquisition of shares / providing loan to any company belonging to the same group. However, the company may issue equity shares for purposes of repayment of loan to or investment in companies belonging to the same group.

a. The debenture trustees shall supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption reserve.

10.3 Creation of Debenture redemption reserves (DRR)

10.3.1 A company has to create DRR in case of issue of debenture with maturity of more than 18 months.

10.3.2 The issuer shall create DRR in accordance with the provisions given below,

(a) If debentures are issued for project finance for DRR can be created up to the date of commercial production.

(b) The DRR in respect of debentures issued for project finance may be created either in equal instalments or higher amounts if profits so permit.

a. In the case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debenture issue on the same lines as applicable for fully non-convertible issue.
b. In respect of convertible issues by new companies, the creation of DRR shall commence from the year the company earns profits for the remaining debentures.

(c) DRR shall be treated as a part of General Reserve for consideration of bonus issue proposals and for price fixation related to post tax return.

a. Company shall create DRR equivalent to 50% of the amount of debenture issue before debenture redemption commences.

b. Withdrawal from DRR is permissible only after 10% of the debenture liability has actually been redeemed by the company.

c. The requirement of creation of a DRR shall not be applicable in case of issue of debt instruments by infrastructure companies.

10.4 Distribution of Dividends

(a) In case of new companies, distribution of dividend shall require approval of the trustees to the issue and the lead institution, if any.

(b) In the case of existing companies prior permission of the lead institution for declaring dividend exceeding 20% or as per the loan covenants is necessary if the company does not comply with institutional condition regarding interest and debt service coverage ratio.

(c)(i) Dividends may be distributed out of profit of particular years only after transfer of requisite amount in DRR.

(ii) If residual profits after transfer to DRR are inadequate to distribute reasonable dividends, company may distribute dividend out of general reserve.

10.5 Redemption

10.5.1. The issuer company shall redeem the debentures as per the offer document.

10.6. Creation of Charge

10.6.1 The security shall be created within six months from the date of issue of debentures.

Provided that if for any reasons the company fails to create security within 12 months from the date of issue of debentures the company shall be liable to pay 2% penal interest to debenture holders.

Provided further that if security is not created even after 18 months, a meeting of the debenture holders shall be called within 21 days to explain the reasons thereof and the date by which the security shall be created.

10.6.2 If the issuing company proposes to create a charge for debentures of maturity of less that 18 months, it shall file with Registrar of Companies particulars of charge under the Companies Act.

Provided that, where no charge is to be created on such debentures, the issuer company shall ensure compliance with the provisions of the Companies (Acceptance of Deposits) Rules, 1975, as, unsecured debentures / bonds are treated as "deposits" for purposes of these rules.

10.6.3 The proposal to create a charge or otherwise in respect of such debentures, may be disclosed in the offer document along with its implications.

10.7 Requirement of letter of option

10.7.1 Filing of letter of option

A letter of option containing disclosures with regard to credit rating, debenture holder resolution, option for conversion, justification for conversion price and such other terms which the Board may prescribe from time to time shall be filed with the Board through an eligible Merchant Banker, in the following cases:

10.7.1.1. In case of Roll over of Non Convertible portions of Partly Convertible Debentures (PCDs)/Non Convertible Debentures (NCDs)

i. In case, the non-convertible portions of PCD/NCD issued by a listed company, value of which exceeds Rs. 50 lacs, can be rolled over without change in the interest rate subject to the following conditions:

a. An option shall be compulsorily given to debenture holders to redeem the debentures as per the terms of the offer document.

b. Roll over shall be done only in cases where debenture holders have sent their positive consent and not on the basis of the non-receipt of their negative reply.

c. Before roll over of any NCDs or non-convertible portion of the PCDs, a fresh credit rating shall be obtained with a period of six months prior to the due date of redemption and communicated to debenture holders before roll over.

d. Fresh trust deed shall be executed at the time of such roll over.

e. Fresh security shall be created in respect of such debentures to be rolled over.

Provided that if the existing trust deed or the security documents provide for continuance of the security till redemption of debentures fresh security may not be created.

10.7.1.2 In case of conversion of instruments (PCDs/FCDs, etc.) into equity capital

i. In case, the convertible portion of any instrument such as PCDs, FCDs etc. issued by a listed company, value of which exceeds Rs. 50 Lacs and whose conversion price was not fixed at the time of issue, holders of such instruments shall be given a compulsory option of not converting into equity capital.

ii. Conversion shall be done only in cases where instrument holders have sent their positive consent and not on the basis of the non-receipt of their negative reply.

Provided that where issues are made and cap price with justification thereon, is fixed beforehand in respect of any instruments by the issuer and disclosed to the investors before issue, it will not be necessary to give option to the instrument holder for converting the instruments into equity capital within the cap price.

iii. In cases where an option is to be given to such instrument holders and if any instrument holder does not exercise the option to convert the debentures into equity at a price determined in the general meeting of the shareholders, the company shall redeem that part of debenture at a price which shall not be less than its face value, within one month from the last date by which option is to be exercised.

iv. The provision of sub-clause (iii) above shall not apply if such redemption is to be made in accordance with the terms of the issue originally stated.

10.7.1.3 In case of Conversion of Debentures Issued under Consent of Controller of Capital Issues (CCI)

A. In case, the value of convertible portion of any instrument such as PCDs, FCDs, etc. issued by a listed company exceeds Rs 50 Lacs and;

i. where in terms of the consent issued by the Controller of Capital Issues, the price of conversion of PCDs / FCDs is to be determined at a later date by the Controller, such price and the timing of conversion shall be determined at a general meeting of the shareholders subject to -

the consent of the holders of PCDs / FCDs for the conversion terms shall be obtained individually and conversion will be given effect to only if the concerned debentureholders send their positive consent and not on the basis of non- receipt of their negative reply; and

such holders of debentures, who do not give such consent, shall be given an option to get the convertible portion of debentures redeemed or repurchased by the company at a price, which shall not be less than face value of the debentures.

C. Where the consent from the Controller of Capital Issues stipulates cap price for conversion of FCDs / PCDs, the board of the Company may determine the price at which the debentures may be converted.

Provided that options to debentures / other instrument holders for conversion into equity not required where the consent from the Controller of Capital Issues stipulates cap price for conversion of FCDs and PCDs and the cap price has been disclosed to the investors before subscription is made.

i. In case of issue of debentures fully or partly convertible made in the past, where the conversion was to be made at a price to be determined by the CCI at a later date, the price of conversion and time of conversion shall be determined by the issuer company in a meeting of the debenture holders, subject to the following:

The decision in the said meeting of debentureholders may be ratified by the shareholders in their meeting.

Such conversions shall be optional for acceptance on the part of individuals debenture holders.

The dissenting debenture holders shall have the right to continue as debenture holders if the terms of conversions are not acceptable to them.

(iii) Where issue of PCDs and FCDs is made pursuant to the consent given by the Controller of Capital Issues and the consent specifies the timing of conversion but the price of conversion of PCDs / FCDs is to be determined at a later date, the following shall be complied with:-

A. the consent of the shareholders is to be obtained only for the purposes of fixing the price of conversion and not for the pre-poning and postponing the timing of the conversion approved by CCI.

a. The conversion price shall be reasonable (in comparison with previous conversion price where the terms of the issue provide for more than one conversion) and the conversion price shall not exceed the face value of that part of the convertible debenture which is sought to be converted.

b. In cases where an option is to be given to the debentureholders and, if any debentureholder does not exercise the option to convert the debentures into equity at a price determined in the general meeting of the shareholders, the company shall redeem that part of debenture at a price which shall not be less than its face value within one month from the last date by which option is to be exercised.

c. The provision in sub-clause (c) above shall not be applicable in case such redemption is to be made in accordance with the original terms of the offer.

B. In cases of issues of debentures fully or partly convertible, irrespective of value made in the past, where conversion was to be made at a price to be determined by CCI and the consent order does not provide for a specific premium or a cap price for conversion, the draft letter of option to the debenture holders filed with the Board shall contain justification for the conversion price.

10.8 Other requirements

10.8.1 No company shall issue of FCDs having a conversion period of more than 36 months, unless conversion is made optional with "put" and "call" option.

2. If the conversion takes place at or after 18 months from the date of allotment, but before 36 months, any conversion in part or whole of the debenture shall be optional at the hands of the debenture holder.

3. (a) No issue of debentures by an issuer company shall be made for acquisition of shares or providing loan to any company belonging to the same group.

Sub-clause (a) shall not apply to the issue of fully convertible debentures providing conversion within a period of eighteen months.

4. Premium amount and time of conversion shall be determined by the issuer company and disclosed.

10.8.5 The interest rate for debentures can be freely determined by the issuer company.

10.9 Additional Disclosures in respect of debentures

The offer document shall contain:-

a. Premium amount on conversion, time of conversion.

b. In case of PCDs/NCDs, redemption amount, period of maturity, yield on redemption of the PCDs/NCDs.

c. Full information relating to the terms of offer or purchase including the name(s) of the party offering to purchase the khokhas (non-convertible portion of PCDs).

d. The discount at which such offer is made and the effective price for the investor as a result of such discount.

e. The existing and future equity and long term debt ratio.

f. Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures.

g. That the certificate from a financial institution or bankers about their no objection for a second or pari passu charge being created in favour of the trustees to the proposed debenture issues has been obtained.

13. Obligation before appointment as debenture trustees

13.(1) No debenture trustee who has been granted a certificate under regulation 8 shall act as such in respect of each issue of debenture unless -

(a) he gives consent in writing to a body corporate to act as debenture trustee under trust deed for securing any issue of debentures by each such body corporate;

consent under clause (a) is given before the issue of debentures for subscription.

Obligation of the debenture trustees

14. Every debenture trustee shall amongst other matters accept the trust deed which contain the matters specified in Schedule IV to the regulations.

Duties of the debenture trustees

15.(1) It shall be the duty of every debenture trustee to -

call for periodical reports from the body corporate;

inspect books of accounts, records, registers of the body corporate and the trust property to the extent necessary for discharging his obligations;

(a) take possession of trust property in accordance with the provisions of the trust deed;

(b) enforce security in the interest of the debenture holders;

(c) do such acts as are necessary in the event the security becomes enforceable;

(d) carry out such acts as are necessary for the protection of the debenture holders and to do all things necessary in order to resolve the grievances of the debenture holders;

(e) ensure that the -

(i) refund monies due to the applicants applying for the debentures have been paid in accordance with the Companies Act and the listing agreement of the stock exchange on which the debentures of the company are listed;

(ii) debenture certificates have been despatched to the debenture holders in accordance with the provisions of the Companies Act;

(iii) interest warrants for interest due on the debentures have been despatched to the debenture holders on or before the due dates;

(iv) debenture holders have been paid the monies due to them on the date of redemption of the debentures;

(h) exercise due diligence to ascertain whether or not the assets of the body corporate which are available by way of security or otherwise are sufficient or are likely to be or become sufficient to discharge the claims of debenture holders as and when they become due;

exercise due diligence to ensure compliance by the body corporate, with the provisions of the Companies Act, the listing agreement of the stock-exchange or the trust deed;

to make appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trust deed or law comes to his notice;

(i) to ascertain that the debentures have been converted or redeemed in accordance with the provisions and conditions under which they are offered to the debenture holders;

(j) inform the Board immediately of any breach of trust deed or provision of any law.

[15](2) A debenture trustee shall call or cause to be called by the body corporate a meeting of all the debenture holders on -

(a) a requisition in writing signed by at least one tenth of the debenture holders in value for the time being outstanding; or

(c) the happening of any event, which constitutes a default or which in the opinion of the debenture trustees affects the interests of the debenture holders.

Code of Conduct

16. Every debenture trustee shall abide by the Code of Conduct as specified in Schedule III.

Maintenance of books of accounts, records, documents etc.

17. (1) Subject to the provisions of any law every debenture trustee shall keep and maintain proper books of accounts, records and documents relating to the trusteeship functions for a period of not less than five financial years preceding the current financial year.

(2) Every debenture trustee shall intimate to the Board, the place where the books of accounts, records and documents are maintained.

Information to the Board

(1) Every debenture trustee shall as and when required by the Board submit the following information and documents namely:-

(a) the number and nature of the grievances of the debenture holders received and resolved;

(b) copies of the trust deed;

(c) non-payment or delayed payment of interest to debenture holders in any in respect of each issue of debentures of a body corporate;

(d) details of despatch and transfer of debenture certificates giving therein the dates, mode, etc;

(e) any other particular or document which is relevant to debenture trustee.

Where any information is called for under sub-regulation (1) it shall be the duty of the debenture trustees to furnish such information".

10. **See** also

Argentina Section 345

".....the trustee shall have the following authority:

To examine the documentation and accounting of the debtor company".

India Section 15 of the Guidelines

"It shall be the duty of every debenture trustee to call for periodical reports from the body corporate [and to] inspect books of accounts, records, registers of the body corporate and the trust property to the extent necessary for discharging his obligations".

Malaysia Sections 76 and 78

Nauru Sections 74 and 75

Papua New Guinea Securities Regulation 1999 – Section 37

"(3) The issuer shall on regular basis —

(a) at the request in writing of the trustee, make available for its inspection the whole of the accounting and other records of the issuer; and

(b) give to the trustee such information as it requsires with respect to all matters relating to such records".

Paraguay Section 1145

Singapore Section 99

"(1) Where a corporation offers debentures to the public for subscription in Singapore, the debentures or the relevant trust deed .....shall contain covenants by the borrowing corporation, or if the debentures do not or the trust deed does not expressly contain those covenants they or it shall be deemed to contain covenants by the borrowing corporation, to the following effect:

(a) .....

(b) that, to the same extent as if the trustee for the holders of the debentures or any approved company auditor appointed by the trustee were a director of the corporation, the borrowing corporation will:

(i) make available for its or his inspection the whole of the accounting or other records of the borrowing corporation; and

(ii) give to it or him such information as it or he requires with respect to all matters relating to the accounting or other records of the borrowing corporation".

11. **See** also

Bangladesh Securities and Exchange Commission Public Issue Rules, 1998 – Rule 16(2)

"(2) The debentures trustee shall be a bank, a financial institution or an insurance company".

Canada Section 84

"A trustee, or at least one of the trustees if more than one is appointed, shall be a body corporate incorporated under the laws of Canada or a province and authorised to carry on the business of a trust company".

Malaysia Section 1

"Trustee Corporation means

(a) a company registered as a trust company under the Trust Companies Act 1949; or

(b) a corporation that is a public company under this Act or under the laws of any other country, which has been declared by the Minister to be a trustee corporation for the purposes of this Act".

Nauru Section 2

Singapore Section 4

United States Section 77**jjj** (Trust Indenture Act of 1939)

"(a) Persons eligible for appointment as trustee

(1) There shall at all times be one or more trustees under every indenture qualified or to be qualified pursuant to this subchapter, at least one of whom shall at all times be a corporation organized and doing business under the laws of the United States or of any State or Territory or of the district of Columbia or a corporation or other person permitted to act as trustee by the Commission (referred to in this subchapter as the institutional trustee), which (A) is authorized under such laws to exercise corporate trust powers, and (B) is subject to supervision or examination by Federal, State, Territorial, or District of Columbia authority. The Commission may, pursuant to such rules and regulations as it may prescribe, or by order on application, permit a corporation or other person organized and doing business under the laws of a foreign government to act as sole trustee under an indenture qualified or to be qualified pursuant to this subchapter, if such corporation or other person (i) is authorized under such laws to exercise corporate trust powers, and (ii) is subject to supervision or examination by authority of such foreign government or a political subdivision thereof substantially equivalent to supervision or examination applicable to United States institutional trustees. In prescribing such rules and regulations or making such order, the Commission shall consider whether under such laws, a United States institutional trustee is eligible to act as sole trustee

under an indenture relating to securities sold within the jurisdiction of such foreign government".

12. **See** also

Australia Section 1054

"A corporation shall not, in this jurisdictions, invite subscriptions for or the purchase of debentures or offer debentures for subscription or purchase unless the relevant trust deed

(a) contains a limitation of the amount that the borrowing corporation may borrow under that deed or those debentures";

Brazil Section 60

"Except as provided for by special legislation, the total amount of debenture issues may not exceed corporate capital".

Egypt Section 162

"A company shall not issue debentures unless the total of the issued capital shall be paid-up in full and provided that the total value of previously issued added to the new debentures to be issued shall not exceed the net value of the company assets as stated by the accounts auditor in his report to the general meeting considering the issue of the new debentures and on basis of the information contained in the last balance sheet approved by the general meeting".

Japan Section 297

"The amount of debentures for which subscriptions are to be invited shall not exceed the net amount of the existing assets of the company as shown by the last balance sheet".

Malaysia Section 76

"(1) Where a corporation offers debentures to the public for subscription in Malaysia the debentures or the relevant trust deed shall contain a

limitation on the amount that the borrowing corporation may pursuant to those debentures or that deed borrow".

Romania Section 118

"The joint-stock company may issue bearer or nominal bonds, for an amount not exceeding three quarters of the deposited and existing capital, according to the latest approved annual report".

Singapore Section 99

Thailand Section 1230

"The total amount of debentures may not exceed the amount which has been paid up on the capital.

If the latest balance sheet shows the amount of the assets to be less than the amount which has been paid up on the capital, the total amount of debentures may not exceed the amount represented by the assets".

Turkey Section 422

"The amount of debentures to be issued by companies limited by shares may not exceed the amount of the basic capital which has been paid up, as ascertained by the last balance sheet that has been approved".

Venezuela Section 305

".....in amounts that exceed the capital contributed and still subsisting, in accordance with the last approved balance sheet".

13. **See** also

Malaysia Section 78

Nauru Section 75

India Section 15(1)(h)

".....exercise due diligence to ascertain whether or not the assets of the body corporate which are available by way of security or

otherwise are sufficient or are likely to be or become sufficient to discharge the claims of the debenture holders as and when they become due".

14. **See** also

Malaysia Section 80

Nauru Section 77

St Lucia Section 274

"At least once in every 12 month period beginning on the date of the trust deed and at any other time upon the demand of a trustee, the issuer or guarantor of debentures issued under the trust deed shall furnish the trustee with a certificate that the issuer or guarantor has complied with all requirements contained in the trust deed that, if not complied with, would, with the giving of notice, lapse of time or otherwise, constitute an event of default, or, if there has been failure to comply giving particulars of that failure".

.....

CHAPTER 13 - FINANCIAL STATEMENTS -THE AUDITOR AND THE EXPECTATION GAP – ACCESS TO RECORDS BY INTEREST GROUPS

13.1 At the beginning of the 20th century it was thought that corporations should only disclose financial information to its members. It was believed that public disclosure would benefit competitors and if the information was positive, that the disclosure could lead to increased wage demands by labour.(1)

13.2 Today it is widely accepted that public disclosure of the financial affairs of corporations is vital to the wellbeing of economies, not only for the reason

> "that the price of limited liability ought to be the maximum possible disclosure of information regarding the company's financial position".

but because the users of the information represent all sections of the economy.

13.3 Leading entities in the field of accounting, such as

— the International Accounting Standards Committee (IASC) which represents 140 accountants organizations;

— the Financial Accounting Standards Board (FASB) of the United States;

— the Accounting Standards Board of the UK;

agree that the objective of financial statements is to provide useful information about the the performance of an enterprise, its financial position and any changes therein.

13.4 The FASB regards 'useful information' as information useful to users in making rational investment, credit and similar decisions and useful for purposes of predicting, comparing and evaluating potential cash flows in terms of amount, timing and related uncertainty.

13.5 The members of corporations are no longer regarded as the only potential users of the financial statements. The Accounting Standards Steering Committee (now the Accounting Standards Board) identified seven user groups, namely —

— the equity investor group;

— the loan creditor group;

— the employee group;

— the analyst – adviser group;

— the business contact group;

— the government;

— the public.[(2)]

13.6 Factors such as the growth in size of modern corporations, the growth in the volume of their transactions, the advent and growth of institutional investors, the shift away from the detection of fraud as a primary audit objective and the diversity of the needs of the users of the financial statements, have resulted in a situation where the auditing profession as presently employed cannot fulfil the expectations of the diverse users of the financial statements who each want to be able to make meaningful investment decisions based on the contents thereof.

13.7 Unfortunately the diversity of the needs of the users of financial statements is not the only stumbling block to the publication of reliable information because the contents of financial statements are often coloured by management to suit their own purposes. Professor MacGregor stated it as follows:

> "Although many of the items requiring disclosure by statute are couched in general terms, there is an overriding requirement that financial statements in accordance with generally accepted accounting practice fairly present the state of affairs of the company (the so-called 'true and fair' view) and the directors are obliged by statute to ensure that this is so.
>
> This is a legal requirement and directors have found that it is possible to show the 'true and fair' view by adopting one of the many bases of, for example, depreciation, valuation of stock and work-in-progress, providing for deferred taxation, valuations of uncompleted construction contracts, all of which bases have been categorized as

generally acceptable accounting practice by accountants and auditors. It is understandable that the preparers of financial statements will choose the alternative that best suits their purpose, be it increasing disclosed profits or suppressing profits, and provided that the 'true and fair' requirement has not been disregarded, they are not contravening any part of the statute".[3]

13.8 In addition, the often unexpected liquidations of entities soon after having been reported as profitable and the often perceived non-independence of their auditors, have led to a distrust of the auditing profession and the generation of the well documented '**expectation gap**'. This is a worldwide phenomenon as proven by studies conducted in countries such as the **United States** (1978), **Australia** (1993), **New Zealand** (1993) and **South Africa** (1993).[4]

13.9 The Commission became convinced that as a result of

— the flexibility inherent in the interpretation and in the application of the rules pertaining to Generally Accepted Accounting Practice (Principles);

— the diverse needs of the users and potential users of financial statements;

— the inevitable time lag before interim reports and financial statements are issued;

— the dishonesty or ineptitude of some managers and some auditors;

access to the records of corporations should no longer be the exclusive domain of directors, management, auditors and sometimes the majority shareholders.

13.10 Comments were invited from interested persons by means of the dissemination of a Consultation Paper – **'The Role of the Auditor – The Elimination of the Expectation Gap and the Appointment of Auditors by all Significant Interest Groups'.**

13.11 The contents of the Consultation Paper were designed to convey the reasons why the Commission regards

– the contents of financial statements;

– the traditional audit thereof;

— the required audit report thereon

as inadequate for the needs of the users thereof and why a structural shift towards transparency is regarded as a necessity.

13.12 To avoid needless repetition and to better understand the criticisms and the emotions evoked when it is suggested that the statutory veil of secrecy which surrounds the affairs of South African companies be lifted, the text of the Consultation Paper is reproduced in full.

"CONSULTATION PAPER

1. INTRODUCTION

1.1 During the late eighties and early nineties the systems designed to protect investors in South Africa failed and hundreds of millions were lost by small investors, many of them pensioners. The systems are still failing with disastrous effects for the victims, many of whom can never recover financially.

1.2 One of the failures during the early nineties, was the Masterbond Group of Companies which over a number of years 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 a 'Ponzi' scheme. The Group collapsed and thousands of investors were left destitute, many of them pensioners who specifically had been targeted and tempted with the carrot of security and higher than normal interest rates.

1.4 A public outcry led to the appointment of the Commission of Inquiry. Its First Report reads —

> **"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."**

and

> **"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".**[1]

1.4 The Commission also reported that it was investigating a number of aspects regarding the auditing profession, including

– **the introduction of legal backing for accounting and auditing standards;**

– **the creation of a public oversight board which would be charged with public oversight over the profession's discharge of its regulatory, disciplinary and standard-setting responsibilities;**

– **the preservation of auditor independence;**

– **the compulsory duty to report all irregularities discovered during an audit to the proper authorities and to the shareholders of the entity;**

— **the creation of avenues of communication between auditors and shareholders or holders of debentures.**

1.5 The response by the auditing and accounting professions represented by the Public Accountants' and Auditors' Board, the South African Institute of Chartered Accountants (SAICA), the Institute of Commercial and Financial Accountants of South Africa (CFA) and the Association of Chartered Certified Accountants (ACCA) was extremely positive.

1.6 The Executive Summary of the submission by SAICA concludes with the following paragraph:

> **"Even if all the above mentioned changes can be achieved, SAICA is not convinced that public protection can be achieved. It is the view of SAICA that underlying all of these problems is an unhealthy attitude of mind that exists in this country. Many South Africans have a view that it is acceptable to cheat the system, not pay taxes, or to avoid complying with laws and regulations. SAICA believes that for effective investor protection to take place, the regulators need the co-operation of the people involved, the entities and the government. How this mental attitude is changed is a challenge facing this country, but it is a very important one. Government and community organisations will have to take the lead in helping to forge a greater spirit of morality in South Africa".**

Total protection of the public cannot be achieved by the proposed changes referred to in paragraph 1.4 above, but if implemented, should significantly improve protection. The unhealthy attitude of mind to which SAICA refers, applies to not only South Africa but to each and every country in the world.

The First Report of the Commission stated —

"The investigations, enquiries and research revealed that the circumstances which had led to the losses suffered by the Masterbond investors were not unique to the Masterbond group in particular or even in South Africa in general.

In one form or another these circumstances prevail elsewhere in the world but in many countries legislative measures have been taken to minimise losses caused by fraud and bad management".

1.7 The Commission has come to the conclusion that in addition to the proposed changes set out in paragraph 1.4 above, more effective steps could and should be taken to protect all the stakeholders in the modern corporation.

Stakeholders are persons such as shareholders, holders of debentures, employees (trade unions), suppliers and other trade creditors, members of pension funds, provident funds and a myriad of investment funds, lenders, bank depositors and the assured by insurance companies.

1.8 It is clear that the methods of financial accounting which have evolved into 'generally accepted accounting practice (principles or standards)' and the traditional audit and audit reports in respect thereof, often no longer serve the purpose of adequately informing and thus protecting the stakeholders in the modern corporations.

1.9 The shortcomings in the present methods of accounting and auditing are expounded upon in Chapter 2 hereof.

1.10 To achieve adequate protection for the stakeholders a fundamental and structural change to the audit function is required.

The change envisaged is the empowerment of all significant stakeholder interest groups by granting them the right to appoint their own auditors to investigate and report on matters which particularly affect them.

1.11 The purpose of this Paper is to ensure the widest possible consultation with all interested parties regarding the views expressed herein and the practicality of achieving the proposed changes in the role of the auditor.

Matters to be considered include

- **the additional cost to the entity;**
- **confidentiality;**
- **defining a significant stakeholder interest group;**
- **whether entities such as potential investors (when offers to the public are made), the government and the public (in environmental disputes) should also be included;**
- **the method of appointment of the additional auditors;**
- **the possible effect on the auditing profession;**
- **the qualifications of the additional auditors.**

2. BACKGROUND

2.1.1 In modern economies, all members of society are actively encouraged to save some portion of their earnings by investing in pension funds, unit trusts, insurance policies, listed companies and the like. They are encouraged to do so to

achieve capital growth and to enable them to provide for their old age. Usually unable to rely upon their own skills, they entrust their future in the hands of persons such as professional advisers, managers of investment schemes, trustees of pension funds and the like.

2.2 The AICPA (American Institute of Certified Public Accountants) Special Committee on Financial Reporting (the Jenkins Committee Report), described the sources of information of the users of business reports as follows:

> **"Users need and use information from multiple sources for two reasons. First, users need information from the best sources, which differ depending on the type of information and other factors. For example, users obtain information about the economy from economic studies and reports by economists and other sources. They obtain information about industry conditions from industry trade publications, government statistics, and others. Although a company's management is often the best source for a large portion of company specific information, it is not the only source, nor always the best source. For example, users learn about a company's stock price and trading volume from a stock exchange. Second, obtaining the same type of information from multiple sources allows users to compare views and assess the relative reliability of the information. For example, users may learn about a company's strengths and weaknesses from its management, competitors, customers, and other users, each of which may offer a different perspective. Users can judge for themselves about which view is the most reliable. Despite its usefulness, users do not want business reporting to become the only source for their information".**

The 'users' referred to were defined as

> **"investors and creditors, including potential investors and creditors, and their advisers that use business reporting as a basis for their capital allocation decisions".**

(professional investors and creditors and their advisers)

Although business reporting is not the only source of information, the Committee described it as the 'cornerstone'.

”People in every walk of life are affected by business reporting, the cornerstone on which our process of capital allocation is built. An effective allocation process is critical to a healthy economy that promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit.

Conversely, a flawed allocation process supports unproductive practices, denies cost-effective capital to companies that may offer innovative products and services that add value, and undermines the securities market. Without adequate information, users of business reporting cannot judge properly the opportunities and risks of investment opportunities. To make informed decisions, they need a variety of information, including data about the economy, industries, companies, and securities. Complete information provided by the best sources enhances the probability that the best decisions will be made. And for company-specific information; which is a key because companies are the sources of cash flows that ultimately result in the return on securities or the repayment of loans; management often is the best source. Business reporting packages management’s company-specific information and delivers it to users in a meaningful way. Few areas are more central to the national economic interests than the role of business reporting in promoting an effective process of capital allocation. It simply must be made to work as well as possible.”[(2)]

2.3 History teaches that it is often dangerous to rely upon pronouncements of management.

The Commission reported as follows on this aspect:

“The lack of severe penalties for the making of false statements, the virtual collapse of the Office of the Registrar of Companies, and the inefficiency of prosecuting authorities allow some chairmen of boards in South Africa to deceive their shareholders, creditors and other interested parties with relative impunity.

Pretoria Bank : The Chairman’s Report dated 31 October 1990:

“The past Twelve Months have been a period of strong performance by Pretoria Bank with Strong Growth in both Assets and Income.

In the year under review…….net income after tax increased by 192,2% from R292 439 to R861 381.

As Chairman, I wish to thank my co-directors for their loyalty and support…..

……my appreciation is extended to the management and personnel of Pretoria Bank for the diligent and competent way in which they fulfilled their duties."

In fact —

— Pretoria Bank was insolvent;

— the managing director had been dismissed as a result of massive fraud;

— the general manager had also been dismissed;

— during the financial year approximately R700 000, more than 15% of the capital of the bank, had been stolen.

Cape Investment Bank : Chairman's Review also dated 31 October 1990 —

"This is the 3rd annual review of the Group. It was a difficult but gratifying year characterised by achieving forecasted results, rapid expansion both in terms of organic and acquired growth, uncertain environments and the resultant strain on people and the organisation."

In fact —

— the bank was insolvent;

— numerous offences had been committed by directors;

— but for hand-outs of approximately R50 million by the Reserve Bank, the auditors would not have signed unqualified reports to the annual financial statements.

Masterbond : Press Announcement published by the Board on 3 September 1991 and signed by Jonker and Brits —

"Prospects: The Masterbond Trust Group has achieved excellent profits during the year under review. Despite the expected downturn in the economy we believe the Group will maintain its profit growth.

In fact

— the probability of liquidation was being foreseen and eventuated within 30 days thereafter".

2.4 The problems associated with reliance on the contents of financial statements compiled in accordance with generally accepted accounting practice and audited in accordance with generally accepted auditing standards are briefly sketched hereinafter.

2.5 At the end of the 17th and the beginning of the 18th centuries, companies, incorporated an unincorporated, proliferated in England. There were no regulating authorities and fraud, corruption, insider trading and manipulation of stock prices were not uncommon.

2.6 As from the 24th June 1720 virtually all unincorporated companies were outlawed by the British Parliament and brokers ('stockjobbers') were prohibited from dealing in their securities. 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).(3)

2.7 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 18th 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.

2.8 The rise in numbers and importance of the unincorporated companies led to the repeal of the Bubble Act in 1825. This led to the evolvement of the modern company in the English-speaking world.(4)

2.9 In 1844 a Select Committee under the chairmanship of Gladstone and

appointed by the House of Commons

> *'to inquire into the State of Laws respecting Joint Stock Companies .....with a view to greater security of the public'*

reported that it believed that disclosure and transparency in corporate affairs could prevent fraud and that —

> *'Periodical accounts, if honestly made and fairly audited, cannot fail to excite the attention to the real state of a concern.....'* (5)

2.10 The Gladstone Report was followed by the first general companies act, the Joint Stock Companies Act 1844, which provided for —

— **the preparation and delivery of 'full and fair' audited balance sheets and auditors' reports to all shareholders and the reading thereof at the annual meetings of companies;**

– **the right of shareholders to inspect the books of accounts of companies.**

This heralded the beginning of never-ending attempts to enforce proper disclosure of the affairs of corporations, the birth of the modern auditing profession and eventually led to the development of supervisors such as Stock Exchanges, Central Banks, the SEC in the United States, the FSA in the United Kingdom and the Financial Services Board in South Africa.

2.11 This first attempt to enforce a 'full and fair' disclosure of the affairs of companies is described by Chatfield as —

> **"Though ambitious in intent, the 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 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.

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." (6)

2.12 The compulsory audit of balance sheets of companies was abolished in 1856 but reintroduced by the Companies Act of 1900.

2.13 According to H W Robinson (quoted by Chatfield p.147) the British accounting profession

'was born through bankruptcies, fed on failures and frauds, grew on liquidations and graduated through audits'.

Chatfield describes the development of the profession during the latter part of the 19th century as follows:

"The Companies Act of 1862 soon became known as 'the accountant's friend'. By requiring that dividends could be paid only from income, it made the service of skilled accountants absolutely necessary. Auditors no longer had to be stockholders, and their precise duties for examination and reporting were set forth. The 1862 Act also created the position of official liquidator for the purpose of winding up insolvent companies, and this job was usually given to a professional accountant. The first important liquidation under the act followed the collapse of Overend, Gurney and Company, Ltd., together with four large banks, during the crisis of 1866. The failure of the City of Glascow Bank in 1878 directed attention to public accountants when leading Glascow practitioners took charge of the liquidation while others testified for the prosecution or the defense.

A law passed in the following year required annual audits of financial institutions in return for the privilege of incorporation with limited liability.

H A Shannon[7] estimates that just over 30 percent of all English corporations formed between 1856 and 1883 ended in insolvency, and that a majority of these were liquidated within six years of their inception. Business depressions followed one another with machinelike regularity.

The British government responded to these crises, with their attendant upsurge of business failures, by passing a series of bankruptcy acts. It is likely that no other law enacted during the nineteenth century, not even the companies acts, provided so much work for accountants. The stewardship provisions of these statutes varied, but all required the appointment of administrators to take control of the bankrupt's property, both in his interests and to protect his creditors from asset concealment and conversion".

2.14 In the United States the development of accounting principles was largely activated by banks who required audited balance sheets when approached for credit. The bankers 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.

2.15 The crash of the stock market in 1929 and the depression of the thirties led to the acceptance by the New York Stock Exchange of the proposal by the American Institute of Accountants that accounting methods should be within the framework of 'accepted accounting principles'. Later it became 'generally accepted accounting principles (standards)' and was also followed by 'generally accepted auditing standards'.[8]

2.16 Prior to the 1920's the detection of fraud was regarded as a primary audit objective. This is stated by Professor Brenda Porter of Massey University in her comparative historical and international study 'Auditors' Responsibility to Detect and Report Corporate Fraud' (1994) —

"This is clearly evidenced by the auditing texts of the time : for example, Dicksee (1898) stated that the objective of an audit was made up of three parts, the detection of fraud, the detection of technical errors, and the detection of errors in principle; similarly, Montgomery (1912) referred to the prevention and detection of fraud and error as the 'chief objects' of an audit (p 2)."

The term 'fraud' as used by Porter includes –

"the use of deception, such as manipulation, falsification, or alteration of accounting records or supporting documents, so as to obtain an unjust or illegal financial advantage;

intentional misstatements in, or omissions of amounts or disclosures from, accounting records or financial statements;

intentional false accounting or misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure;

misappropriation of assets".

2.17 During the period from the 1920's to the 1960's, a fundamental change occurred. It is described by Porter as follows:

".....largely as a result of changes in the socio-economic environment, the auditing profession acknowledged progressively less responsibility for detecting fraud. During this period, companies grew in size and their management's established systems of internal control designed, inter alia, to prevent and detect fraud and error. As companies increased in size, so did the number of their transactions and it soon became infeasible for auditors to verify all of a company's transactions and accounting entries. Auditing techniques changed in response to the new environment and detailed checking of accounting records gave way to examining the company's internal controls and testing a sample of accounting entries.

Additionally, as company ownership became more widespread and diverse, investors grew less interested in the fortunes of 'their' company per se, and more

interested in the returns it generated. If they perceived that better returns could be earned elsewhere, they rapidly switched their allegiance to another company. This changed attitude of investors stimulated a change in focus with respect to financial statements. Instead of being seen as documents which reflected the stewardship of company managers entrusted with the financial resources of shareholders, they came to be regarded as a basis for investment decisions. As a consequence, attention focused on the fairness with which financial statements portrayed the financial affairs of the reporting entity. Reflecting these changes in the socio-economic environment, audit objectives shifted away from detecting fraud and error towards assessing the truth and fairness of information contained in financial statements.

Towards the end of the 1920s-1960s phase, the auditing profession was, in general, denying all but an incidental responsibility to detect corporate fraud. This is reflected in Montgomery's (1957) auditing text which referred to the detection of fraud as 'a responsibility not assumed' (reported in CAR, 1978, p.34). It is also reflected in the professional promulgations of the time. For example, in 1951, the American Institute of Certified Public Accountants (AICPA) stated in its Codification of Statements on Auditing Procedure:

> *'The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied upon to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organised concern reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive.' (pp. 12-13)"*[9]

2.18 As pointed out, the Joint Stock Companies Act 1844 provided for the preparation of 'full and fair' audited balance sheets and the right of shareholders to inspect the books of account of companies.

During the ensuing years shareholders lost their right to inspect the books of account of their companies. The rights which some other stakeholders had to appoint their own auditors, also disappeared.

In 1891 Pixley in his Treatise on the Duties and Responsibilities of Auditors stated —

> **"For instance, some Assurance Companies have Auditors for the Assured as well as for the Assurers or shareholders. Occasionally the Debenture Holders of a Company have their own Auditor, as also have the Preference Shareholders.**
>
> **Within the last few years, Companies have been formed with 'Founders' Shares', the holders of which are entitled to a proportion of the profits after the other shareholders have received a minimum dividend. In all these cases their specially appointed Auditors have to ascertain their clients receive their full privileges, and that the reserves for depreciation, for loss on realisation of debts, and general reserve, are not unduly high".**

As pointed out, the shareholders and other stakeholders in the modern corporation are largely dependent on its published financial statements and the pronouncements of management.

Other 'stakeholders' are often more dependent upon the welfare of the corporation than the original contributors of its capital. For instance such persons as

- **holders of debentures;**
- **employees;**
- **members of its pension fund;**
- **suppliers and other trade creditors;**
- **lenders;**
- **assured;**
- **depositors;**
- **the large numbers who are members of institutional investors who invest in the corporation.**

2.20 The International Accounting Standards Committee (IASC) accepts that in addition, the users of the audited financial statements of corporations also include

— **potential investors;**
— **customers;**
— **governments;**
— **the public.**[10]

To this list should be added the multitude of financial analysts and financial advisers, the editorial staff of financial magazines and newspapers, supervisors, stock exchanges and trade unions.

2.21 The FEE also accepts the obvious, namely that the auditor's opinion enhances the credibility of the financial statements and assists in the making of decisions such as for the provision of finance, for the granting of credit, for employment and for taxation or the grant of subsidies.[11]

2.22 It is also accepted that in addition to unfair or fraudulent conduct by market participants, inadequate disclosure of information upon which users can make informed choices about financial products and their providers could lead to market failure.[12]

In a recent speech (28 September 1998) Arthur Levitt, the chairman of the SEC, remarked as follows:

> **"The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situations in Asia and Russia are stark examples of this new reality. These markets are learning a painful lessons taught many times before : investors panic as a result of unexpected or unquantifiable bad news.**
>
> **If a company fails to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate for no discernible reasons; and the trust that is the bedrock of our capital markets is severely tested".**[13]

The disclosure requirements prescribed by the corporate laws, by the stock

exchanges and by supervisors are thus in place not only to protect investors but also to protect financial systems.

2.23 Factors such as the growth in size of modern corporations, the growth in the volume of their transactions, the advent and growth of institutional investors, the shift away from the detection of fraud as a primary audit objective and the diversity of the needs of the users of the financial statements, have resulted in a situation where the auditing profession as presently employed cannot fulfil the expectations of the diverse users of the financial statements who each want to be able to make meaningful investment decisions based on the contents thereof.

2.24 Investment decisions regarding a particular entity could include

— to invest or disinvest in its shares or debentures;

— to seek or terminate employment;

— to accept or reject wage proposals;

— to join or terminate membership of pension schemes, provident funds and other investment schemes;

— to supply or refuse to supply goods;

— to extend or refuse credit;

— to supply finance;

— to deposit or withdraw money;

— to enter into or to terminate insurance agreements.

2.25 In addition, the often unexpected liquidations of entities soon after having been reported as profitable and the often perceived non-independence of their auditors, have led to a distrust of the auditing profession and the generation of the well documented 'expectations gap'. This is a worldwide phenomenon as proven by studies conducted in countries such as the United States (1978), Australia (1993), New Zealand (1993) and South Africa (1993).[14]

2.26 In the United States the Cohen Commission reported as follows:

> **"Users of financial statements expect auditors to penetrate into company affairs, to exert surveillance over management, and to take an active part in improving the quality and extent of financial disclosure. In all of these areas, users seem to expect more than they believe they are receiving from auditors.**
>
> **Despite efforts by many auditors to downgrade the importance of detection of fraud as an audit objective, all segments of the Public — including the most knowledgeable users of financial statements — appear to consider the detection of fraud as a necessary and important objective of an audit. Users expect the auditor to be concerned with the possibility of both fraud and illegal behaviour by management. They expect him to protect the interests of shareholders and be independent of management in doing so.**
>
> **Some segments of the public have an erroneous impression of the auditor's role. Several expectations are neither feasible to meet nor practical from a cost-effectiveness viewpoint. For example, some users believe that a 'clean' opinion by an auditor necessarily means that the company is financially sound. Some investors feel that the auditor should not only express an opinion on the financial statements but should also interpret them in such a way that the investor can judge whether he should invest in the company. These misunderstandings cause the auditor serious difficulties, and their existence emphasizes the importance of clarifying his role. The profession has tried in the past to improve users' understanding of the role and function of auditors. While the Commission has refrained from specific recommendations for such educational activities, it believes that they are useful and should be continued".**

2.27 In 1998, Sikka, Puxty, Willmott and Cooper published an article 'The Impossibility of Eliminating The Expectations Gap: Some Theory and Evidence' in which they examined the 'expectation gap' and the response of the auditing profession thereto.

The introduction reads as follows:

> **"'The expectation gap', signifying the differences between what the public expects from an audit and what the auditing profession prefers the audit**

objectives to be, has been a recurring issue in the audit literature (Chandler & Edwards, 1996). It is an issue for auditors since the greater gap of expectations, the lower is the credibility, earning potential and prestige associated with their work. It is an issue for the public, investors and politicians because, in a capitalist economy, the process of wealth creation and political stability depends heavily upon confidence in processes of accountability, of which an external audit of financial statements is considered to be an important part. Not surprisingly, 'the expectation gap' has attracted considerable institutional interest (for example, American Institute of Certified Public accountants, 1978; Chartered Association of Certified Accountants, 1986a, 1986b; Canadian Institute of Chartered Accountants, 1988) as it is considered to be a threat to effective corporate governance (The Committee on the Financial Aspects of Corporate Governance, 1992) and legitimacy of the institutions of auditing (Auditing Practices Board, 1992, 1994a).

In general, the academic literature on the expectations gap is quite fragmented (see Gwilliam, 1987; Holt & Moizer, 1990; Gaa, 1991) and is relatively uninformed by any sustained appreciation of the broader historical and political context in which expectations are formed, frustrated and transformed (Willmott, 1991). One major element of this body of literature relies upon questionnaires and opinion surveys to draw attention to the gap between the profession's preferred meanings of audit and the public's expectations (see for example Lee, 1970; Beck, 1973; Arthur Andersen, 1974; Purewal & Sikka, 1977; Steen, 1990; Humphrey et al., 1992b, 1993a; Porter, 1993). Another major element assumes that the meaning of audit is uncontested and fixed and that this can be deduced (or is self-evident) from a study of the contents of audit reports (see Baskin, 1872; Estes & Reimer, 1977; Firth, 1978, 1979; Alderman, 1979; Ball et al., 1979; Libby, 1979; Chow & Rice, 1982; Davis, 1982; Elliott, 1982; Estes, 1982; Houghton, 1983; Dodd et al., 1984; Crasswell, 1985; Gul, 1987). Such studies are founded upon the assumption that there is only one correct reading of the audit report and that this correct reading is identical to the values preferred by the profession. Associated with this assumption is the belief that the expectations gap would be substantially reduced, if not entirely eliminated, if only auditors' intentions could be accurately transmitted to the users and regulators (Auditing Practices Board, 1991; Hatherly & Skuse, 1991).

Of the remaining research and scholarship in this field, a few studies offer valuable contemporary commentary which shed light on the part played by the

profession in sustaining and perpetuating the expectations gap (e.g. Humphrey et al., 1993b), but provide little conceptual guidance for understanding its persistence. A number of commentators have attributed the gap to users' confusion (Lange, 1987; Marra & Radig, 1987), widespread misunderstanding (Baron et al., 1977; Campbell & Michenzi, 1987; Krasnoff, 1987; Ellis & Selley, 1988: Auditing Practices Board, 1991), ignorance (Singleton-Green, 1990a) and/or lack of education (Cockburn, 1986; Amhowitz, 1987; Kirk, 1987; Singleton-Green, 1990b). Many more have uncritically accepted the definition of, and solution to, the problem favoured by the profession. Namely, that a deficient understanding of auditing objectives amongst users that can, and must, be remedied by educating users and other non-accountants (Goldwasser, 1987; Miller et al., 1990). Despite raising numerous questions about the agenda, definitions, meanings, interests and values which the profession wishes to advance or marginalise, this orientation to the issue reflects and legitimises a string of initiatives and publications intended to 'educate' non-accountants (see for example, Buckley, 1980; Shaw, 1980; Calpin, 1984; Auditing Practices Board, 1992, 1993). It tends to confirm the profession's conception of, and response to, the expectations gap, formulated in terms of others' ignorance coupled with the right and responsibility of the profession to take care of 'the problem'. In effect, the profession is absolved from responsibility for its involvement in creating and sustaining the conditions in which the expectations gap has developed, except perhaps for its limited grasp of, and responsiveness to, the scale of the public's ignorance. Although not blameless, the profession is placed in a 'positive space' where its responsibility is defined primarily in terms of educating a confused and ignorant public. By representing the expectations gap in this way, the systemic nature of the gap is obfuscated and the profession strives to silence, or at least draw private boundaries around, discussion of issues that could unsettle its authority, such as the status of auditor independence, the unwillingness or inability of auditors to detect fraud, report actively on going concern issues, the social function of audits and so on (Willmott, 1986, 1989).In responding to widespread criticism from politicians, regulators and the media, the favoured strategy for the profession has been to equate the expectations gap with audit failures and to ascribe such failures to the incompetence of some individuals or special circumstances. The way to deal with errant auditors, it is argued, is to strengthen the disciplinary and related apparatuses even though many previous attempts to strengthen self-regulation have been ineffective (Mitchell et al., 1994). A related strategy has been for the profession to acknowledge that, due to public expectations, auditor responsibilities in areas such as 'fraud' and 'going concern' need to be revised. However, the outcome

has been a move to require more exacting audits without requiring auditors to fulfil social expectations or exert additional audit effort (Fogarty et al., 1991; Hooks, 1992; Sikka, 1992; Power 1993b). This response is accompanied by obfuscation and denial of responsibilities for matters such as detection and reporting of fraud and arguing that they are the responsibility of directors (APC, 1984, 1985, 1990a). However, this strategy has done little more than repeatedly paper over its cracks and contradictions as it slides away from the common sense of the public and politicians who expect the auditor to discover frauds. As Singleton-Green (1990a, p. 34, cited by Humphrey et al., 1993a, p. 57), the Editor of Accountancy has commented, 'the layman expects the auditor to discover all serious frauds', adding that a denial of this responsibility 'will do nothing to diminish the auditor's duties, but will help to discredit the profession'.

As we shall argue later in this paper, contemporary moves to diminish or limit their responsibilities for fraud detection depart markedly from the discourses advanced by the profession when, during the nineteenth century, it often directly associated auditing expertise with the detection and reduction of fraud (Chandler et al., 1993). At that time, members of the profession sought to raise the material and symbolic value of their labour by presenting themselves as specialist authorities capable of reducing the risks associated with investment in general, and the liability of joint stock ownership, in particular. As these claims have become accepted and institutionalised, the performance expected of auditors has also been raised. Not surprisingly, the profession has subsequently sought to exercise its (limited) powers of self-regulation to reduce expectations by shifting the meaning of the audit. As Humphrey et al, (l993b, p. 55) have observed

'In general, the position adopted by the profession in Britain during the twentieth century has been to downplay the suggestion that auditors have any responsibility connected with fraud other than that derived from the need to confirm the truth and fairness of financial statements'.

At the heart of the expectations gap, we argue, is a clash of preferred meanings about the nature, practice and/or outcomes of auditing. As sellers of auditing services, members of the auditing profession have a stake in securing the material and symbolic value of their labour. Historically, this they have done by successfully petitioning the state for monopoly control over the supply of external auditing labour and by minimising the formal obligations (and associated liabilities) placed upon them. In contrast, the buyers and regulators of auditing labour have a stake in ensuring that audits deliver whatever quality of practice is deemed to be necessary to secure the confidence of the public, and investors in particular, in the operation of capital markets. This uneasy relationship between buyers and sellers of audit services, mediated by complex and obscure (self) regulatory mechanisms, is compounded by auditors' relationship to management upon whom they depend to sell-on more profitable services. As Humphrey et al. (1993b, p. 56) have concluded:

'Greater professional priority would appear to have been placed on the need to maintain the auditors' relationship with management than on satisfying the demands of the public'.

Although the respective stakes of the parties are subject to change and redefinition, it is this fundamental difference in orientation between the buyer and seller of auditing labour, we suggest, that accounts for the continuation of an expectations gap which flourished in earlier times (Brief, 1975; Humphrey et al., 1992b) and continues to exist despite the numerous institutional attempts to reduce or eliminate it (AICPA, 1978; ICAE, 1986; CICA, 1988; APB, 1992). From this perspective, understanding the expectations gap is a matter of identifying and applying conceptual tools capable of explaining the relationship between the negotiation of the meaning of social practices (e.g. audits) and the organization of power (Fogarty et al., 1991; Hooks, 1992; Humphrey et al., 1992a; Lee, 1994)".[(15)]

2.28 In the foreword to the publication 'Modern Company Law For a Competitive Economy' published by the British Department of Trade and Industry (March 1998), the President of the Board of Trade stated:

"Our current framework of company law is essentially constructed on foundations which were put in place by the Victorians in the middle of the

last century. There have been numerous additions, amendments and consolidations since then, but they have created a patchwork of regulations that is immensely complex and seriously out of date".(16)

2.29 Similar thoughts about auditing are being expressed from within the auditing profession. Addressing a meeting of accountants Harvey Kapnick, the then Chairman of Arthur Andersen & Co, said that the accounting (auditing) profession

> **"should be the link between responsible business and the public in providing adequate financial data in an understandable manner for use in arriving at sound, unbiased conclusions about the effectiveness of business enterprises in managing our economic wealth for the overall benefit of society. Unfortunately, however, the accounting profession has been subject to the same regulatory pressures and the same failures to tell all the facts as business. The result has been public skepticism of the accounting profession to the point that it, too, is faced with a potential loss of credibility".**

One of the problems singled out by him was —

> **".....the accounting profession treats business today in large measure as business existed in the early part of the century. When organized business activity consisted largely of personal ownership and interests, together with a limited number of creditors, the accounting needs of those owners and creditors could be easily served. There was little need for or interest in accounting information by outsiders. The interests of owners and creditors were satisfactorily served by a relatively simple determination that there was no overstatement of net worth or profits. The emphasis was to make certain that those elements were at least as great as represented.**
>
> **Now, however, the existence of large numbers of public stockholders removed from the day-to-day activities of the business in which they have an investment requires an entirely different concept of financial reporting. Yet, in large measure, the accounting profession has failed to recognize the importance of the changes in business activity and has persisted in applying the outmoded concepts acceptable to an earlier era."(17)**

The views of some commentators as reported by the Jenkins Committee are —

> **"The American Accounting Association Committee on Accounting and Auditing Measurement, 1989-1990, concluded that '.....the most general criticism to be leveled at financial statements in their present form is that they are seriously *incomplete*'.**
> **Alter P. Schuetze, a past chair of AcSEC and now chief accountant of the SEC, said that 'We need an .....inquiry into the met and unmet needs of users of financial statements'.**

> **Meanwhile similar events were occurring in other countries. U.K. accountancy bodies issued several documents challenging current business reporting.**

> ***Making Corporate Reports Valuable* (1988). 'The present model for corporate reporting is not satisfactory.....Presentday financial statement packages seldom give any indication of the overall objectives of the entity; and even crucial information about is management and ownership is provided only on a limited scale'.**

> ***Financial Reporting. The Way Forward* (1990): 'What is principally wrong with present financial statements is that they do no reflect the economic reality of a company's progress and position .....Present day financial statements are deficient in that they concentrate on .....past events rather than the future'.**

> ***The Future of Financial Reports* (1991): 'There is increasing support for the view that the existing financial reporting package is not adequate to meet the needs of users. The balance sheet and profit and loss account have evolved from the limited requirements of reporting in the developing industrial economy of the nineteenth century, and extensive tinkering has not been sufficient to bring them in line with the requirements of the late twentieth century market economy.....The contents of financial reports should be user driven.....' ".[(18)]**

2.30 Mr John Whitney, the Executive Director of the Columbian Business School's Deming Centre (at the 1997 World Congress of Accountants) summarised the problems associated with the traditional audit as —

Timeliness

"We are all painfully aware of the time it takes to complete an audit. By the time the audit is finished and the financial statements are printed, two things will have happened: people will have lost interest and the world will have changed. Moreover, financial statements are lagging indicators".

Trustworthiness

"Trustworthiness is a much more complicated issue. It deals with both reliability and scope of the audit. Let's deal first with reliability. We are all tired of hearing about the number of companies that have filed for bankruptcy following the receipt of 'clean' opinion from their auditors. We are tired of it, but we cannot escape its implications. It impugns the credibility of the profession and exposes it to litigation. In this same vein, it is foolish to blame the auditors because someone made an investment in or extended credit to a company that goes bankrupt. Rather, these constituencies should use the audit as just one piece of information. Under present accounting practices, companies have to rely on other resources to learn whether the company's technologies, knowledge capital, systems, and procedures are pertinent to the markets they are serving.

Last but not least, trustworthiness is called to question because the auditor serves two masters: the company, which pays the bill, and the external constituents, who wish to rely on the information. An inherent conflict exists and it does no good to say it doesn't".

Trajectory, in that users are interested in the future of the entity and not in its financial history.

"Traditional accounting provides an historical look at financial data. But the people who read financial statements are interested in the future. Bankers and suppliers want to know if obligations will be met. Investors want to know if their expectations will be fulfilled. Managers and the board of directors of the company that pays for accounting services want to know if their business systems and control procedures are adequate. We know, of course, that no one can predict the future with certainty.. But we also know that traditional accounting statements are, as I said before, a fuzzy approximation of a distant past.

Accountants have been mired in financial history while their constituencies have been asking for a look at the future".[19]

2.31 A number of these problems were raised by Professor I H MacGregor, professor of accountancy at the University of Witwatersrand, during his inaugural lecture (1982) —

"In dealing with published annual financial statements the law prescribes the matters which must be disclosed in somewhat broad terms, setting out a basic and minimum framework of objectives and content. The extent of disclosure has increased steadily over the years, largely as a result of changes in the economic and social environment, but also as a result of the increasing separation between ownership and management of large companies which has changed the pattern of share ownership over the past decades. Governments are concerned with the protection afforded creditors and investors as one consequence of the change in the pattern of share ownership has been a concentration of shareholdings in the hands of institutions. These institutions are pension funds, long-term insurers and mutual funds in which the man in the street (and never let it be forgotten that he is a voter) has an indirect stake.

We can now see that it is no longer merely a matter of disclosure for the peace of mind of creditors and shareholders. Today such disclosure is of great relevance to wider groups such as potential investors and lenders, employees, government departments, trade unions and the public at large.
Although many of the items requiring disclosure by statute are couched in general terms, there is an overriding requirement that financial statements in accordance with generally accepted accounting practice fairly present the state of affairs of the company (the so-called 'true and fair' view) and the directors are

obliged by statute to ensure that this is so.

This is a legal requirement and directors have found that it is possible to show the 'true and fair' view by adopting one of the many bases of, for example, depreciation, valuation of stock and work-in-progress, providing for deferred taxation, valuations of uncompleted construction contracts, all of which bases have been categorized as generally acceptable accounting practice by accountants and auditors. It is understandable that the preparers of financial statements will choose the alternative that best suits their purpose, be it increasing disclosed profits or suppressing profits, and provided that the 'true and fair' requirement has not been disregarded, they are not contravening any part of the statute.

The potential users are likely to include owners, lenders, suppliers of goods and services, potential investors, lenders and creditors, bankers, employees, management, customers, financial analysts, stockbrokers, underwriters, financial journalists, taxation authorities, trade unions and the general public. A formidable list of people all of whom are expected to get all their answers from this one set of financial reports — for this is the assumption underlying current company legislation, requiring as it does annual financial statements to be prepared for the members of the company.

It must be noted, however, that these financial statements are generally issued 3 to 5 months after the end of the company's financial year and this is too late for most users to act on the information they contain. Annual financial statements should not contain any real surprises in the case of a listed company as the preliminary results are announced some 4 to 6 weeks after the financial year-end and most investment decisions will have already been taken by the time the annual report appears".[20]

2.32 In 1997 a book titled 'Corporate Collapse, Regulatory, Accounting and Ethical Failure' was published. Its authors were Professor F L Clarke of the University of Newcastle, Professor G W Dean of the University of Sydney and Mr K G Oliver. They examined the role of accounting in corporate collapses in Australia during the last three decades and the repeated inadequate professional responses thereto.

The authors state —

"There is no disputing that these leading companies had another common factor. They all collapsed, many suddenly, seemingly unexpectedly. For many, collapse followed news releases of reportedly successful operations. Only occasionally, in advance of collapse, were those companies identified to be ailing over a period of years. Certainly they were not failing according to many in the press and some of those in the market claiming to be in-the-know. Understandably so, for those companies' financial reports failed to indicate unambiguously their impending failure. Despite claims by the 'punters' (the uninformed investors) that they are denied information apparently available to others in the market, the published financial statements are the primary source of financial information to virtually all in-the-know punters (e.g. the institutional investors) too. History demonstrates that corporate failure does not appear to have had a lengthy public incubation period. Whilst symptoms are there and some ferret them out, the financial reporting system masks them. Therein lies a major problem — matters of unquestionable public interest are able to be kept private.

Public complaint, criticism, and questioning of the role of accountants and auditors were features of the highly publicised bankruptcies and liquidations in the 1980s and early 1990s. Complaint and criticism of that kind were international phenomena. Comments on the crumbled empires of Asil Nadir, Aghan Abedi and Robert Maxwell in the United Kingdom indicate that 'the crumbling of firms like Polly Peck, BCCI, and, most recently, Maxwell Communication, [occurred] all within months of getting a clean bill of health from their auditors, has raised serious questions about the usefulness of company accounts'. Likewise in this assessment on the US Savings and Loans affair: '[Democratic Congressman] Wyden and others lay a large part of the blame for the S&L crisis at the door of the accounting profession. 'Accountants didn't cause the S&L crisis', says Wyden. 'But they could have saved taxpayers a lot of money if they did their jobs properly and set off enough warning alarms for regulators'. And the similar lament in a 1993 United States Public Oversight Board Report:

'The accounting profession has suffered a serious erosion of confidence:....in its standards, in the relevance of its work and the financial reporting process....[because] in some cases, not long before an entity failed, it

received an auditor's report giving no indication that the entity was in its latter days'."

"Mostly, however, the comments have evoked a flurry of attention by the professional accountancy bodies to search out someone, or more commonly 'something', they might blame — bad management, declining business ethics and inadequate educational resources have each had their turn. Indicative of the search for causes is the 1994 Australian study by Greatorex et al., Corporate Collapses: Lessons for the future, which surveyed Australian liquidators of 162 cases of corporate collapse and recorded their observations on the causes of corporate failure. They identified lack of CEO management skills, overreliance on debt, and the failure to have sufficient capital for ongoing development or survival. An equally pertinent question might have been why those who failed had shortly earlier been reported as profitable, sometimes as highly successful".(21)

2.33 In a letter from the SEC dated October 9, 1998, addressed to the Director, Audit and Attest Standards of AICPA, the following warning was sounded:

"Our financial reporting system generally has served our markets well and has minimized the premium charged for capital. However, the staff has noticed recently some trends in financial reporting that, if left unaddressed, may threaten the pre-eminent position of US markets because they cause investors to question the reliability and transparency of the financial statements of US registrants. These trends range from an inappropriate management of earnings to fraud, and encompass inappropriate application of generally accepted accounting principles ('GAAP'), and aggressive applications of GAAP. These trends have been manifested in a rash of recent highly publicized cases of alleged financial accounting fraud in which corporate financial results may have been misrepresented.

The Commission cannot tolerate an erosion of investor confidence, which will inevitably occur if investors believe that the information they receive is a product of manipulation or gimmickry. Manipulated, incomplete, or unreliable information generally is cited as a common problem in weaker financial reporting systems and has contributed to economic problems in other areas of the world, such as Asia and Russia".

2.34 In the Cape Times Business Report, October 23, 1998, the following appeared under the heading —

"'Undervalued' Sappi to list in New York next month.

In terms of the listing, Sappi will have to comply with the US's generally accepted accounting principles. Under these rules, the restated earnings were less than a quarter of those reported under local rules for the past financial year.

Analysts, however, said this information was already known by institutional investors and should not negatively affect the share price.

Sappi told shareholders in a letter that full-year earnings for 1996 would have come in at 113c a share, and not the 230c a share as reported by Sappi. Last year's earnings would have come in at 41c a share, less than a quarter of Sappi's reported 172c a share. First-half earnings for the current year would, however, have been 1c higher at 162c a share.

Van As told shareholders that the changes related largely to the timing of when income was recognised for accounting purposes".

2.35 In the Saturday Business Report (Saturday Argus), October 24, 1998, the following appeared under the heading —

"Better off reading tea leaves than financial results.

Of the many shadowy professions proliferating in the world, few show any less commitment to truth and reality than accountants. Just recently, we have heard how Sappi's profits would be much lower if they used American standards. Anglogold, using South African accounting methods, earned R810 million in the most recent quarter; by American standards, it earned $37 million. We know the rand-dollar exchange rate has depreciated, but clearly not by that much.

It is not just South African companies that have problems. When Daimler-Benz listed in the US and started using their accounting standards, their profit fell by 75 percent. Some might say that American accountants are just more stringent and honest than their foreign counterparts. Dream on. When US companies

make acquisitions, they frequently write off the whole goodwill and the value of all R&D in process and yet to come, allowing the company to take a one-time exceptional loss and then huge profits in the years to come, which is jiggery-pokery of the highest order.

Arthur Levitt, the chairman of the SEC, is trying to change this. Accounting rules exist, after all, so that companies can be compared on the same basis. But as long as so much leeway exists to do what you like with numbers, an observer would be better off reading tea leaves than financial results".

2.36 These newspaper reports illustrate the deficiencies inherent in financial statements compiled in accordance with GAAP and the utter contempt in which the auditing profession is held in some circles.

2.37 As pointed out by Sikka *et al*, the auditing profession describes the expectation of the users of financial statements as unreasonable and attributes the 'expectation gap' to confusion, ignorance and a deficient understanding of auditing objectives.

The profession considers the solution to these problems to be better corporate governance and the education of the confused and ignorant users of financial statements.

2.38 The authors of 'Corporate Collapse' have little faith in 'corporate governance' to which they refer as the 'Buzz phrase' of the nineties.—

" 'Corporate governance' is one of the buzz phrases of the 1990s, fertile ground for producing reports and codes of practice. Following the 1960s failures, the Australian accountancy profession sheeted most of the blame to poor management in its white paper, Accounting Principles and Practices Discussed in Reports on Company Failures. Analysis of the l980s collapses has contained more of the same, blaming bad management and declining ethics. It is the same the world over. Pratten's 1991 inquiry into UK failures commissioned by The Institute of Chartered Accountants in England and Wales trots out the same rhetoric, despite recent evidence in the affairs of Polly Peck, Maxwell and BCCI of more fundamental problems in corporate governance. There has been little effective introspection despite a disturbing repetition of past behaviour.

One might have expected increased promulgation of Accounting and Auditing Standards to have been accompanied by decreased complaint and criticism. But just the opposite is the case — increased specification of accounting and auditing practices by the profession is positively correlated with increased litigation. Understandably so, we would argue, for compliance with Standards then in vogue was as likely to have contributed to creative accounting as deviation from them. Perversely, corporate regulators and the accounting profession are calling for even more Accounting and Auditing Standards.

One product of the 'better corporate governance' movement is the 1992 wisdom of the Cadbury Committee in the United Kingdom, in particular its 'Code of Best Practice'. Ultimately, however, the code amounts to little more than a series of motherhood statements regarding the virtues directors must display and be seen to display, plus the recommendation for audit committees to be mandatory for all public companies. Overall, the inevitable impression to be gained is that bad, dishonest or unethical conduct by managers, directors and the like, are the major causes of corporate failure – and that the code will set that right. At best, that is a pious hope.

Commonly suggested remedies take little heed of lessons of the past. The UK's 'Cadbury Code' is typical. Significantly, nowhere does the code explain how the appointment of audit committees will ensure that the financial information disclosed by companies will be indicative of their wealth and progress".

2.39 The proposed education of the so-called confused and ignorant users of financial statements cannot solve the problem. The users want financial statements and auditors' reports which would enable them to make informed investment decisions.

The auditing profession as presently employed is not able or not willing to provide such a service. Hence the need for the structural changes set out in Chapter 3.

3. PROPOSALS FOR THE EMPOWERMENT OF INVESTORS AND OTHER STAKEHOLDERS

3.1 Many of the problems created by unfair or fraudulent conduct by market participants, inadequate disclosure of information upon which users can make informed choices and dishonest or inefficient auditors, could be eradicated by the appointment of auditors for and by each significant interest stakeholder group.

3.2 Significant interest groups would be groups such as No-vote shareholders, minority shareholders in a take-over bid situation, debenture holders, suppliers and other trade creditors, persons assured by insurance companies, members of pension and provident funds, employees, trade unions, bank depositors, etc.

3.3 Their auditors would have access to the audit files of the main auditor of the entity. This would obviate duplication of work and fees and should also have a salutary effect on the main audit.

3.4 The value of such auditors for interest groups is obvious. Some examples are —

— employees (trade unions) will not be dependent upon financial information prepared by management when conducting wage negotiations or disputing the necessity to retrench;

— the debenture holders in the failed Masterbond companies such as Mykonos, Fancourt, Marina Martinique and a host of smaller companies will not have lost hundreds of millions of rand. Their auditors would have raised early warnings that monies were being used for other purposes and that the securities were inadequate;

— similarly, the investors in the failed Owen Wiggins companies would have received early warnings;

— participation bond investors in the Masterbond, Owen Wiggins and Supreme Bond schemes would not have lost their investments;

— **SA Rail Commuters Corporation would not have lost R247 million deposited in Cape Investment Bank. The auditor of the depositors would have warned them that the insolvent bank was being propped up by the Reserve Bank;**

— **the depositors in Pretoria Bank would have been warned of its imminent liquidation and that it was riddled with maladministration, theft and fraud. This could have saved the taxpayer millions;**

— **members of pension funds which fail to produce the required annual returns could take steps to prevent or reduce the extent of the losses or the theft of their monies.**

In this regard the reports which emanate from the Registrar of Pension Funds could only be described as frightening;

— **minority shareholders would not have to be left to the mercy of the majority shareholder in a take-over situation.**

Recently a typical dispute such as between IBM SA and its minority shareholders was reported in the press as follows:

> **"The dispute between IBM SA and disgruntled minority shareholders has escalated with the shareholders launching a last-ditch bid to force the US-controlled company to disclose more about its financial condition.**
>
> **The shareholders, who are former IBM employees, have lodged a complaint with the Securities Regulation Panel claiming the company is worth more than it admits.**
>
> **The minorities are hoping to thwart the computer company's efforts to buy back the 46% of shares it does not already own at R12 each.**
>
> **The ex-employees are concerned that IBM SA's figures may have been manipulated to keep its share price in the doldrums. They allege the US parent overcharged its SA subsidiary for the secondment of foreign managers, and bumped up the wholesale price of its hardware and software to reduce the**

subsidiary's profit margin.

The complaint to the panel accuses IBM of withholding information crucial to determine the true value of the shares. A key request is that the panel instruct IBM SA to disclose its figures for the half-year to June 30 1998. These accounts are being prepared but are unlikely to be published before a vote on the buyback offer on August 5.

.....

IBM SA said yesterday it was not aware of any formal complaint. 'In terms of the offer made to minority shareholders and in terms of the scheme of arrangement, we believe we have conformed to all JSE requirements by making available all information that is appropriate and available', said a spokesman".

An auditor, appointed by the minority shareholders, would have been able to report on the adequacy of the offer.

Investors, such as the investors in 'Proplace', would probably have not lost their investments.

The plight of these investors was reported in the Saturday Argus, August 29, 1998 under the heading —

"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.

Proplace lured investors with promises of guaranteed returns of up to 16 percent with tax advantages through investments in endowment policies with the big assurance houses such as Old Mutual, Sanlam, Southern Life, Fedlife, and Norwich.

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 life savings into this scheme.' Says Cameron-Ellis who has described the Proplace scam as the 'biggest debacle since Masterbond' ".

3.5 If auditors are appointed by each significant interest group, some of the most pressing problems which confront the auditing profession and which are demonstrated by the 'expectation gap', could also be alleviated.

Problems such as

— **the extent and scope of the main audit which often cannot cater for the particular needs of all significant interest groups;**

— **the non-independence or perceived non-independence of the main auditor who renders other services for the client.**

— **the liability for damages caused to a particular interest group by the dishonesty, negligence or lack of insight of the main auditor;**

— **the interpretation and application of generally accepted accounting standards to the accounts or the account items of an entity;**

3.6 In addition, if auditors are appointed for each significant interest group, it would result in

— **increased specialisation in the profession;**

— **the employment of specialists by smaller firms;**

— **from a globalization point of view, the overall audit function could be fulfilled on a modular basis, especially where use is made of specialist correspondent auditors;**

— **the use of specialist auditors should lead to more uniformity in the presentation of account items, in the auditing thereof and in the auditors' reports thereon;**

— **specialist auditors would keep abreast with dynamic developments in their fields.**

3.7 The Commission is of the view that if stakeholders are empowered by

— **the right to appoint their own auditors; and**

— **appropriate class actions,**

corporate fraud would be prevented to a large extent and, if not prevented, significantly curtailed.

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3. *Scott W R. Constitution and Finance of English, Scottish and Irish Joint Stock Companies to 1720. 1912.*

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5. *First Report of the Select Committee on Joint Stock Companies. (Gladstone Report) 1844.*

6. *Michael Chatfield. A History of Accounting Thought. 1974.*

7. *Shannon H A. The First Five Thousand Limited Companies and Their Duration. Economic History. Vol. II. (1930 – 1933).*

8. *Chatfield. Chapter 10.*

9. *Brenda Porter. Auditors' Responsibility to Detect and Report Corporate Fraud. A Comparative Historical and International Study. 1994.*

10. *International Accounting Standards Committee. International Accounting Standards. 1998, par. 9.*
Steve Lawrence. International Accounting. 1996.

11. *Federation Des Expert's Comptables Europeens — Continuance Quality Assurance. April 1998, p. 6.*

12. *Australia. Financial Systems Inquiry. Final Report (Wallis Report). 1997.*

13. *Arthur Levitt. "The Numbers Game". NYU Center for Law and Business, New York, N.Y. September 28, 1998.*

14. *United States. American Institute of Certified Public Accountants.*
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16. *Margaret Beckett. Foreword to the Company Law Reform Consultation Paper. March 1998.*
17. *Arthur Andersen & Co. In the Public Interest. Vol. 1 p. 46.*
18. *Jenkins Committee Report.*
19. *John Whitney. "There's a Rhinoceros in the Room". IFAC World Congress. 1997.*
20. *McGregor I H. Corporate Financial Reporting : Past, Present and Future. 1982.*
21. *Clarke, Dean & Oliver. Corporate Collapse — Regulating, Accounting and Ethical Failure. 1997.*

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13.13 A fairly predictable outcry followed the dissemination of the Consultation Paper. In jurisdictions such as South Africa where company law remained under the influence of the Victorian view as expounded by the Davey Commitee in 1896, that

> "(the) true financial position of the company should be honestly disclosed to shareholders not less than once a year but not for public use",

the idea that any outsider should have access to the records of a company is viewed with horror. After all, in South Africa even members who are the owners of the company

— are not allowed to inspect its financial records;

— need a special order by the court to have access to the books and papers of the company when it is unable to pay its debts and is being wound up (section 360(1));

- need a special order by the court or the Master to attend the examination of directors, officers or other persons regarding the affairs of a company after a winding-up order has been made (section 417(7)).

13.14 The negative comments were welcomed in that they crystallized the views of those who wish to preserve the *status quo,* and enables the Commission to clarify some aspects of its proposals and to endeavour to allay some of the concerns expressed.

13.15 Some extremely scholarly comments were also received and in particular the paper by Professors **Chambers, Clarke** and **Dean**, the authors of 'Corporate Collapse'. It is reported in full.(5)

13.16 Generally, the auditing profession and the academics were not in favour of more transparency and more access to the records of corporations.

Their objections related to

- the fear of administrative mayhem if a number of persons should have access to the records;

- problems relating to confidentiality and secrecy;

- the additional cost which will be incurred;

- problems which might arise if auditors differ.

13.17 Unfortunately no attempt was made to justify their objections with reference to practical experience elsewhere in the world.

Jurisdictions where all members of corporations have access to the books and records, and jurisdictions where a special interest group, namely the holders of debentures, have full access by means of trustees, or jurisdictions where employees have access by means of representation on boards, have simply been ignored.

The rights to access to the books and records by members of corporations or by trustees of holders of debentures have been extensively dealt with in Chapters 10 and 11, but for the sake of convenience the names of these jurisdictions are repeated.

13.18 Jurisdictions in which members of companies have access to the records of corporations, are

Anquila

Belize

British Virgin Islands

Philippines

United States of America

Alabama	**Mississipi**
Alaska	**Missouri**
Arizona	**Montana**
Arkansas	**Nevada**
California	**New Hampshire**
Colorado	**New Jersey**
Connecticut	**New Mexico**
Delaware	**North Carolina**

Florida	**North Dakota**
Ohio	**Texas**
Oklahoma	**Utah**
Oregon	**Vermont**
Pennsylvania	**Virginia**
Rhode Island	**Washington**
South Carolina	**West Virginia**
South Dakota	**Wisconsin**
Tennessee	**Wyoming**

13.19 Jurisdictions in which trustees of holders of debentures have access to the records, include

Australia
Argentina
India
Malaysia
Nahru
Papua New Guinea
Paraguay
Singapore

13.20 The comments submitted by the South African Institute of Chartered Accountants (SAICA) reflect the attitude of those who wish to preserve the *status quo* and who wish to preserve the cloak of secrecy which protects fraudulent and incompetent directors, managers and auditors.

They propound the idea that adequate protection for the public can be achieved by

- the raising of the standards of financial reporting and auditing;
- improving the standards of corporate governance;
- relying upon the supervisory activities of entities such as the Securities Exchange, the Reserve Bank and the Financial Services Board.

13.21 According to SAICA the comments were compiled after the views of its members in the various SAICA constituencies had been sought, namely members in commerce and industry, practising auditors in both small and large firms and members in the academic field. For purposes of convenience, the full text is reproduced, interspersed with some comments by the Commission.

"THE ROLE OF THE AUDITOR - ELIMINATION OF THE EXPECTATION GAP AND APPOINTMENT OF AUDITORS BY ALL SIGNIFICANT INTEREST GROUPS

Set out below are the comments of The South African Institute of Chartered Accountants (SAICA) on the above-mentioned consultation paper. In compiling these comments we sought the views of members in the various SAICA constituencies, namely members in commerce and industry, practising auditors, including small and large firms, and members in academia.

Before commenting on the detailed proposals contained in the paper, we believe it is necessary to reiterate that SAICA acknowledges that the investigation into the affairs of the Masterbond group of companies highlighted deficiencies in the audit process applied and a lack of independence on the part of certain of the auditors involved. However, we feel it is important to make the point that this only related to a limited number of auditors involved in a limited number or transactions and therefore should not be regarded as reflecting on the entire audit arm of the profession, as was implied in recent press articles.

The criticism expressed in the First Report of the Commission was not restricted to the activities of the auditors of the Masterbond Group.

The criticism extended to, inter alia, the auditors of the Owen Wiggins Group, the Supreme Bond Group, Pretoria Bank, Cape Investment Bank, Prima Bank, Bankorp and the Reserve Bank.

The 'limited number of transactions' referred to by SAICA included the following: (Vol. 1 p. 50-52)

— **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;**

— **changing accounting policies to convert loss situations into profit situations without proper disclosure;**

— **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 scrutinize 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."**

As pointed out above, the 'limited' number of auditors referred to by SAICA were not limited to the auditors of the Masterbond Group.

With reference to the secret donations by the Reserve Bank to Bankorp, Prima Bank and Cape Investment Bank, the Commission reported as follows (Vol.1, p. 68-69):

> *"The auditors were members some of the most prestigious internationally affiliated auditing firms whose members are amongst the leaders in their profession. Leaders who are also perceived to be responsible for the setting and maintaining of ethical standards and generally accepted accounting practice".*

Unfortunately deficiencies in the audit process and the lack of independence on the part of some auditors are not restricted to South Africa. Similar problems occur in jurisdictions where much better regulation and supervision are in place. An example is the report 'Fraudulent Financial Reporting : 1987-1997. An Analysis of US Public Companies'.

The research was commissioned by the Committee of Sponsoring Organization of the Treadway Commission and provides a comprehensive analysis of fraudulent financial reporting occurrences investigated by the SEC since the issuance of the 1987 'Report of the National Commission on Fraudulent Financial Reporting (The Treadway Report)'.

> **"We analyzed instances of fraudulent financial reporting alleged by the SEC in AAERs issued during the 11 year period between January 1987 and December 1997. The AAERs, which contain summaries of enforcement actions by the SEC against public companies, represent one of the most comprehensive sources of alleged cases of financial statement fraud in the United States. We focused on AAERs that involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act given that these represent the primary antifraud provisions related to financial statement reporting. Our focus was on cases clearly involving financial statement fraud. We excluded from our analysis restatements of financial statements due to errors or earnings management activities that did not result in a violation of the federal antifraud statutes.**

Our search identified nearly 300 companies involved in alleged instances of fraudulent financial reporting during the 11 year period. From this list of companies, we randomly selected approximately 200 companies to serve as the final sample that we examined in detail. Findings reported in this study are based on information we obtained from our reading of (a) AAERs related to each of the sample fraud companies, (b) selected Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) business press articles about the sample companies after the fraud was disclosed.

Several key findings can be generalized from this detailed analysis of our sample of approximately 200 financial statement fraud cases. We have grouped these findings into five categories describing the nature of the companies involved, the nature of the control environment, the nature of the frauds, issues related to the external auditor, and the consequences to the company and the individuals allegedly involved.

Nature of Companies Involved

— **Relative to public registrants, companies committing financial statement fraud were relatively small. The typical size of most of the sample companies ranged well below $100 million in total assets in the year preceding the fraud period. Most companies (78 percent of the sample) were not listed on the New York or American Stock Exchanges.**

— **Some companies committing the fraud were experiencing net losses or were in close to break-even positions in periods before the fraud. Pressures of financial strain or distress may have provided incentives for fraudulent activities for some fraud companies. The lowest quartile of companies indicate that they were in a net loss position, and the median company had net income of only $175,000 in the year preceding the first year of the fraud period. Some companies were experiencing downward trends in net income in periods preceding the first fraud period, while other companies were experiencing upward trends in net income. Thus, the subsequent frauds may have been designed to reverse downward spirals for some companies and to preserve upward trends for other companies.**

Nature of the Control Environment (Top Management and the Board)

— **Top senior executives were frequently involved. In 72 percent of the cases, the AAERs named the chief executive officer (CEO), and in 43 percent the chief financial officer (CFO) was associated with the financial statement fraud. When considered together, in 83 percent of the cases, the AAERs named either or both the CEO or CFO as being associated with the financial statement fraud. Other individuals named in several AAERs include controllers, chief operating officers, other senior vice presidents, and board members.**

— **Most audit committees only met about once a year or the company had no audit committee. Audit committees of the fraud companies generally met only once per year. Twenty-five percent of the companies did not have an audit committee. Most audit committee members (65 percent) did not appear to be certified in accounting or have current or prior work experience in key accounting or finance positions.**

— **Boards of directors were nominated by insiders and 'grey' directors with significant equity ownership and apparently little experience serving as directors of other companies. Approximately 60 percent of the directors were insiders or 'grey' directors (i.e., outsiders with special ties to the company or management). Collectively, the directors and officers owned nearly 1/3 of the companies' stock, with the CEO/President personally owning about 17 percent. Nearly 40 percent of the boards had not one director who served as an outside or grey director on another company's board.**

— **Family Relationships among directors and / or officers were fairly common, as were individuals who apparently had significant power. In nearly 40 percent of the companies, the proxy provided evidence of family relationships among the directors and / or officers. The founder and current CEO were the same person or the original CEO / President was still in place in nearly half of the companies. In over 20 percent of the companies, there was evidence of officers holding incompatible job functions (e.g., CEO and CFO).**

Nature of the Frauds

— **Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved. The average financial statement misstatement or misappropriation of assets was $25 million and the median was $4.1 million. While the average company had assets totaling $533 million, the median company had total assets of only $16 million.**

— **Most frauds were not isolated to a single fiscal period. Most frauds overlapped at least two fiscal periods, frequently involving both quarterly and annual financial statements. The average fraud period extended over 23.7 months, with the median fraud period extending 21 months. Only 14 percent of the sample companies engaged in a fraud involving fewer than twelve months.**

— **Typical financial statement fraud techniques involved the overstatement of revenues and assets. Over half the frauds involved overstating revenues by recording revenues prematurely or fictitiously. Many of those revenue frauds only affected transactions recorded right at period end (i.e., quarter end or year end). About half the frauds also involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant and equipment and other tangible assets, and recording assets that did not exist.**

Issues Related to the External Auditor

— **All sizes of audit firms were associated with companies committing financial statement frauds. Fifty-six percent of the sample fraud companies were audited by a Big Eight/Six auditor during the fraud period, and 44 percent were audited by non-Big Eight/Six auditors.**

— **All types of audit reports were issued during the fraud period. A majority of the audit reports (55 percent) issued in the last year of the fraud period contained unqualified opinions. The remaining 45 percent of the audit reports issued in the last year of the fraud departed from the standard unqualified auditor's report because they addressed issues related to the auditor's substantial doubt about going concern, litigation and other uncertainties, changes in accounting principles, and changes in auditors between fiscal years comparatively reported. Three percent**

of the audit reports were qualified due to a GAAP departure during the fraud period.

— **Financial statement fraud occasionally implicated the external auditor. Auditors were explicitly named in the AAERs for 56 of the 195 fraud cases (29 percent) where AAERs explicitly named individuals. They were named for either alleged involvement in the fraud (30 of 56 cases) or for negligent auditing (26 of 56 cases). Most of the auditors explicitly named in an AAER (46 of 56) were non-Big Eight/Six auditors.**

— **Some companies changed auditors during the fraud period. Just over 25 percent of the companies changed auditors during the time-frame beginning with the last clean financial statement period and ending with the last fraud financial statement period. A majority of the auditor changes occurred during the fraud period (e.g., two auditors were associated with the fraud period) and a majority involved changes from one non-Big Eight/Six auditor to another non-Big Eight/Six auditor".**

Another example is the contents of the "Report of the Internal Investigation of Independence Issues at PriceWaterhouseCoopers LLP'. The investigation was conducted at the request of the SEC to ascertain to what extent the professional accountants employed by PwC LLP violated the rules and guidelines issued by the SEC and by AICPA regarding the independence of accountants and more specifically the rules that relate to financial interests in an audit client.

> **"The Internal Investigation revealed that substantial numbers of PwC professionals, particularly partners, had violations of the independence rules, and that many had multiple violations. While many PwC professionals reported violations in the firmwide March 1999 Confirmation Process, the full numerical magnitude of independence non-compliance was evident only from the Random Sample Study, which demonstrated that the overwhelming majority of partners selected for audit failed to report at least one violation in the March 1999 Confirmation Process.**
>
> **Violations and the failure to report violations appear to have resulted, for the most part, from a range of reasons that included excusable mistake, various forms of laxity, and an insensitivity to the importance of the**

independence rules or reporting requirements, although at least one individual acknowledged intentional non-compliance.

.....

Nonetheless, the numbers alone, as PwC acknowledges, disclose that there was widespread independence non-compliance at PwC that reflected serious structural and cultural problems rooted in both its 'legacy' predecessors."

In the years since the Masterbond failure, there has been significant improvement in relevant legislation, corporate governance practices and auditing standards. These include compulsory protection of minority shareholders required by the Securities Regulation Panel and the Johannesburg Stock Exchange, as well as various enhancements to financial services legislation. In addition, the issue of the King Report on Corporate Governance in 1994 has significantly increased awareness of the need for good corporate governance and the acknowledgement of the corporation's duty to other stakeholders. It is internationally acknowledged that the King Code is one of the finest in the World. Adherence to the Code is encouraged and is growing.

In the case of listed companies, the Johannesburg Stock Exchange requires directors to state the extent to which they adhere to the principles of the Code.

It is not correct to refer to improvements as 'significant'. During the last three years, the South African business world has become littered with corporate failures. Examples can be found in the notes to Chapter 1, and include the Islamic Bank, Amalia, Proplace, New Republic Bank, pension funds, Refcorp, MacMed, LeisureNet and Business Bank to name a few.

The perception of a 'significant' improvement is certainly also not shared by others.

Cape Times Business Report : 17 December 1999 (Clive Robertson)

"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".

A year later, Clive Robertson said the following

SA business failures raise questions of morality (Business Report : Cape Times – 25,10,2000.)

"Every time Clive Robertson, the general manager of Credit Guarantee South Africa, reads about loss-making companies in the newspaper the alarm bells ring. For him, the recent spate of listed company failures poses the question whether South African business is morally bankrupt. Often we complain about the levels of criminal activity on the streets, but perhaps eyebrows need to be raised at what happens – or does not happen – at board level.

Credit Guarantee covers the risk of almost every company listed on the JSE. For a premium it will cover costs of the companies offshore and locally should things go awry, and it will ensure payment of suppliers and clients.

The number of listed companies is on the decrease. Of the total number of listed companies, 16 have failed over the past two years including household names such as the Hyundai Group and Kelvinator. Medical supplies business Macmed is involved in a closed inquiry and there has been the recent high-profile liquidation (albeit provisional) of LeisureNet.

'In a nutshell, creditors and other stakeholders take an enormous gamble when affording credit today as the possibility of corporate failure is so high that it is safer to play roulette at a local casino than investing in a business,' says Robertson.

He says this makes any grantor or underwriter of credit fearful of what lies ahead. One thing's for sure – in case no one's noticed - a listing on the JSE is no longer any indication of financial health".

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.

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."

Business Day 16 November 2000—"A case of imaginative accounting - Greta Steyn

A joke doing the rounds might be applied to Specialised Outsourcing. An accountant and a mathematician are asked to add two and two. The mathematician does not hesitate to answer 'four'. The accountant replies: 'Tell me what you want the answer to be, and I'll see what I can do'."

Another example that others certainly do not share the views of SAICA that an improvement in corporate governance is perceptible,

let alone 'significant', is the view expressed by Mr Hutton-Wilson (director of the Institute of Directors' Centre for Directorship and Corporate Governance) as reported in the Cape Times Business Report of 13 March 2001:

> **" 'Why corporate governance is so important to companies, public corporations and even the national economy, is because South Africa is under scrutiny by major lenders of money and unless we run a clean economy we will not attract foreign capital.'**
>
> **The result is that whenever international risk-aversion is running high – as it did last year – the global electronic herd instinct is to ditch emerging countries which have poor corporate governance score cards.**
>
> **For instance, says Hutton-Wilson, last year net foreign investment in the JSE Securities Exchange plummeted to R17,4 billion from R40,3 billion in 1999.**
>
> **'It is vital that we be perceived to run a clean economy, which the world right now doesn't seem to think we do. For instance, we're generally seen as one of the worst offenders in the world for insider trading,' he says.**
>
> **'Despite a large number of cases of insider trading investigated, each has been settled by the Financial Services Board out of court and not a single case has been prosecuted or individual imprisoned. South Africa is seen as too soft.**
>
> **The position of director is the only position in any company which does not require qualifications – other than the disqualifications contained in the Companies Act. Yet the King Report on Corporate Governance published in 1994 concludes: 'Directors have awesome responsibilities and must be properly prepared to carry out their duties.'**
>
> **There are no less than 43 clauses in the Companies Act relating to the responsibilities of directors. Yet few directors would even know where to locate these duties in the act notwithstanding the fact that transgressors can**

face individual penalties of up to a R2 million fine and imprisonment of 10 years.

'So it is surprising that most directors accept their appointment with little induction or training in their new role. In the UK the IoD, which is 40 000 strong, carried out a survey of 1 000 companies and found that less than 6 percent of directors of those companies had had any formal training for their responsibilities,' says Hutton-Wilson.

'A recent McKinsey Investor Opinion Survey reported on the views of 200 institutional investors representing $3 trillion in assets, found that board practices are as important as financial disciplines when they come to evaluate companies for investment.

The report found that 80 percent of investors would be willing to pay more for the shares of a well-governed company'."

Further, we refer you again to our previous submissions where we made certain recommendations relating to the audit process. We believe that these recommendations would significantly strengthen the audit process and therefore overcome the type of difficulties experienced with the Masterbond group of companies.

COMMENT ON PROPOSAL

1. On reading the paper it appears that the objective of the proposal is to provide protection for all parties having a relationship with a corporation from business failure and consequent financial loss.

2. To achieve this objective, the paper proposes that every significant stakeholder group should be given the opportunity to appoint its own auditor to investigate and provide assurance on various matters of interest to that particular stakeholder group. SAICA does not support the proposal and believes that it is unworkable.

SAICA states that the proposal that every significant stakeholder group should be given the opportunity to appoint its own auditor to provide assurance on matters of interest would be unworkable. No reasons are stated for this view, and their own statement on South African Auditing Standards, SAAS 800 'The Auditor's Report on Special Purpose Audit Engagements', seems to have been ignored.

Practical problems

3. Identified practical problems relating to the proposal are summarised below.

Affected corporations

4. It is not clear from the paper which corporations would be affected by the proposal, i.e. will it apply, to listed companies only or to all companies falling within the ambit. of the Companies Act? Or will affected corporations be identified based on quantitative measures? If the intention is to apply it to listed companies only, we would question the appropriateness of this, as there is already in place a significant amount of regulation through the Johannesburg Stock Exchange and, in appropriate cases, other regulatory bodies such as the Financial Services Board and the Registrar of Banks. Furthermore, as was the case with the Masterbond group of companies, business failures often occur within unlisted companies. However, we believe that to impose the proposal on all corporations would be unduly burdensome and could result in the cost becoming prohibitive for most corporations. This could discourage entrepreneurship and the development of small and medium size enterprises in South Africa.

All public companies will be affected by the proposal.

Regulation and supervision by the Stock Exchange is virtually non-existent. It is a toothless organization which plays little if any part in the protection of investors.

Despite the supervision by the Registrar of Banks (which is the most effective supervisor in SA) banks such as the Business Bank, the Islamic Bank and the New Republic Bank have recently collapsed.

The Financial Services Board does its utmost with limited resources.

However, nobody could realistically rely on the Registrar of Banks and the Financial Services Board to provide the protection envisaged by the Commission's proposals to provide more access to the records of companies. In addition, the Registrar of Banks and the Financial Services Board have no jurisdiction over ordinary companies and could also have an interest which differs from that of other stakeholders. An example is the role played by the Bank of England in the BCCI affair, alluded to later.

There is no basis for the fear that costs might become prohibitive. A well regulated business world should encourage and not discourage entrepreneurship.

If a company seeks funds from the public, it should be prepared to pay for a system which protects the public.

Identification of stakeholders

5. The paper lists a number of stakeholder groups. However, the wording used implies that there could be more stakeholder groups than those listed. Is it intended that the categories of stakeholder will be listed somewhere and each or them will have an automatic right to appoint an auditor, or can any stakeholder group of a company apply for recognition as a stakeholder group with the right to appoint an auditor? In addition, to whom would a stakeholder group apply for recognition? Where, for example, more than one trade union is represented, does every union have the right to appoint an auditor?

6. Once a stakeholder group has been identified, how will the group's representative be identified? How will it be ensured that the views of all the members of that particu1ar stakeholder group are adequately represented?

The Commission reconsidered the practical possibility of identifying creditor and supplier stakeholder groups. It came to the conclusion that in normal business and trading situations there are too many groups or sub-groups to be able to identify

particular creditors or suppliers for the purposes of the appointment or election of representatives.

The Commission is of the view that the groups be limited to

- **shareholders who individually or in the aggregate hold 5 per cent or more of the issued ordinary shares of a company save in special circumstances. See Chapter 11;**
- **holders of debentures. See Chapter 12;**
- **depositors in banks and other financial institutions;**
- **contributors to pension/provident funds;**
- **the assured of long-term insurance companies;**
- **all recognized trade unions;**
- **owners of time-share;**
- **members of medical aid societies;**
- **investors in participation bond schemes;**
- **holders of non-voting shares;**
- **holders of preferent shares.**

It is envisaged that the interests of holders of debentures, depositors, contributors to pension funds and the assured of insurance companies and the owners of time-share etc. will be represented by trustees

appointed in the same manner as trustees for holders of debentures should be appointed (see Chapter 11), and who would have access to the records and to the working papers of the external auditor.

Auditors on behalf of trade unions would have access at times of wage negotiations or retrenchment.

Cost implications

7. The paper does not make it clear who will bear the additional cost of the proposed stakeholder audits. The paper seems to imply that the additional cost will be borne by the corporation. We do not believe that this is equitable, as it will burden the corporation with expenses over which it has no control. At the end of the day it will be the shareholders who will bear the cost in the form of reduced earnings and dividends. In addition, there will be loss to the corporation in the form of distraction and loss of time of senior management and key staff. These increased cost structures and inefficiencies will negatively impact on South African corporations ability to compete in a global market. We believe that this could be harmful to the economy particularly at a time when South Africa is competing with other emerging markets for foreign investment.

It is difficult to believe that SAICA could seriously consider that any additional cost and the so-called distraction of senior management could have an adverse impact on foreign investment.

As pointed out above, the reality of the situation in other jurisdictions is ignored, or worse, is not known.

When a company issues debentures, it carries the costs of the trustee of the holders of the debentures. It has never been suggested in any jurisdiction that such costs are prohibitive.

Similarly, costs which will be incurred by banks, insurance companies, pension funds, time-share companies, etc. in respect of trustees for their particular interest groups need not be prohibitive.

It is envisaged that minority shareholders (save in mergers, sale of assets or in a take-over situation) and trade unions should pay the costs themselves.

In addition, to suggest by implication that the distraction of the attention of the directors or other senior management and key staff of corporations such as Masterbond, Supreme Bond, Owen Wiggins, MacMed, Prima Bank, Cape Investment Bank, etc. by the investigations of stakeholder auditors could have led to an increase in losses for the entities, can only be described as preposterous. In any event, any such loss caused to these entities would have been insignificant compared to the losses actually suffered by the investors.

Interaction amongst auditors

8. The paper proposes that the stakeholder auditors should have a right of access to the audit files of the main auditor. The practicality of such a proposal needs to be considered including the following: What are the time constraints? What are the cost implications for the main auditor? Who has priority access to the main auditor's files? What is the status of working papers, and how much reliance can be placed on them by a stakeholder auditor?

In group companies' audits a similar situation can occur. It is for the stakeholder auditors to decide how much reliance can be placed on the working papers. See also SAAS 600 (South African Auditing Standards):

> **"The principal auditor should perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment".**

9. The proposal inevitably will create a relationship between the main auditor and the stakeholder auditors, as the stakeholder auditors will be reliant on the main auditor for certain information. This in itself raises a number of questions.

10. What are the liability, implications for the stakeholder auditors who misinterpret the main auditor's files or rely on them without obtaining evidence that the work of the main auditor is adequate for the stakeholder auditors' purposes?

11. Worldwide there are currently problems around the issue of auditor liability and we believe that the proposal will exacerbate those problems in South Africa.

Why the proposals should exacerbate auditor liability is not stated. In fact, it should alleviate auditing problems in that independent peer professional opinions will be heard. The stakeholder auditor will not be reliant on the external auditor for information, the information will be at his disposal.

12. An auditor is required to exercise judgement during the course of an audit. The type of audit being performed and stakeholder group being represented would affect an auditor's judgement. However, the paper does not address the issue of disagreement between auditors. What if there is disagreement between the main auditor and a stakeholder auditor on the treatment of an item in the financial statements? Or if there is a disagreement between one stakeholder auditor and another stakeholder auditor on such treatment? How would disagreements be reported to the various stakeholders?

Objectivity is required from auditors, whoever might employ them or whoever might pay them.

Bona fide disagreement is not unique. If additional evidence cannot resolve the disagreement, the disagreement should be disclosed.

13. What about the confidentiality aspects? The main auditor has a duty of confidentiality to his/her client. To whom will the stakeholder auditors report and what duty of confidentiality and care will they have to the company in question? Could their clients ask them to disclose all sorts of information that in any other situation would have remained

confidential/proprietary, such as information relevant to the company's competitors or creditors?

The stakeholder auditors will report to whoever employed them. Information irrelevant to the needs of the group should not be disclosed by the auditor concerned.

The issue of confidentiality is often over-emphasised. In jurisdictions where there is extremely limited confidentiality, problems do not seem to arise. See Chapter 11.

Class actions

14. The Commission also recommends, apart from the right on the part of stakeholders to appoint their own auditors, that class actions should be permitted. Much has been written about class actions, which are a fairly common occurrence in the United States but not, as far as SAICA is aware, in any other jurisdiction. It is SAICA's opinion that the South African legal system, as is the case with the United Kingdom's legal system, does not lend itself to class action. If and when class actions are permitted they will have a far-reaching effect on the liability of professional persons and on the incidence of claims against them, and are likely to give rise to demands for these persons to be allowed to practise in a form, which will give them limited liability. Furthermore, there may be other undesirable consequences of class actions, which cannot now be foreseen.

A class action does not mean the creation of new or additional legal liabilities.

It is difficult to believe that SAICA with all its international contacts and experience, is unaware of the existence of class actions in the legal systems of the United Kingdom, Canada, Australia and Israel and the proposed introduction thereof in Sweden. In addition, it is a right enshrined in section 38 of the South African Constitution which reads as follows:

> **"(38) Anyone listed in this section has the right to approach a competent court, alleging that a right in the Bill of Rights has been infringed or threatened, and the court may grant appropriate relief, including a declaration of rights. The persons who may approach a court are –**
>
> **(a) anyone acting in their own interest;**
>
> **(b) anyone acting on behalf of another person who cannot act in their own name;**

(c) anyone acting as a member of, or in the interest of, a group or class of persons;

(d) anyone acting in the public interest;

(e) an association acting in the interest of its members".

In the United Kingdom the history of class actions has been sketched as follows:

> **"The modern era of class actions began with the passage of the Supreme Court of Judicature Act, 1873 in England, and the fusion of law and equity. As indicated, prior to this time the class action device could be employed only in the court of Chancery and, therefore, only equitable remedies, such as an accounting, a declaration, and an injunction, could be claimed in a representative action. Damages, being a common law remedy, were not available in an action brought in class form in the Court of Chancery. In other words, the nineteenth century forms of action determined when and how the class action device could be employed, despite the functional similarity of a claim for an accounting, for example, and a suit asserting a right to damages.**
>
> **The merger of the common law courts and the courts of equity resulted in the adoption of a single set of procedural rules applicable to all civil proceedings. Included in these rules was a Rule for representative or class actions. Rule 10 of the Rules of Procedure scheduled to the Supreme Court of Judicature Act, 1873 provided as follows:**
>
> > **'Where there are numerous parties having the same interests in one action, one or more of such parties may sue or be sued or may be authorised by the court to defend in such action on behalf of or for the benefit of all parties so interested' ".**

Corporations in temporary difficulty

15. In many instances corporations may be experiencing short-term difficulties. However, in the long-term they may be able to work through the problems and operate as a viable going concern.

16. The paper does not address the difficult problem of how to ensure that failure is not precipitated by the auditor's indication that the corporation is in difficulty, where in fact it could have been avoided. In the case of a bank, even the smallest indication by the auditor of possible difficulties may itself result in certain failure of the bank, due to the heavy reliance of banks on confidence to attract and retain depositors.

17. Should a corporation fail as a result of the report of a stakeholder auditor, the effect on other stakeholder groups could be disastrous. Therefore, protection of one stakeholder group could be achieved to the detriment of all other stakeholder groups.

These comments serve to illustrate the difficulties which some members of the auditing profession seem to have with an honest and objective approach. If a corporation is experiencing difficulties, the auditor should report it, whatever the consequences. The auditor should not try to deceive by suppressing facts.

Other arguments against the proposal

Director's responsibilities and corporate governance

18. It is important to distinguish between business and audit failure. When corporations fail, the blame for failure is often laid at the door of the auditor when in fact the real problems rested with management. Corporations function in a free market environment and; as a result, there will always be business failures. It needs to be remembered that the auditor is but one of the cogs in the regulatory framework. If the other important regulatory functions do not operate effectively, the problems which arise will not timeously be addressed and gaps in the framework will continue to be exploited.

The Commission does not lay the blame for business failures at the door of the auditor; the blame for not timeously warning of impending failure is often, and with just cause, laid at the door of the auditor.

19. The statutory audit cannot be utilised to provide protection for all stakeholders. However, stakeholder protection, and empowerment, is provided for in the King Report, as well as other applicable legislation and by the relevant regulators. The compulsory appointment of employees to management boards of pension funds is one such example.

The statutory audit cannot be utilized to provide protection for all stakeholders. That is why the Commission proposed the introduction of stakeholder auditors. The Commission does not believe that other entities provide the necessary protection.

20. If irregularities occur in large public corporations, they should be detected by one or more of the screening processes of the governance structure (e.g. non-executive directors, internal audit function, audit committee) before the auditor becomes aware of them. These screening processes are integral to the King Report. However, as noted before, the King Report was issued in 1994. As a result, these processes in many instances did not exist in the companies investigated by the Commission. Indeed there was very little evidence of any form of governance in the companies investigated.

As pointed out above, no discernable improvement has occurred since 1994. Arguably, the situation has become worse.

Dishonesty by management

21. A management team that is determined to commit fraud will almost certainly be able to mislead any number of audit teams. The proposal will afford protection only in those few situations where the audit firm/partner colludes with the management team.

The stakeholder auditor will have access to the records at all times. While such an auditor could be misled, it does not mean that the stakeholder should not have the right to attempt to satisfy himself that the investment is safe or that internal controls are in place.

22. An example of the above was noted in a consultation paper, 'Fraud and Audit: Choices for Society", issued by the Auditing Practices Board in the United Kingdom in November 1998 (copy attached). According to this paper, at its headquarters BCCI had a separate "Special Duties Department" dedicated to deceiving its auditors by fabricating thousands of documents to support the lending to sham companies secretly controlled by the Gulf Group, including letters of introduction, loan documentation, financial statements, credit reviews, Board minutes and resolutions, and audit confirmations.

23. The aim was to create the impression that there was real and substantial commercial activity with genuine third parties and that the Gulf Group companies were keeping up interest payments on their loans, when in reality vast sums of money were simply going round in a circle every day between BCCI and the Gulf Group laundered through special conduit accounts at two New York banks.

The reference to the activities of the BCCI Bank is unfortunate in this context. Two of the so-called 'big five' in the auditing world, Ernst & Young and PriceWaterhouseCoopers, agreed to pay $30 million and $95 million respectively to the liquidators of the bank as damages for their roles as external auditors of the bank.

Findings of Lord Bingham who had conducted an inquiry into the supervision of BCCI and findings by the US Congressional Investigation are reported by Arnold and Sikka as follows:

> **"Throughout the 1980s, BCCI's auditors continued to issue unqualified reports on the Bank's financial statements despite several warning signs of potential problems in the bank's accounts (USS Senate, 1992b, Chapter 10). In 1987, the Bank of England received reports of fraudulent activity by BCCI (Bingham, 1992, p. 56), but no decisive action was taken, in part, because auditors did not suspect BCCI management of fraud (Bingham, 1992, p. 57). In May 1988, Price Waterhouse prepared a substantial report for the College of Regulators (originally formed in 1987). The report drew attention to the heavy concentration of BCCI loans to certain customers, several of whom were shareholders. The report also included information concerning BCCI nominee companies and possible illicit investments in the United States. The information provided to regulators, however, was minimal because auditors 'faced the dilemma of seeking to reconcile their duty to make appropriate disclosure to the (bank) supervisors with the need to retain confidence of their client' (Bingham, 1992, p. 59).**
>
> **Price Waterhouse's relationship with BCCI changed dramatically in April of 1990 when the auditors, acting under the authority of the 1987 Banking Act, notified the Bank of England of lending problems and possible fraud at BCCI without informing BCCI of their action (US Senate, 1992b, p. [2]71-173). However, despite notifying the Bank of England of possible fraud at BCCI, the auditors (in May 1990) issued an unqualified report on BCCI's 1989 financial statements. Possibly fearing that a qualified opinion would prompt a run on BCCI and undermine confidence in the banking system, UK regulators wanted the 1989 BCCI accounts [to] be published with an unqualified audit opinion and the Abu Dhabi guarantees made this possible (Bingham, 1992, p. 82). In fielding public criticisms, Price**

Waterhouse continued to defend their decision to sign the accounts by arguing that the Bank of England and Luxembourg regulators had been informed and wanted BCCI to continue operations, the auditors believed the extent of fraud was limited, the royal house of Abu Dhabi had agreed to recapitalize the bank, and the audit report disclosed that the auditor's opinion was based on guarantees provided by Abu Dhabi (US Senate, 1992b, p. 275).

The US Congressional investigators, however, were severely critical of Price Waterhouse's decision to sign the accounts and accused the auditors of collaborating with bank regulators to deceive the public. According to the Congressional report (US Senate, 1992b, p. 276) on the BCCI affair:

> **'By agreement, Price Waterhouse, Abu Dhabi, BCCI and the Bank of England had in effect agreed upon a plan in which they would each keep the true state of affairs at BCCI secret in return for cooperation with one another in trying to restructure the bank to avoid a catastrophic multi-billion dollar collapse. Thus to some extent, from April 1990 forward, BCCI's British auditors, Abu Dhabi owners, and British regulators, had now become BCCI's partners, not in crime, but in cover up.'**

The resulting report (hereafter the Bingham Report) was based on written and oral evidence from over 200 witnesses, including the Institute of Chartered Accountants in England & Wales (ICAEW). In the course of the inquiry, the issue of whether auditors should have a 'duty' as opposed to a 'right' to report to regulators was revisited (also see Mitchell, 1991). In its evidence (written and oral), the ICAEW defended the status-quo and opposed the need for auditors to have a statutory 'duty' to report fraud and irregularities to the regulators. But, Lord Justice Bingham rejected the ICAEW's case and recommended that a statutory duty to report fraud to regulators be imposed upon auditors. Subsequently, the government legislated (Hansard, 6 November 1992, cols. 523-594) and a 'duty' to report fraud and irregularities was imposed on auditors of all financial sectors, including banks, insurance companies, financial services, pension funds. (Hansard, 15 February 1994, cols. 852-875; Auditing Practices Board, 1994; Sikka et al, 1998)".

International standardisation

24. Rapid globalisation of world markets has changed the way in which corporations worldwide do business and has created a greater degree of interdependence amongst countries. This process has resulted in the need for countries to harmonise laws, regulations and standards, which South Africa has actively been pursuing since its reintroduction to world markets.

25. The audit of financial statements is well defined and understood by knowledgeable users or financial statements, and follows the same process in all Anglo Saxon countries.

Implementation of the proposal would cause the audit function and its incumbent risks in South Africa to be different from that which is well understood and already defined in international auditing standards.

The Commission's proposal does not impact on the normal audit function. The proposal relates to special purpose audits. The only impact it could have would be to enhance an honest and efficient main audit. This, surely, should be an aim of SAICA.

Conclusions drawn in the paper

26. Paragraph 3.4 makes statements as to how certain collapses could have been prevented. Although we are not in a position to comment on the detail of the examples cited, we do believe that they are speculative and one cannot say with any certainty that if the proposal had been implemented, loss to the various stakeholder groups would have been prevented.

There can be no doubt at all that if the holders of the debentures in the Masterbond companies had been represented by honest trustees with access to the records, no debentures would have been issued. The statement that this is mere speculation flies in the face of the factual situation, well known to the auditors at the time and subsequently to SAICA, that short-term funds were being utilized to fund long-term projects of extremely dubious value.

The examples which were cited are those of corporate failures which were well publicised, in which millions were lost, in which members of SAICA were involved and many of which had occurred almost ten years ago. The examples include Masterbond companies, Mykonos, Fancourt, Marina Martinique, Owen Wiggins, Cape Investment Bank and Pretoria Bank.

The fact that SAICA can assert that it is unaware of the details of the examples is an indication of the need for a Public Oversight Board for the profession. The Public Oversight Board will set ethical standards and discipline members of the profession when necessary.

Conclusion and recommendations

27. Although SAICA supports the objective of protecting stakeholders, we believe that it would be unrealistic and undesirable to try and achieve this solely through the audit function. However, we do believe that the presentation of reliable financial information and the statutory audit play a fundamental part in achieving this objective.

The Commission agrees that it would be unrealistic and undesirable to achieve the protection of stakeholders solely through the audit function. This is certainly not the intention of the proposals.

The intention is to create an opportunity for interest groups to satisfy themselves whether their investments are safe or at risk, and not to have to rely on the statutory audit or on the protection of regulatory authorities who might have agendas of their own or who might not have the resources or the necessary will to fulfil their functions.

28. In this regard we believe that the focus should be on improving the quality of financial reporting and the audit thereof in its current format. As mentioned above, we have in our previous submissions to you made recommendations on how to achieve this; however, we would like to reiterate some of the more important points here.

The obvious fact that improved quality of financial reporting and auditing cannot be equated with transparency, is ignored.

It seems to be clear that SAICA believes that the services of additional auditors conducting special purpose audits would not be of any assistance to investors.

The Commission has not suggested that investor protection could be achieved 'solely through the audit function'. The Commission believes that investor protection would be significantly enhanced by the appointment of interest group auditors.

It is not clear why SAICA takes the opposite view.

Legal backing for accounting standards

29. SAICA believes that the lack of legal backing for accounting standards seriously affects the quality and consistency of information presented to shareholders and other stakeholders in corporations.

30. The status quo also inhibits the carrying out of an effective audit as auditors often have weak ground on which to qualify their audit report for non-achievement of fair presentation. Clients are able in the current framework to demonstrate that their chosen accounting policy is "generally accepted" even though it is often misleading and not supported by reputable accounting standards.

31. Steps taken by SAICA with regard to legal backing for accounting standards were covered in our previous submissions to the Commission. However, SAICA is concerned at the length of time it is taking to implement these proposals because many of the other building blocks in the system rely on this foundation stone to be effective.

Legal backing for accounting standards is recommended by the Commission.

Improved standards

32. To adapt to changing market demands, SAICA has promoted and driven a programme of harmonisation to enable South African businesses to compete on an equal footing with their competitors in other countries. The key areas or harmonisation have been accounting standards, auditing standards, the code of professional conduct and education and training standards.

33. SAICA has not only been involved in harmonising South African standards; it has also played a very effective and important role in the setting of standards in the international community. It has done this through its representation on the Council of the International Federation of Accountants and its technical committees as well as through its representation on the International Accounting Standards Committee and the International Auditing Practices Committee.

The profession in South Africa has reached an advanced stage in harmonising its accounting and auditing standards with international standards. Being part of the international accountancy profession, the profession in South Africa has to monitor international developments and adapt its own requirements accordingly. This process of internationalisation has been operating for some years, but the main effect has been felt over the past five years. It is likely that South African auditing standards will be fully harmonised with international standards by the end of 1999 and accounting standards by the end of 2000.

35. Internationally, developments are taking place on further clarifying the auditor's responsibility for the detection and prevention of fraud. Once international guidance or standards have been issued on the subject, equivalent standards will be issued in South Africa.

36. SAICA believes that comp1iance with these internationally harmonised auditing standards will address many of the audit related problems highlighted in the Commission's report and paper prepared by Justice Nel.

Monitoring

37. To ensure that the abovementioned standards are being complied with, an appropriate monitoring mechanism needs to be in place. The practice review process, which takes place under the auspices of the Public Accountants' and Auditors' Board, was instituted to carry out this monitoring function. It is now in its fifth year and every practitioner has been reviewed at least once. Remedial actions in the form of disciplinary proceedings have followed in cases where the required standards have not been met.

38. SAICA believes that practice reviews have resulted and continue to result in a raising or practice standards. It has also had the effect of making practitioners who cannot meet the required standards give up attest function work.

Over the years SAICA has made many changes to its own requirements and it has issued guidance to its members and the public on many topics. It has worked with its members, the regulatory authorities, government and non-government organisations to find solutions. As was the case with its previous submissions to the Commission, SAICA is willing to work with the Commission to find a workable solution to the problems identified in the paper."

.....

13.22 The **Association for the Advancement of Black Accountants** (**ABASA**) listed what they regard as the positive aspects of the proposals by the Commission -

- improved regulation and levels of morality in a country beset with white-collar crime;
- an opportunity to develop new lines of business for the auditing profession;
- more opportunity to develop financial skills and thus from ABASA's point of view, black accountants in South Africa;
- improved credibility of South African financial reporting within the international business community.

13.23 **ABASA** also expressed concern about possible cost implications, confidentiality and the definition of stakeholder groups.

These concerns have been dealt with in the comments on the SAICA document.

13.24 **ABASA** is also of the view that a number of other matters should be considered, namely

> "Regulation of additional auditors. How will, *inter alia,* required skill levels be ensured?
>
> Resolving conflicts of interest between various stakeholders and defining the criteria and circumstances for appointment of additional auditors (differentiating between genuine concern vs witch-hunts and frivolous actions).

Relationship between the statutory auditor and additional auditor. For example, how will conflicting findings be dealt with? When will the 'responsibility' to report pass from the auditor to the additional auditor? Who will be liable when there is supposed failure by both auditors and there is a business failure that was not reported on in time?

Affordability to South Africa in terms of time requirements of skilled individuals which could be used elsewhere for the overall good of the country. Are current avenues of reporting, with a few modifications, not sufficient? As a developing nation, can we afford this additional regulation, which developed nations do not have?

Will the proposal address the current concerns regarding investor protection and will responsibility for investor protection now rest with various stakeholders themselves? Or if in the case of business failure and losses in the future, will responsibility now rest with additional auditors, which does not really address the issue?"

The necessary skill levels must be ensured by the profession. The trustees for the various interest groups will be financial institutions and should not have any reason to institute witch-hunts or frivolous actions.

The possibility of conflicting views between auditors is not something new and in fact could only result in a more objective auditing and reporting process (current avenues of reporting are demonstrably not successful) and additional costs will be more than off-set by the saving of the enormous losses which are suffered under the present system.

Protection will not be the responsibility of the various stakeholders themselves. The proposals envisage an opportunity to enhance their protection.

13.25 ABASA concluded as follows:

"Based on the above, we believe that:

1. The responsibility for fair presentation of financial statements is and should continue to be management's responsibility. However, the auditor has a specific duty to ensure that financial statements are fairly presented.

2. The responsibility for investor protection and for the detection of possible business failure cannot and should not be the responsibility of the financial auditor. Investors themselves should show more vigilance when appointing and evaluating their appointed officers. Directors should also not be allowed to hire, fire and pay auditors - this should be the responsibility of a shareholders committee. The effectiveness of audit committees in South Africa can be questioned. The current shortcomings needs to be addressed through improved corporate governance in South Africa and the role and responsibility of directors need to be reconsidered. The South African investing public also needs to be educated.

3. The King code addresses many of the requirements of good corporate governance. We believe that consideration should be given to possibly regulating the King code.

4. We believe that the current South African Companies Act is out of date and requires some serious attention in order to get it up to date and in line with internationally accepted standards. For example, it is a criminal offence to lie to the external auditors in the UK and Malaysia, which it is not in South Africa. The profession has for a long time been

asking for legal backing but this process has been delayed, for a number of reasons.

5. We recognise that the regulatory framework for accountants and auditors needs to be improved and our suggestions to this effect are contained in our submission to the NACF.

6. We are in principle in agreement with the appointment of additional auditors, however, there are certain practicalities listed above, which has to be addressed, some of which are fairly fundamental to making the recommendations contained in the Nel submission workable.

7. Finally, we believe that in a free market, there can never be 100% assurance and it is a matter of balance being achieved between risk and cost".

The Commission agrees that the South African Companies Act is out of date and that a major revision should be undertaken. Such a revision could include some of the matters raised by ABASA, namely, shareholders committees, improved governance, improved audit committees and the like.

13.26 In addition to the reasons stated why particular interest groups should have access to the records of corporations, the provisions of the **'Promotion of Access to Information Act' No. 2 of 2000** must also be taken into account.

These provisions enable anyone who wants to exercise a right or protect a right to have access to records of the corporation.

13.27 Section 50(1) of the Act reads as follows:

"**50.** (1) A requester must be given access to any record of a private body if —

(a) that record is required for the exercise or protection of any rights;

(b) that person complies with the procedural requirements in this Act relating to a request for access to that record; and

(c) access to that record is not refused in terms of any ground for refusal contemplated in Chapter 4 of this Part".

13.28 Section 68(1) which lists some grounds for refusing access to commercial information reads as follows:

"**68.**(1) Subject to subsection (2), the head of a private body may refuse a request for access to a record of the body if the record —

(a) contains trade secrets of the private body;

(b) contains financial, commercial, scientific or technical information, other than trade secrets, of the private body, the disclosure of which would be likely to cause harm to the commercial or financial interests of the body;

(c) contains information, the disclosure of which could reasonably be expected —

(i) to put the private body at a disadvantage in contractual or other negotiations; or

(ii) to prejudice the body in commercial competition; or

(d) is a computer program, as defined in section 1(1) of the Copyright Act, 1978 (Act No.98 of 1978), owned by the private body, except insofar as it is required to give access to a record to which access is granted in terms of this Act".

13.29 Structural access to the records as recommended by the Commission, would be far superior to the random access envisaged by the Act.

13.30 It is recommended that the following interest groups should have access to the records of corporations

- **minority ordinary shareholders, see Chapter 11;**
- **holders of debentures, see Chapter 12;**
- **depositors in banks and other financial institutions;**
- **contributors to pension and provident funds;**
- **the assured of long-term insurance companies;**
- **owners of time-share;**
- **members of medical societies;**
- **investors in participation bond schemes;**
- **holders of non-voting shares;**
- **holders of preferent shares.**

13.31 It is recommended that the access should be exercised by means of trustees to be appointed with the powers and in accordance with the procedure set out in Chapter 12.

13.32 It is also recommended that at times of wage negotiations or retrenchments, auditors appointed by recognised trade unions should have access to the records of the corporations.

.....

NOTES

1. **See Chapter 3.**

2. **Professor I H Mac Gregor :** 'Corporate Financial Reporting : Past, Present and Future' (University of the Witwatersrand 1982) identified the potential users of published annual financial statements as likely to include

- owners;
- lenders;
- suppliers of goods and services;;
- potential investors;
- lenders and creditors;
- bankers;
- employees;
- management;
- customers;
- financial analysts;
- stock brokers;
- underwriters;
- financial journalists;
- taxation authorities;
- trade unions;
- the general public.

3. **Ibid.**

4. **United States.** American Institute of Certified Public Accountants.
The Commission on Auditors' Responsibilities: Report. Conclusions and Recommendations (Cohen). 1978.

Australia. Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia - A Research study on financial Reporting and Auditing - Bridging the Expectation Gap. 1994.

New Zealand. Brenda Porter. An Empirical Study of the Audit Expectation Performance Gap. 1993.

Republic of South Africa. J.D. Gloeck - The Expectation Gap with Regard to the Auditing Profession in the Republic of South Africa. 1993.

5. Raymond J Chambers
Frank L Clarke
Graeme W Dean

"SUBMISSION TO THE NEL COMMISSION OF INQUIRY INTO INVESTOR PROTECTION AND EMPOWERMENT

SUMMARY

This submission responds to the Consultation Paper addressing the above issue. It should be read in conjunction with the supplementary material referred to in it, particularly *Corporate Collapse: Regulatory, Accounting and Ethical Failure*, (Clarke, Dean and Oliver, CUP, 1997) to which reference is made in the Consultation Paper, and the additional material attached, namely:

Securities and Obscurities; R. J. Chambers, Gower Press Australia, 1973.

Photocopies:
Accounting Standards Review Committee, Company Accounting Standards, under the Chairmanship of R. J Chambers, NSW Government Printer, Sydney, 1978.

"Chaos in the Counting-House: Accounting under Scrutiny", F. L. Clarke and G. W. Dean; *Australian Journal of Corporate Law,* Vol 2 No 2 1992, pp.177-201.

"Creative Accounting, Compliance and Financial Commonsense", G. W. Dean and F. L. Clarke; *Australian Journal of Corporate Law*, 378 7 (1997), pp.366-386.

References in parentheses of the kind (CP2.21, p.20) are to the relevant paragraphs and pages of the Consultation Paper.

The general themes of this submission are that:

(i) investors in general and creditors in particular, can be afforded little protection so long as published the Financial Statements contain data which are not serviceable for determining the wealth and financial progress of companies and other business entities;

(ii) the data generally emerging from the use of conventional GAAP are not serviceable;

(iii) the perception of misleading (*creative*) accounting being primarily the consequence of deviations from the prescribed Standards is in error;

(iv) the Financial statements of companies that have complied with the prescribed Standards are almost certainly equally misleading as those that have deviated from the Standards;

(v) the labeling of the variation between what the investing public expect of the products of accountants and auditors and what they receive as an *Expectation Gap* is a misnomer, it is a *Performance Gap;* and,

(vi) the general principles underlying the quality- control effected upon, and the protection of consumers in respect of, ordinary goods and services ought apply equally to the products of accounting and auditing services.

Accordingly, whereas this submission addresses the overall thrust of the Consultation Paper and the impact of the matters addressed in it, from our perspective these coalesce into issues that might be described broadly as: the function of financial statements; creative and feral accounting; the functions of auditors - the *Expectation v. the performance gap*; and, the need to reconstruct accounting practice. These are addressed below, seriatim.

COMMENT

1. Function of financial statements

An all-pervading emphasis in the accounting literature is that accounting data are for the purposes of informing interested parties in the context of making economic decisions. This appears to have been spawned by the conceptual framework exercises in the United States. the United Kingdom and the English speaking countries whose accounting is influenced by them. A focus on decision usefulness may not be as justified as appears to be implied, nor as backed by tradition as might be presumed.

A feature of the promotion of the decision usefulness theme has been the manner in which the functions of general purpose financial statements have been considered in the context of the interests, the potential specific decisions by (an ever -increasing list of) potentially interested parties. A fuzzy logic has been employed to translate *general purpose* into a *specific purpose*, without justification. One might have expected the listing of the separate categories of parties likely to be interested in the contents of general-purpose financial statements to have sprung from evidence that general-purpose

statements do not have any function in the domain of contemporary commerce. Instead, the focus on potential individual *users* has emerged from a contestable affiliation forged between a legitimate function of general purpose statements and the unknown potential decisions by myriad potential users.

No evidence exists to the effect that the function intended by the UK 1844 Act for dated financial statements was other than to inform of the overall wealth and progress of companies. As such, the data might well have been expected to be generally relevant to the investment and other similarly financial decisions of all associated with the company or contemplating an association. Indeed, it is fair to suggest that until Geo. O May (*Financial Accounting-. A Distillation of Experience*, The Macmillan Company, 1943) produced a tentative list of likely users of published financial data, it was not presumed that the specific decisions of individuals were ever intended to be serviced, except in the broadest of terms, by the contents of published financial statements. Since May (1943) the specific interests of individual categories of investors and others has increased with successive publications. The decision usefulness theme has itself been transformed from *general purpose decision usefulness to specific decision usefulness*, and implied characteristic of *generally* relevant to *specifically* relevant.

Of course, the data in general purpose financial statements cannot be expected to be specifically- relevant to the particular and idiosyncratic interests of all associated or contemplating an association with a company. To that end, the overall objective underlying the accounting provisions and financial statement requirements of the 1844 Act were promulgated on the understanding that data in a dated balance sheet ,which disclosed the wealth and progress of a company were generally relevant to virtually every financial assessment, evaluation or decision. that an interested party might make. Those data may, of course, be insufficient to satisfy all the needs of an individual interested party. Nor should they be expected to be, or it follow that published financial data could ever be so crafted.

Underlying the specific relevance push is a curious (though unstated) denial of what we know and do not know about decision making. Whereas only some parties of interest are entitled to receive a public company's financial statements directly from it, those data almost universally are in the public domain. As such it is impossible to even sensibly contemplate the myriad different specific interests of the parties or the specific decisions they might wish to make regarding their relationship or contemplated relationship with the company in question, other in the most general and broadest of terms. *Broadly*, that is, to show a company's wealth and financial progress, the nature, composition and contemporary worth of its assets; the nature, composition and amount

of its liabilities; the consequential amount and composition of the equity of its shareholders, as at the date of the statement; and the changes in those items and amounts during the period under review and the causes of those changes. Such are unequivocally of general relevance to virtually every financial decision - to invest, disinvest, lend, borrow, seek or contemplate terminating or continuing employment in, extending or contracting credit to, purchasing or otherwise doing business with - the company, though in no case might it be sufficient information.

A considerable part of the discussion (CP2.1 - 2.25) in the Consultation Paper is consistent with the general theme that the individual decisions of the specific users of financial statements ought to be serviced by published financial statements in more than a generally relevant manner. The focus on specific interest groups (CP2.1, 2.2, 2.19, 2.24) and their specific decisions are illustrative of the pervading attempts to have general purpose financial statements do what they cannot do, provide other than generally relevant information. Yet elsewhere the notion of general relevance underlies the validity of comment and exposes the futility of imagining that it would ever be possible to identify the specific information needs of every specific category of user. Jenkins (CP 2.2), for example, is noted to refer to "*People in every walk of life* are affected by business reporting, the cornerstone . . ." (emphasis added); the Gladstone Committee is noted (CP2.10) to have referred to " .. . greater security of the *public*" (emphasis added); Arthur Levitt (1998) is quoted in what we might take to be a generic reference to the panic of " . . . *investors*"; and, for example, the Cohen Commission referred to the generic "users" (CP 2.26). Point is, when it comes to discussing the failure of published financial statements to provide adequate information, in one way or another, reference is made to generic deficiencies or omissions that amount to a failure to disclose what we have labeled the wealth and financial progress of companies, and it is made in reference to the public at large. And, it ought to be noted that Jenkins somewhat acknowledged this in his Report by ultimately canvassing the possibility that different categories of users with the leverage to exercise pressure might contract or demand *negotiated disclosures* for their particular use. Of course, banks and financial institutions already do this.

A focus on specific, rather than, general relevance as the goal of published financial data draws upon the idea that individuals who make decisions regarding their association with companies can be categorised according to their common information needs. Clearly Jenkins was of that view. That necessitates subscribing to the idea that individuals or categories of them understand the process by which they make their decisions. It is as if there is a belief that decision models exist in real life, and as if the exact manner in which published financial information meshes with other information is

known. We suggest that decision-making is by far more complicated than suggested in the accounting or management literature sympathetic to accounting. Indeed, it is doubtful if anyone actually *knows* how all the information they gather meshes to prompt a particular course of action. Reflection in respect to one's own decision-making almost certainly reveals that whilst some information may take on greater significance than other information, how it meshes to move us in one direction rather than the alternatives is a mystery. Even when a particular factor is deemed to be the *decider*, why it is so deemed is problematic.

Many in commerce have been drilled in the mysteries of decision-making through recourse to illustrative decision models. Accountants' drilling in the use of NPV's to discriminate between possible alternative courses of action, is a case in point. But nobody in commerce would contemplate the use of such a process other than as a rough-and-ready tool. Nobody would deny the influence of other deliberate inputs and, more importantly, the influence of known and (we suspect) unknown subliminal inputs. How they all mesh is a mystery. That is what "gut feeling" is intended to describe! Decision-making is a mystery. Decision models are just that - mere models. No more! If it is impossible to know the decision models of user categories, and certainly not of the individuals comprising them, it is humbug to contemplate a search for financial information which might be other than generally relevant to the broad scope of decisions made in everyday commerce regarding relationships between corporations with other corporations and with individuals.

Financial statements are an *instrument* for disclosing the wealth and progress of corporations. As with other forms of instrumentation it is critical that the readings accounting gives are reasonably accurate quantitative representations of the characteristics of which they. are held-out to be indicative. As such, if they are to be a general guide to commercial action and the means by which to derive reliable indications of other features of companies, the data they contain must be indicative of the financial characteristics and consequences of the items, actions or circumstances they are held-out to represent. Data which emerge from the use of conventional accounting practices drawing primarily upon input data from transactions supplemented with hypothetical data relating to physical asset amortisation, cost capitalisation, periodic amortisation of costs, consolidation of the data in the context of a presumed economic *group*, tax effect accounting, and the like, aggregated in published financial statements, cannot function as reliable financial instrumentation.

Arguably, not only- is the focus on specific relevance misguided, the data which emerge from the use of conventional accounting practices are, for the most part. not serviceable

for providing the necessary generally relevant information on the wealth and progress of companies generally- relevant to the interests of the public at large.

Conventional accounting processes are not geared to disclosing the wealth and progress of business entities. So many of the data produced through complying with GAAP (in most of its varied manifestations) are not indicative of actual amounts of money in the possession of or accessible to the entity; so many are indicative of money the entity once had in the past and has since spent on the physical assets and the like it currently has; many represent money spent for which nothing currently exists except the record of the expenditure carried forward; some are not representative of anything that currently exists, existed in the past or is likely to exist in the future - mere artifacts of the system; and still others are indicative of a balance of money spent in the past arbitrarily amortized.

It is no wonder that nobody can gain much insight of the wealth and progress of companies from the contents of published financial statements. No wonder that there is a public outcry (CP1.3). But arguably the problem arises not so much from companies' failure to comply with (deviating from) GAAP as from complying with GAAP, and not so much as from failing to disclose conventionally prepared accounting data in the published financial statements as disclosing those data that do not have any legitimate part in the representation of wealth or the assessment of financial progress.

Corporate history is replete with examples of misleading accounting data arising from compliance with the conventional rules and entrenched practices of accounting. Our enquiry in corporate failures in *Corporate Collapse . . .* (Clarke, Dean and Oliver, CUP 1997) disclosed that most of the accounting of most of the companies involved in the most celebrated of Australian failures complied with the Accounting Standards current at the time. That is, by far more of their accounting complied with the Standards then in force than deviated from them. Of course, some instances of more than questionable conduct existed. But we would argue that those companies' published financial statements would have been misleading without the impact of any deliberate intentions to mislead. And more to the point, the statements of companies that did not fail, companies whose performance has received adulation, arguably have been equally misleading entirely by virtue of compliance with the Accounting Standards in force.

A confounding issue in the discussion of creditor protection has been the literature which identifies *creative accounting* as the consequence of departure from the prescribed practices, rules or Standards. That has tended to divert attention from the inevitably misleading nature of many of the data arising from compliance. Creditors are

not protected by data which do not disclose the wealth and progress of those with whom they do business. If they do not know a company's wealth and progress, they are not in any position to decide whether to do business with it! A distinction between accounting practices undertaken with the intention to mislead and those without such an intention is more fruitful. The evidence upon which we draw suggests to us that the misleading (*creative*) data which emerge from complying with the Standards without the intention to mislead might better be labeled *creative accounting*, and the misleading data from practices with the intent to mislead are better labeled *feral accounting*.

2. *Creative* and *feral* accounting

We draw your attention to the matters discussed under this head in Chapter Two of *Corporate Collapse* . . . Attention is drawn also to the similar matters coursing through *Securities and Obscurities*. Juxtaposed, these are indicative of the persistence of misleading data arising through the prosecution over time of the conventional rules of accounting of the day. A point we would emphasise is that the creative character of conventional accounting has been a longstanding problem. As such, it is reasonable to claim that the problem of *creative accounting* is a much greater problem than the products of deliberate intent to mislead - what we have labeled *feral accounting. I*n that context your attention is drawn to the matters addressed "Chaos in the Counting House …", (Clarke and Dean, 1992) and "Creative Accounting,…(Dean and Clarke, 1998).

What we have argued is consistent with Levitt's observation (CP2.22, p.21). How can data be *meaningful disclosure* unless (as Levitt puts it) it show *where it has been, where it is?* And how can data show *where [a company]* is financially, unless the data are indicative of the money's worth of the assets it has and the actual money's worth of its liabilities. There is no room for data that do not relate to actual amounts of money, or its equivalent to which the company has access or the actual amounts it owes. There is no place for data indicating the prices paid for assets acquired in the past - money long gone, no place for imputed data for goodwill arising as the balance between the amounts attributed to net assets acquired and the price paid for them, no place for imputed tax-effect accounting debits or credits, no place for capitalised expenses, no place for accruals based upon time rather than upon recoverable or payable amounts, no place for arbitrary amortision charge unrelated to the actual *de pretium*, no place for the artifacts of consolidation accounting, and the like. Yet all of those are the everyday fare of the application of conventional forms of GAAP.

It is worth contemplating whether the creditors, shareholders and other stakeholders aggrieved when companies fail would ever calculate their own financial position, *where*

they are, with many, of the data of the kind found in conventional marine statements and balance sheets. Nobody would assess their financial position by recourse to amounts of money they once had, but have no more. Nor would they bring into calculation numbers that they know are not indicative of money to which they have access directly, or by virtue of what they know of the prices for which items could be sold. It is inconceivable that anybody would count as an amount owing by them, something they knew not to be. Must GAAP imply that they would! And certainly require accountants to do so in respect of the affairs of public companies.

We would question Levitt's implied plea that published financial statements might reasonably show *where [a company] is going*. Nobody knows the future. It cannot be presented in dated financial statements. But prediction depends upon an accurate knowledge of the past and of the present position. Balance Sheets certainly could and should be constructed to reveal a good representation of the latter. Indeed, the future cannot be predicted unless the present position is known, for every future position is a departure from the present.

We suspect that a considerable part of the mythical nature of accounting data arises from the focus on the unknown processes of decision-making. Apart from the commonsense proposition that accurate data might be expected to be more useful than the inaccurate, for most purposes no real mapping is possible. That is partly why many supporters of the *status quo* are able to claim that conventional accounting *works* and draw upon the success of companies over very long periods using it.

In contrast, it is unequivocable that many of the data emerging from compliance with the conventional GAAP in most countries are not serviceable for deriving most of the indicators (solvency, rate of return, debt to equity, asset backing, earnings per share, return on total assets, capacity to pledge assets as security, for borrowing, conformity with borrowing covenants), that are the salient financial characteristics of companies. We return to this below.

3. Function of auditors

Whereas the function of auditing may have changed as Porter (CP2.17) points out and notwithstanding the confusion as to the extent to which auditors ought to detect fraud, it is unequivocal that a clean auditors' report is taken (and expected to be taken) to add credibility- to the contents of published financial statements. Various semantical rules and other tactics have been employed to soften the auditor's role. But, unless the

auditor's role is to check the accuracy and declare the credibility, or otherwise of the financial statements, audit fees are money wasted.

It has to be acknowledged, however, that auditors are placed in an invidious position. In most settings they are now required to form their opinion regarding the veracity of the financial statements within a framework implying that compliance with GAAP will, *prime facie,* lead to *true and fair* accounts (or something of equivalent meaning). Auditors are thus in a no win situation. The inherent defects addressed in the previous section in most GAAP specifications mean that auditors are d*amned if they do, and damned if they don't !* Reporting GAAP compliant accounts to be true and fair entails them engaging in declaring what is almost certainly false, and permitting departure from GAAP without qualification exposes them to the risks attaching to deviating from the rules of their profession and, in Australia for example, the dictates of the Corporations Law. We discuss this situation in *Corporate Collapse . . .* (1997, pp232-260) in respect to the uncomfortable position of accountants in general.

Not much written about the supposed *Expectations Gap* points to remedying the situation in a manner that promotes the dissemination of financial information more serviceable than currently exists. From our perspective the Sikka, Puxty, Willmott and Cooper discussion (CP2.27, pp23-27) of the underlying reasons for the Gap misses the messenger more than the message. True, a considerable part of the literature has addressed the Gap *in terms of others' ignorance* (CP2.27, p.25). Education of the *laity* has been the preferred remedy. The Australian profession, for example, suggested that the position would be resolved by educating the general public to understand that what they expected was not what they would get (Australian Society of Certified Practising Accountants and The institute of Chartered Accountants in Australia, *A Research Study on Financial Reporting and Auditing - Bridging the Expectation Gap*. ASCPA and ICAA, Melbourne 1993). Sikka, Puxty, Willmott and Cooper identify a *systematic nature of the gap*, presumably as a social problem. Possibly it is. But analyses of the manner in which the Gap survives does nothing to expose the major cause of it.

In reality the public is neither ignorant nor confused in their understanding of the role of auditors according to the history of their craft. The general public is absolutely correct in their understanding of what it is reasonable to expect from auditors. It may, be more to the point to declare that the auditing profession is ignorant of what their historical professional responsibilities are and the continuing relevance of them in today's commercial environment. Most commentators do not see it that way (as the Porter, and the Sikka, Puxty., Willmott and Cooper discussions expose). In many respects the

failure to grasp the underlying essence of the problem means that most commentaries on the Expectation Gap do more to perpetuate than remove it.

At the heart of the problem is that the public at large expects that auditors are able to form reliable opinions on the truth and fairness of the financial statements - and the truth is that auditors cannot do so within the framework in which auditors are required to work. The public in general is entitled to its expectation. The history and tradition framing the development of auditing supports the public's expectation. The recent history of auditors' performance, does not. The legislature' and the profession's obligation is to create the circumstances in which auditors can do what is reasonably expected of them and what is their rightful role and function. Only then can creditors' rights be protected as part of everyday commercial intercourse.

That necessitates that the accounting produces data that are serviceable for showing the wealth and progress of companies and from which their salient financial characteristics can be derived.
With that in place little would be served by having different auditors appointed by different stakeholder groups. In contrast, appointment of special auditors to serve the needs of particular stakeholder groups would achieve little were the general serviceability of the content of published financial to remain as it is.

4. A reconstruction of accounting?

A primary thrust of our argument here, and in the materials attached to this submission and our *Corporate Collapse* . . . (cited in the Consultation Paper), is that accounting needs to be reconstructed with a view to the data emerging being serviceable for determining the wealth and progress of companies and for deriving their various financial characteristics.

Whereas neither the actual decisions made by myriad stakeholders in companies can be known (except in the broadest generic sense of *invest* and *disinvest*), nor how they are made, there is considerable evidence regarding particular habitual uses made of published financial data. It is incontestable also that data are extracted from the published income statements and balance sheets of companies to derive assessments of solvency, rate of return, asset backing, earnings per share, return on total assets, debt to equity, and the like. How those indicators are meshed with the other information that impacts decision-making is the mystery discussed earlier. But it is beyond dispute that such assessments and calculations are made habitually, widely published and, indeed, the outcomes traded commercially. Of what each is to be taken to be indicative is also

beyond dispute - clearly, defined financial characteristics of the company. Whilst how best to assess solvency is debatable, no informed person would deny that the notion refers to the capacity to pay debts; no such person would deny that rate-of-return refers to the rate of increase in the entity's net wealth, that asset backing refers to the proportional money's worth of asset cover for each voting share, that earnings per share refers to the proportion of income attributable to each ordinary share, and the like. Nor would an informed person dispute that each of those indicators refers unequivocally to a *financial* characteristic incapable of meaningful assessment or calculation unless the data are indicative of either actual money or money's worth possessed by the entity or actually owing by it. There is no place, no role, and no serviceable function for data that are mere artifacts of the double entry system.

Above we argued that a focus on users in the decision-usefulness framework tended to misdirect attention from the inherent generic defects off conventional accounting and encouraged suggestions that the needs of individual user groups be considered. In many respects those misdirections have tended to imply that general-purpose financial statements of the kind envisaged in the 1844 Act and pursued since in corporate laws framed in the British tradition currently serve little purpose. A change in focus from users to *uses* places general-purpose financial statements in a setting in which the necessary characteristics of the data they contain are unequivocal. Unequivocal also is the role of auditors, one they reasonably can fulfill and accord with what is expected of them. The Expectations Gap would not exist. There would not be any excuse for a Performance Gap.

There is no good reason why accounting data ought not satisfy the same general serviceability criterion commonly applied to all other goods and services. In the general run of consumer law there is no argument than goods and services are to be of merchantable quality, fit for use, *serviceable* in the ordinary uses habitually made of them. Whilst this argument is put elsewhere in our work (it underpins the general thrust of the Report of the Committee of Enquiry in Accounting Standards [Chambers, et al. 1978]; the argument in "Chaos in the Counting-house, . . .", [Clarke and Dean, 1993]; "'Creative Accounting. . . . . .", [Dean and Clarke, 1998]; Chapters 2, 15, 16, 17 and 18 of *Corporate Collapse* . . . [Clarke, Dean and Oliver, 1997]), it is worth highlighting some of the general points upon which it rests.

No serious dispute can be put to the claim that the data from published financial statements are extracted habitually to assess the wealth and progress of companies and are subjected to mathematical manipulation to derive critical indicators of various financial characteristics of those companies. We have already argued that there also can

be little serious dispute as to what those indicators are held-out to be indicative, that each refers to a financial characteristic that can be indicated only with numbers representing actual money or its equivalent possessed or accessible by a company or owing by it. Such conditions invoke the generic characteristic of financial data *serviceability* that must be satisfied.

It is significant that the only balance sheet data from conventional accounting practice that unequivocally satisfy the serviceability criterion are the liquid items. Were accounting to be on a cash basis only, except for deliberate intent to deceive or absolute incompetence, all the data would be serviceable in the uses specified above. All the usual inter and intra-firm comparisons could be made on both static and inter-temporal bases, all the data would be homogeneous contemporary measurements of current general purchasing power, mathematical procedures could be applied to all and yield valid and interpretable products. Accounting procedures need to simulate the cash-to-cash basis as best they can. That requires only two deviations from the general framework of conventional accounting. At each period's end all the balance sheet data have to be either representing actual cash or its equivalent - cash amounts stated at their then current balances, accounts receivable and payable by the entity stated at their respective contractual amounts, and vendible physical assets stated at the prices for which they might be sold at that time in the ordinary course of business. Non-vendible physical assets make no contribution to the current financial wealth of the company at that date, though through their use they may contribute to it in the future.

Balance sheets and income statements are dated statements. The discipline imposed by being dated is that what they disclose is indicative of the present position and the changes in it since the last set of dated statements, providing a basis for diagnosis, plans for future action, and prognosis. Nobody would expect anything other than that from other than dated position statements; a dated bank statement for example does not deny, that the balance shown may well be different from what it was in the past and what it might be at some future date. Nor does a ticket from a weighing machine deny that the weight of the user might be differ at some future time, or a reading from a sphygmometer declare other than what the blood pressure is at that time. No good reason exists for published income statements and balance sheets to function in any different way - to tell it other than *how it is*.

In passing it is worth noting that the usual criticism that non-vendible physical assets must *be valuable to the firm*, and be shown in the balance sheet as such, completely misses the point of preparing dated financial statements - to assess the financial characteristics of the company *at that time*, to assess its progress *up to that time* and,

amongst other things, determine what might be possible in the future, evaluate the financial feasibility of the alternatives available to it, and the like. It also completely misses the distinction between the past and the present - capable of being a*ccounted* for and capable of being *audited*, and the future of which only *predictions* are possible and at that time are incapable of corroboration.

Simulation of the *cash -to-cash basis* period by period also meshes with the ultimate overall financial outcome of business activity. No matter for how long corporations operate, they commence with cash and ultimately end up with cash. Periodic financial statements are meaningfully viewed as attempts to simulate the company's successive positions at selected points in time to depict its progress through that continuim. One would imagine it commonsense to best structure accounting to best reflect the progress at the end of each period towards the ultimate outcome. That does not entail any prediction as to when the ultimate outcome will arise or what it might be.

Such a specification could presage harsh treatment for many of the rules and practices underpinning conventional GAAP. This implication is spelled out in respect to the Australian Accounting Standards in *Corporate Collapse*... and in the other papers. Most of the Standards could be scrapped and be replaced with a *general serviceability criterion* embedded in a General Quality Standard of the kind that underpins the general consumer protection movement. The 1978 Report of the Chambers Committee recommended such an approach though it did not specify it in terms of applying the general rules applicable in the consumer protection domain.

There promises to be considerable benefits for company stakeholders, accountants in general and auditors in particular, and also for regulators, from such a radical approach. The stakeholders would receive serviceable data indicative of the wealth and progress of companies. Accountants would not be at risk in the manner they are currently. Auditors could proceed to meet their traditional role without the expectations and performance gaps currently eroding their professional image and status. Regulators would have a simpler set of rules by which to effect governance over the financial affairs of corporations (see the general arguments in respect of accountants and auditors in Chapters 17 and 18 of *Corporate Collapse*…).

Importantly, appointing auditors for the separate stakeholder groups in the manner suggested in the Discussion paper would be unnecessary. Published financial statement data would be generally relevant to all, serviceable in all the uses ordinarily made of such data, the failure of which to do so in the past has prompted the multiple auditor approach. The combination of a thousand such auditors and the perpetuation of 'the

publication of data of the kind currently emerging from conventional accounting would achieve nothing - the data (many, individually and all collectively) would continue to be unserviceable in the uses ordinarily made of them.

We would argue that the case for reconstructing accounting along the lines suggested here is incontestable.

We trust that this submission assists the Commission in its important deliberations. Should there be any matter which requires elaboration we would be pleased to assist.

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CHAPTER 14 - THE FIDUCIARY DUTIES OF DIRECTORS

14.1 The South African Companies Acts followed fairly faithfully in the footsteps of the English Companies Acts.(1) One of the results is that, as in the United Kingdom, the duties of directors of South African companies have never been codified.(2) The director is said to stand in a fiduciary relationship to the company and is required to act in accordance therewith. This is a concept of the common law.

14.2 The lack of codification has resulted in directors often not being aware of or not appreciating the extent of their duties towards the company, its shareholders and other stakeholders, and ultimately it is left to the Courts to decide whether the actions or inactions of the directors have been in accordance with their 'fiduciary' duties.

14.3 Unfortunately, 'fiduciary duty' is not a precise concept.

> "in *Bellairs v Hodnett* 1978 1 SA 1109 (A) 1130 it was said: 'Since principles of equity underlie a fiduciary duty we think that the substance of their relationship and not the form in which it was cast must be looked at in order to ascertain its existence, nature, and extent'. In *Howard v Herrigel* supra 678, Goldstone JA said that while a person who accepts appointments as a director becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company and in his dealings on its behalf, the application of this general rule 'to any particular incumbent of the office of director must necessarily depend on the facts and circumstances of each case'. The precise content of a fiduciary's obligations depends on the powers and opportunities that he has: See *Robinson v Randfontein Estates Gold Mining Co Ltd* supra 445. Thus it has been stressed that to describe someone as a fiduciary, without more, is meaningless without further analysis: *Goldcorp Exchange Ltd* 1994 2 All ER 806 (PC).(3)
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> .....
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> Fiduciary relationships to others: It has been held that, as such, directors stand in a fiduciary relation to the company alone. Hence, as such, they owe no fiduciary duties to their company's shareholders individually, or to its creditors, or to its holding company, or to its subsidiary (at least where the subsidiary has an independent board of directors), or, where the company is a member of a group of companies, to the

group as a whole. However, the proposition that directors do not stand in a fiduciary relationship to their company's shareholders individually is no longer free from doubt, for it is accepted that this is a developing area of the law.

Certainly, the office of director does not release a person from what would otherwise be a fiduciary duty. Thus directors may place themselves in a fiduciary relationship to the shareholders individually by acting as agents for them. Furthermore, a fiduciary relationship between directors and shareholders may arise in the special circumstances of the case. Thus it may arise where the company is closely held and participation in the company is premised upon a relationship of mutual confidence and trust. Indeed, in the special circumstances of the case, directors may owe fiduciary duties to the shareholders even when existing powers conferred on the board by the company's articles of association. Of course, the duties arising from such fiduciary relationships depend on the circumstances giving rise to them, and they are inevitably of a more limited nature than those imposed on the directors by virtue of their fiduciary relationships to the company. Usually, they do not more than impose a duty on directors to make full disclosure of all relevant facts concerning the company's affairs when negotiating with the shareholders to purchase their shares.

While *Percival v Wright* has long been regarded as authority for the proposition that directors owe fiduciary duties to their company alone, it has been pointed out that the case is in truth very doubtful authority for that proposition: *Coleman v Myers* 1977 2 NZLR 225 CA (NZ); *Sage Holdings Ltd v The Unisec Group Ltd* 1982 1 SA 337 (W) 366; *Re Chez Nico (Restaurants) Ltd* 1992 BCLC 192 208; *Glandon Pty Ltd v Strata Consolidated Pty Ltd* (1993) 11 ACSR 543 CA (NSW). In *Sage Holdings Ltd v The Unisec Group Ltd* supra 366, Goldstone J expressed the view that *Percival v Wright* supra ought not to be interpreted so widely as to absolve directors from all responsibility towards a buyer or seller of shares when directors themselves trade in those shares"[(4)]

14.4 In England, formulation of the standard of the duty of care owed by a director to the company started to evolve during the latter half of the 19th century. Some of the then leading judgments exonerated directors in circumstances where the assets of companies had been plundered and where investors had been defrauded by the most blatant of lies in prospectuses and the like.

14.5 The meagre standard of care which was required of directors is illustrated by *Re Cardiff Savings Bank* [1892] 2 Ch 100, where an action for damages against the Marquis of

Bute, who was appointed bank president at the age of six months and attended only one meeting of the board in 39 years, was unsuccessful.

14.6 This so-called 'traditional view' of the required standard of care is slowly being replaced by a stricter view of the duties expected of directors.

> "In *Bishopsgate Investment Management Ltd (in liq) v Maxwell* Hoffman LJ suggested, obiter, that the time may now have come for a more objective approach:
>
> [I]n the older cases the duty of a director to participate in the management of a company is stated in very undemanding terms. The law may be evolving in response to changes in public attitudes to corporate governance.... Even so, the existence of a duty to participate must depend upon how the particular business is organised and the part which the director could be reasonably expected to play".(5)

14.7 These 'undemanding terms' referred to by Hoffman LJ are in contrast to the duty of care imposed in other jurisdictions. As an example, the contrast between the standard of care required from directors in the United States and their counterparts in the United Kingdom, is illustrated by **Henn and Alexander:**

> "324. Persons who accept directorships as 'accommodation' or 'dummy' directors, or as sinecures for lending their prestige to boards of directors, are liable for any corporate loses resulting from their passive, as well as active, negligence.
>
> (3). The name 'guinea-pig' was applied to English directors under the older practice of their being paid in guineas. Their function was to add an appearance of respectability to the board by lending it their names or titles. L. Gower, The Principles of Modern Company Law 139, n. 1 (3d ed. 1969).
>
> See 80 Time, No. 14, 96 (Oct. 5, 1962): 'In Britain, where a company's list of directors often reads like a tear sheet from Burke's Peerage, many a titled tycoon sits on more boards than he can count. Lord Boothby, 62, a longtime Tory backbencher who is one of this happy breed himself (he has 'eight or nine' directorships), explained last

> week just what directors do in return for adding prestige to corporate letterheads. 'No effort of any kind is called for', he told an audience of Yorkshire club-women. 'You go to a meeting once a month in a car supplied by the company. You look both grave and sage, and on two occasions say 'I agree," say "I don't think so' once, and if all goes well, you get £1,440 a year. If you have five of them, it is total heaven, like having a permanent hot bath' ".(6)

14.8 Another example is the standard of the duty of care required from directors in California.

> "On its face, the standard of careful conduct is fairly demanding. This is particularly true of the element of prudence or reasonability. For example, in *San Leandro Canning Co. v. Perillo,* the court said that '[the directors] were bound to exercise *that degree of care which men of common prudence* take of their own concerns....' In *Burt v. Irvine Co.*, the court, quoting other authority said:
>
> > 'The rule exempting officers of corporations from liability for mere mistakes and errors of judgment does not apply where the loss is the result of failure to exercise proper care, skill and diligence. 'Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. *They cannot excuse imprudence* on the ground of their ignorance or inexperience, or the honesty of their intentions; and, if they commit an error or judgment through mere recklessness, or *want of ordinary prudence* and skill, the corporation may hold them responsible for the consequences'". [237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 407-08 (1965)] (7)

14.9 Generally speaking, the South African Companies Act is in dire need of modernization. However, it seems that without leadership emanating from UK sources, revision and modernization seldom occur.

14.10 The urgency with which modernization of company law has been approached in jurisdictions such as **Australia, Canada, Hong Kong, New Zealand** and the **United States**, is not discernible in the **United Kingdom** or in **South Africa**.

14.11 A rather unusual illustration of this sense of urgency is the contents of the 'emergency clause' in the **Business Corporation Act** of **Texas** (article 11.0.1).

> "Art. 11.01. Emergency Clause.
>
> A. The fact that existing laws of the State of Texas have been amended from time to time over a period of some seventy (70) years and more without any adoption meanwhile of a complete Act relating to business corporations generally, the provisions of which are consistent with one another; the fact that with so many amendments of the corporation laws applicable to business corporations generally over so many years there have developed many uncertainties in the corporation laws of this State and with the result that there is now an imperative need for clarification of certain provisions of the existing laws; the fact that all of the other states than Texas in which large and important business is transacted have adopted in recent years modern corporation laws and with the result that Texas citizens are increasingly prone to organize their corporate ventures under the laws of other states than the laws of Texas because Texas does not have such a modern act; and the fact that Texas in such connection is losing a substantial volume of corporate enterprise which it should otherwise gain from and after the time that a modern business corporation Act becomes effective in Texas and is losing tax income from *ad valorem taxes,* filing fees and otherwise meanwhile; all such facts create an emergency and public necessity that the Constitutional Rule requiring bills to be read on three separate days in each House be suspended and said Rule is hereby suspended; and require that this Act take effect and be in force from and after the date of its enactment, and it is so enacted".

14.12 The late Professor Gower posed the question whether the **United Kingdom** Company Law which had evolved in the 19th century had adapted itself adequately to the needs of the 20th and the likely challenges of the 21st. He suggested that it had not, and stated that

> "Our system of Company Law was, until recently, the model widely followed in the Common Law countries. That leading role has now been taken over by the United States and we cannot hope to recover it".(8)

14.13 The lack of urgency to revise company law in the United Kingdom and the lack of adaptation to modern needs are illustrated by the century-long debate in the UK as to whether or not the duties of directors and officers of companies should be codified.

— In **1896** the **Davey Committee** recommended that the Companies Act be amended to provide that a director owed a duty to his company to exercise reasonable care and skill, and proposed the following clause:

> "10(2) Every director shall be under an obligation to the company to use reasonable care and prudence in the exercise of his powers, and shall be liable to compensate the company for any damage incurred by reason of neglect to use such care and prudence".

The recommendation was not accepted.

— In **1926** the **Greene Committee** concluded that

> "to attempt by statute to define the duties of directors would be a hopeless task".

— In **1962** the **Jenkins Committee** recommended a non-exhaustive statement of directors' fiduciary duties.

— In **1973** clause 52 was introduced in the Companies Bill to give effect to the recommendation.

"(1) A director of a company shall observe the utmost good faith towards the company in any transaction with it or on its behalf and shall act honestly in the exercise of the powers and the discharge of the duties of his office.

(2) A director of a company shall not make use of any money or other property of the company, or of any information acquired by him by virtue of his position as a director or other officer of the company, to gain directly or indirectly an improper advantage for himself at the expense of the company.

(3) A director of a company who, by any breach of subsection (1) and (2) above, makes a profit or inflicts any damage on the company shall be liable to account to the company for the profit or to compensate it for the damage.

(4) This section is without prejudice to any other provision of the Companies Acts and to any rule of law with respect to the duties or liabilities of directors".

The Bill was not enacted.

– In **1978** codification of directors' duties were once again attempted by the insertion of clauses 44 and 45 in the Companies Bill 1978:

"44. (1) A director of a company shall observe the utmost good faith towards the company in any transaction with it or on its behalf and owes a duty to the company to act honestly in the exercise of the powers and the discharge of the duties of his office.

(2) A director of a company shall not do anything or omit to do anything if the doing of that thing or the omission to do it, as the case may be, gives rise to a conflict, or might reasonably be expected to give rise to a conflict, between his private interests and the duties of his office.

> 45. (1) In the exercise of the powers and the discharge of the duties of his office in circumstances of any description, a director of a company owes a duty to the company to exercise such care and diligence as could reasonably be expected of a reasonably prudent person in circumstances of that description and to exercise such skill as may reasonably be expected of a person of his knowledge and experience.
>
> (2) Subsection (1) above shall have effect instead of the rules of law stating the duties of care and diligence and of skill owed by a director of a company to the company".

The Bill was not enacted.[9]

14.14 In **1998**, in the latest attempt, the **Scottish Law Commission** issued the **Consultation Paper 'Company Directors : Regulating Conflicts of Interests and Formulating a Statement of Duties'.**

14.15 In paragraph 14.8 of the Paper the Commission stated the main advantages of a statutory statement of the director's duty of care to the company —

> "— it makes the law more consistent;
>
> — it makes the law more certain;
>
> — it makes the law more accessible, particularly to lay people : they have less need to have the law mediated for them through professionals;
>
> — it makes the law more comprehensible".

14.16 Unfortunately, the Commission was eventually swayed by the fact that most of the respondents had not been in favour of full

codification and the Commission reported as follows in its Report published in September 1999:

> "The law governing directors' duties is dynamic. It continues to develop. For example, the courts have recently had to determine the duties of a director who has resigned, but who then uses commercial opportunities connected with the company's business for his own benefit. They have also considered the duties which directors owe when there are groups or classes of shareholders whose interests conflict. We expect that the law will need to continue to evolve incrementally as circumstances require. The commercial context is constantly changing. It is important that the law retains the capacity to develop".

It proceeded to recommend that —

> "(1) there should be a statutory statement of a director's main fiduciary duties and his duty of care and skill, being those duties which are set out in Appendix A;
>
> (3) the statement should so far as possible be drafted in broad and general language as in Appendix A; and
>
> (4) it should not be exhaustive i.e. it should state that a director is subject to other duties which have not been codified.
>
> We recommend that Forms 10(2) and 288a should contain the statutory statement of duties and that when a director signs the Forms he should acknowledge that he has read this statement".

Appendix A reads as follows:

> "**General**
>
> (1) The law imposes duties on directors. If a person does not comply with his duties as a director he may be liable to civil or criminal proceedings and he may be disqualified from acting as a director.

(2) Set out below there is a summary of the main duties of a director to his company. It is not a complete statement of a director's duties, and the law may change anyway. If a person is not clear about his duties as a director in any situation he should seek advice.

Loyalty

(3) A director must act in good faith in what he considers to be the interests of the company.

Obedience

(4) A director must act in accordance with the company's constitution (such as the articles of association) and must exercise his powers only for the purposes allowed by law.

No secret profits

(5) A director must not use the company's property, information or opportunities for his own or anyone else's benefit unless he is allowed to by the company's constitution or the use has been disclosed to the company in general meeting and the company has consented to it.

Independence

(6) A director must not agree to restrict his power to exercise an independent judgment.. But if he considers in good faith that it is in the interests of the company for a transaction to be entered into and carried into effect, he may restrict his power to exercise an independent judgment by agreeing to act in a particular way to achieve this.

Conflict of interest

(7) If there is a conflict between an interest or duty of a director and an interest of the company in any transaction, he must account to the company for any benefit he receives from the transaction. This applies

whether or not the company sets aside the transaction. But he does not have to account for the benefit if he is allowed to have the interest or duty by the company's constitution or the interest or duty has been disclosed to and approved by the company in general.

Care, skill and diligence

(8) A director owes the company a duty to exercise the care, skill and diligence which would be exercised in the same circumstances by a reasonable person having both —

(a) the knowledge and experience that may reasonably be expected of a person in the same position as the director, and

(b) the knowledge and experience which the director has.

Interests of employees etc.

(9) A director must have regard to the interests of the company's employees in general and its members.

Fairness

(10) A director must act fairly as between different members.

Effect of this statement

(11) The law stating the duties of directors is not affected by this statement or by the fact that, by signing this document, a director acknowledges that he has read the statement".

14.17 The reasonable and logical response to the Consultation Paper by the international accountants KPMG remained unanswered.

"They asked how directors and others are expected to understand and comply with the law if experts could not reach agreement about it".

14.18 Whilst the **United Kingdom** has been procrastinating for more than a 100 years, numerous countries and numerous States of the USA have codified or have partly codified the duties of their directors.

14.19 Some of these countries are —

Antigua
Argentina
Australia
Austria
Bahama Islands
Barbados
Bermuda
Bolivia
Brazil
British Virgin Islands
Canada
Chile
Costa Rica
Ethiopia
Germany
Grenada
Ghana
Guatemala
Guyana
Honduras
Italy
Japan
Jersey
Liberia
Malaysia
Mauritius
Nauru
New Zealand
Peru
Puerto Rico
Seychelles
Singapore
Spain
Switzerland
St Christopher & Nevis
St Lucia
St Vincent & Grenadines
Western Samoa
Yugoslavia

14.20 The formulation adopted by thirteen of these countries is that of **Canada**.

Antigua (s. 97)
Bahamas (s. 86)
Barbados (s. 95)
Bermuda (s. 97)
British Virgin Islands (s. 54)
Canada (s. 122)
Grenada (s. 54)
Guyana (s. 96)
Jersey (s. 74)
Mauritius (s. 112)
St Christopher & Nevis (s. 74)
St Lucia (s. 97)
St Vincent & Grenadines (s. 97)

"**Canada** s.122(1)

Every director and officer of a corporation in exercising his powers and discharging his duties shall -

act honestly and in good faith with a view to the best interests of the corporation; and

exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

14.21 Following **section 309** of the Companies Act of the **United Kingdom, Antigua**, **Barbados, Guyana, St Lucia** and **St Vincent & Grenadines**, require directors, in determining what the best interests of the corporation are, to have regard to

"Antigua s.97

(2) ..... the interests of the company's employees in general as well as to the interests of its shareholders;

(3) The duty imposed by subsection (2) on the directors of a company is owed by them to the company alone; and the duty is enforceable in the same way as any other fiduciary duty owed to a company by its directors"

St Lucia, with the additional rider —(section 97(2))

'except that the interests of its shareholders shall in all cases prevail'.

14.22 Section 309 of the Companies Act of the **United Kingdom** reads as follows:

"Directors to have regard to interests of employees (Companies Act 1985)

(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.

(2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

(3) This section applies to shadow directors as it does to directors".

14.23 Many **States** of the **USA** have chosen expressions such as '**good faith**', '**in the best interests of the corporation**', '**care**' of '**an ordinary prudent person** and **'business judgment**'.

Alabama (10-2B-1.010)
Alaska (614)
Arizona (10-38-30)
Arkansas (4-27-30)
California (309)
Colorado (7-108-401)
Connecticut (33-756)

"**General standards for directors**.

A director shall discharge his or her duties as a director, including duties as a member of a committee:

(1) In good faith;

With the care an ordinarily prudent person in a like position would

Florida (607.0830)

Georgia (14.2.8.30)

Idaho (30-1-830)

Indiana (23-1-35-1) [10]

Iowa (490.830)

Kentucky (271B.8-300)

Maine (13-A-716)

Michigan (450-1541)

Minnesota (302A.251)

Mississippi (79-4-8-30)

Nevada (78.138)

New Hampshire (293-A18.42)

New Jersey (14A:6-14)

New Mexico (53-11.35)

New York State (717)

North Carolina (55.8.30)

Ohio (1701.59)

Oregon (60.357)

Pennsylvania (15.1712)

Rhode Island (7-1-1-33)

South Carolina (33-9-300)

Tennessee (14-18-30)

Utah (16-10a-840)

Vermont (8.30)

Virginia (13.1.60)

Washington (23B.08.420)

Wyoming (17-16-830)

exercise under similar circumstances; and

In a manner the director believes to be in the best interests of the corporation.

In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters;

Legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

A committee of the board of directors of which he or she is not a member if the director reasonably believes the committee merits confidence.

A director is not acting in good faith if he or she has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

A director is not liable for any action taken as a director, or any failure to take any action, if the director performed the duties of his or her office in compliance with this section. (**Alabama**)

14.24 In addition, **Connecticut** requires a director to consider -

"....in determining what (he) reasonably believes to be in the best interests of the corporation,

(1) the long-term as well as the short-term interests of the corporation,

(2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation,

(3) the interests of the corporation's employees, customers, creditors and suppliers, and

(4) community and societal considerations including those of any community in which any office or other facility of the corporation is located.

A director may also in his discretion consider any other factors he reasonably considers appropriate in determining what he reasonably believes to be in the best interests of the corporation".

14.25 In States such as **Florida, Minnesota, Mississippi, New Jersey, New York State, Ohio, Vermont** and **Wisconsin** a director -

".....**may** consider such factors as the director deems relevant, including the long-term prospects and interests of the corporation and its shareholders, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the corporation or its subsidiaries, the communities and society in which the corporation or its subsidiaries operate, and the economy of the state and the nation".(**Florida**)

"In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director **shall be entitled** to consider, without limitation,

(1) both the long-term and the short-term interests of the corporation and its shareholders and

(2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

(i) the prospects for potential growth, development, productivity and profitability of the corporation;

(ii) the corporation's current employees;

(iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;

(iv) the corporation's customers and creditors; and

(v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions." (sec. 717) (**New York State**)

14.26 In **Indiana**

"(d) A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers. and customers of the corporation, and communities in

which offices or other facilities of the corporation are located, and any other factors the director considers pertinent".(10)

14.27 Some countries use the words '**diligence**', '**loyalty**' and '**prudence**'.

Argentina	(s. 59)	"59. Administrators and representa-
Bolivia	(s. 164)	tives must perform their duties (act)
Peru	(s. 171)	with loyalty and with the diligence
Spain	(s. 127)	of good businessmen (diligence, prudence and loyalty)".

14.28 '**Honesty**' and '**reasonable diligence**' are used in the **Pacific Rim**.

Malaysia	(s. 132)	"132(1) A director shall at all times
Nauru	(s. 109)	act honestly and use reasonable
Singapore	(s. 157)	diligence in the discharge of the duties of his office.
		(5) This section is in addition to and not in derogation of any other written law or rule of law relating to the duty or liability of directors or officers of a company".

14.29 Requirements in some other jurisdictions are

Australia	(s. 180)	'....with the degree of care and diligence that a reasonable person would exercise if they:

		(a) were a director or officer of a corporation in the corporation's circumstances; and (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer'.
Austria		'skill and care of a conscientious manager'
Brazil	(s. 153)	'the care and diligence which an honest man usually employs in the administration of his own affairs'
Chili	(s. 41)	'care and diligence which men ordinarily employ' (in their own affairs)
Costa Rica	(s. 189)	'with the diligence of a mandate'
Ethiopia	(s. 364)	'care due from an agent', 'due care and diligence'
Germany	(s. 93 & 116)	'sound and conscientious business manager'
Ghana	(s. 203)	'fiduciary relationship, utmost good faith, faithful, diligent, careful and ordinarily skilful director'
Honduras	(s. 222)	'with the care demanded of a regular and prudent mercantile administration'
Italy	(s. 1710 & 2392)	'with the diligence of a bonus pater familias'

Japan	(s. 254 – 2)	'faithfully in the interests of the corporation'
Liberia	(s. 6.14)	'in good faith and with that degree of care which an ordinary person in a like position would use under similar circumstances'
New Zealand	(s. 131 & 133)	'in good faith', 'in what the director believes to be the best interests of the company' and 'for a proper purpose'
		"A director of a company that is a wholly-owned subsidiary (or a subsidiary not wholly-owned [subsection 3]) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company".
Puerto Rico	(s. 2.03)	'prudent management'
Seychelles	(s.173)	'in good faith in what they reasonably consider to be the interests of the shareholders of the company as a whole'
Switzerland	(s. 717)	'with all necessary diligence and shall faithfully watch over all the interests of the company'

Western Samoa (s. 89) 'for a proper purpose honestly in what he believes are in the best interests of the international company'

Yugoslavia (s. 22.8) 'shall exercise a good manager's care'.

14.30 Section 180 of the Corporations Law of **Australia** reads as follows:

"Care and diligence – directors and other officers

(1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they

(a) were a director or officer of a corporation in the corporation's circumstances; and

(b) occupied the office held by, and had the same responsibilities within the corporation as, the director officer.

Business judgment rule

(2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

(a) make the judgment in good faith for a proper purpose; and

(b) do not have a material personal interest in the subject matter of the judgment

(c) inform themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate; and

(d) rationally believe that the judgment is in the best interests of the corporation.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is on that no reasonable person in their position would hold.

(3) In this section:
business judgment means any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation'.

14.31 Section 189 reads as follows:

"Reliance on information or advice provided by others

If: (a) a director relies on information, or professional or expert advice, given or prepared by:

(i) an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or

(ii) a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence; or

(iii) another director or officer in relation to matters within the director's or officer's authority; or

(iv) a committee of directors on which the director did not serve in relation to matters within the committee's authority; and

(b) the reliance was made:

(i) in good faith; and

(ii) after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations sof the corporation; and

(c) the reasonableness of the director's reliance on the information or advice arises in proceedings brought to determine whether a director has performed a duty under this Part or an equivalent general law duty;

the director's reliance on the information or advice is taken to be reasonable unless the contrary is proved".

14.32 The Consultancy Report by **Professor Cally Jordan** on the **'Review of the Hong Kong Companies Ordinance'** (March 1997) recommended as follows:

"There should be a statutory statement of directors' duties to act honestly and in the best interests of the company and to exercise the care, diligence and skill that a reasonably prudent person would. These duties should also be made applicable to those corporate officers appointed by the board".

14.33 The commentary on this recommendation is set out in the notes hereto.[11]

14.34 Codification of the duties of directors will

— bring South African company law in line with modern trends;

— eliminate the imprecise 'fiduciary' concept;

— assist directors to appreciate the responsibilities they have to assume;

— assist investors and other stakeholders when maladministration occurs.

14.35 It is recommended that the duties of directors should be codified as follows:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve,

(i) Honestly and in good faith;

(ii) With such reasonable skill, diligence and care, including reasonable inquiry, as a reasonably prudent person in a like position would exercise under similar circumstances; and

(iii) In a manner the director believes to be in the best interests of the company.

(b) A director must act fairly as between different members and between different classes of members.

(c) (i) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general and the interests of its creditors.

(ii) The duties imposed by this subsection on the directors of a company are` owed by them to the company alone.

(d) In discharging his or her duties, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(i) One or more officers or employees of the company whom the director reasonably believes to be reliable and competent in such matters;

(ii) Professional advisers or other experts as to matters the director reasonably believes are within the person's professional or expert competence;

(iii) A committee of the board of directors of which he or she is not a member if the director reasonably believes the committee merits confidence.

(e) **A director is not acting in good faith if he or she has knowledge concerning the matter in question which makes reliance otherwise permitted by subsection (c) unwarranted.**

(f) **(i)** **A former director who has confidential information regarding the business affairs of the company which has come to his knowledge or has been divulged to him during his tenure as director shall not use such information to the detriment of the company.**

(ii) **Such former director shall not disclose such information directly or indirectly to another person knowing or having reasonable cause to believe that such other person will use or cause such information to be used to the detriment of the company.**

NOTES

1. **See** Chapter 2.

2. **In the South African Banks Act**, No. 94 of 1990, a partial codification of the duties of directors of banks has been attempted. It reads as follows:

"**60. Directors of bank or controlling company. —**

(1) Each director of a bank or controlling company shall stand in a fiduciary relationship to the bank or controlling company, as the case may be, of which he is a director (date of commencement 9 August, 1991)..

(2) Without derogating from the generality of the expression 'fiduciary relationship' in subsection (1), the provisions of that subsection imply that a director —

(a) shall, in relation to the bank or controlling company of which he is a director, act honestly and in good faith and, in particular, shall exercise such powers as he may have to manage or represent the bank or controlling company, exclusively in the best interests and for the benefit of the bank and its depositors or of the controlling company, as the case may be; and

(b) shall, in performance of his functions as director of such bank or controlling company, observe such guide-lines and comply with such requirements as may be prescribed under section 90(1)(*b*)"

The Close Corporation Act, No. 69 of 1984, reads as follows:

"42. Fiduciary position of members.—

(1) Each member of a corporation shall stand in a fiduciary relationship to the corporation.

(2) Without prejudice to the generality of the expression 'fiduciary relationship', the provisions of subsection (1) imply that a member —

(a) shall in relation to the corporation act honestly and in good faith, and in particular —

(i) shall exercise such powers as he may have to manage or represent the corporation in the interest and for the benefit of the corporation; and

(ii) shall not act without or exceed the powers aforesaid; and

(b) shall avoid any material conflict between his own interests and those of the corporation, and in particular —

(i) shall not derive any personal economic benefit to which he is not entitled by reason of his membership of or service to the corporation, from the corporation or from any other person in circumstances where that benefit is obtained in conflict with the interests of the corporation;

(ii) shall notify every other member, at the earliest opportunity practicable in the circumstances, of the nature and extent of any direct or indirect material interest which he may have in any contract of the corporation; and

(iii) shall not compete in any way with the corporation in its business activities".

3. **Lawsa** First Reissue.Vol. 4. Part 2, par 116, Note 2. (Butterworths Durban 1996).

4. **Ibid. :** par. 119 and Note 7.

5. **See** also **The Scottish Law Commission**. Consultation Paper : p. 257 – 258.

"In the same vein, a director who failed to attend relevant board meetings, and whose credentials were those of a 'country gentleman not a skilled accountant', was held not

liable for recommending payment of a dividend from capital. In *Re Brazilian Rubber Plantations and Estates Ltd*, Neville J held that a director was

> not bound to bring any special qualifications to his office and may undertake the management of a rubber company in complete ignorance of everything connected with rubber without incurring responsibility for the mistakes which may result from such ignorance.

Re Brazilian Rubber also laid down that if a director did bring special expertise to his office, he was bound to give the company the advantage of it and would be judged accordingly. The position on general business experience was less clear. Some cases seem to have required that a director exercise his judgment, at such board meetings as he did attend, 'as a man of business'. Others, however, required only that he exercise the skill and care of an ordinary prudent man notwithstanding other business experience.

The traditional line culminated in the case of *Re City Equitable Fire Insurance Co* where Romer J, while recognising that the authorities were not entirely clear, reviewed and summarised them. He held that:

> (1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person with his knowledge and experience.... It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment. (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings...He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so. (3) In respect of all duties that, having regard to the exigencies of a business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly".

6. **Henn, Harry G.** and **Alexander, John R.** : 'Laws of Corporations and Other Business Enterprises', 3rd ed., p. 621 (West Publishing Co., St Paul Minn. 1983).

7. **California** Law Revision Commission. Recommendation — Business Judgment Rule, p. 39. (January 1998).

8. **Gower's** Principles of Modern Company Law : 5th ed., p. 70. (Sweet & Maxwell, London, 1992).

9. **The** Scottish Law Commission. **Ob. cit.** : p. 265 – 272.

10. **Chapter 35** of the Indiana Code reads as follows:

"Sec. 1. (a) A director shall, based on facts then known to the director, discharge the duties as a director, including the director's duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner the director reasonably believes to be in the best interests of the corporation.

(b) In discharging the director's duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one (1) or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

….

(4) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent.

(e) A director is not liable for any action taken as a director, or any failure to take any action, unless:

(1) the director has breached or failed to perform the duties of the director's office in compliance with this section; and

(2) the breach or failure to perform constitutes willful misconduct or recklessness.

(f) In enacting this article, the general assembly established corporate governance rules for Indiana corporations, including in this chapter, the standards of conduct applicable to directors of Indiana corporations, and the corporate constituent groups and interests that a director may take into account in exercising the director's business judgment. The general assembly intends to reaffirm certain of these corporate governance rules to ensure that the directors of Indiana corporations, in exercising their business judgment, are not required to approve a proposed corporate action if the directors in good faith determine, after considering and weighing as they deem appropriate the effects of such action on the corporation's constituents, that such action is not in the best interests of the corporation. In making such determination, directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor. Without limiting the generality of the foregoing, directors are not required to render inapplicable any of the provisions of IC 23-1-43, to redeem any rights

under or to render inapplicable a shareholder rights plan puruant to IC 23-1-26-5, or to take or decline to take any other action under this article, solely because of the effect such action might have on a proposed acquisition of control of the corporation or the amounts that might be paid to shareholders under such an acquisition. Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article. Therefore, the general assembly intends:

(1) to reaffirm that this section allows directors the full discretion to weigh the factors enumerated in subsection (d) as they deem appropriate; and

(2) to protect both directors and the validity of corporate action taken by them in the good faith exercise of their business judgment after reasonable investigation.

(g) In taking or declining to take any action, or in making or declining to make any recommendation to the shareholders of the corporation with respect to any matter, a board of directors may, in its discretion, consider both the short term and long term best interests of the corporation, taking into account, and weighing as the directors deem appropriate, the effects thereof on the corporation's shareholders and other corporate constituent groups and interests listed or described in subsection (d), as well as any other factors deemed pertinent by the directors under subsection (d). If a determination is made with respect to the foregoing with the approval of a majority of the disinterested directors of the board of directors, that determination shall conclusively be

presumed to be valid unless it can be demonstrated that the determination was not made in good faith after reasonable investigation".

11. **"COMMENTARY:** A statutory statement of directors' duties would have the beneficial effect of clearly setting out the standard against which actions by directors would be measured. As in other jurisdictions, there is no doubt that the long history in the case law would continue to inform the statutory language, but the statutory standard would prevail. The duties incumbent upon company directors are the product of along evolution at common law; their development was also influenced by certain equitable notions. Directors' duties may be classified into two categories: fiduciary duties and the duty of care and skill. Directors' fiduciary duties represent Equity's most significant contribution to company law; they place the directors under a fiduciary obligation to act in the best interests of the company, not to abuse or fetter their powers, and not to place themselves in situations of conflict of interest.

At common law, the duty of care incumbent upon directors was anything but onerous; in *Re Brazilian Rubber Plantations and Estates Ltd.,* Neville J. said the following:

> 'A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance; while if he is acquainted with the rubber business he must give the company the advantage of his knowledge when transacting the company's business. He is not, I think, bound to take any definite part in the conduct of the company's business, but so far as he does undertake it he must use reasonable care in its despatch.
>
> Such reasonable care must, I think, be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf. He is clearly, I think, not responsible for

> damages occasioned by errors in judgment...(*Re Brazilian Rubber Plantations and Estates*, [1911] Ch. 425 (C.A.) at 437)'.

The duty of care as it has evolved in the case law is derived from a gross negligence standard.

In counterbalance to this very low standard of care (and partly due to the historical development of the company where directors were originally seen as true trustees or fiduciaries), fiduciary duties have been imposed on directors. Initially the fiduciary duties imposed by the courts were quite strict, in keeping with the view that directors were in fact trustees. With time, and in the interests of the promotion of commerce and risk-taking enterprises, these strict fiduciary duties were relaxed by the courts. A more modern view of these new fiduciary-like duties would include some or all of the following:

- to act in good faith
- not to fetter their discretion (such as agreeing to vote in a certain way in future)
- to avoid conflicts of interest (such as interested director transactions)
- not to misuse corporate property, information, or opportunities
- not to compete with the company.

There are various statutory formulations of directors' duties but all are derived from the standard of care (essentially a negligence standard) and the fiduciary duty attributed to directors by the courts. Such formulations have become the accepted norm in company statutes. Delaware is a notable exception, relying instead on its highly specialed judiciary to formulate the standards. Until recently, it seemed that the United Kingdom was moving in the direction of statutory standards. According to the U.K. Department of Trade and Industry working group on Directors Duties, there was 'support emerging for the codification of directors' duties similar to the approach adopted in other Commonwealth countries. The DTI favours a reduced Part X coupled with a

'statement of directors' duties' (Great Britain, Department of Trade and Industry, *DTI's Programme for the Reform of Company Laws – Progress Report I* (London: Department of Trade and Industry, 11 June 1996)). A subsequent Progress Report (October 1996) indicates, however, that such an initiative has been again derailed.

The U.K. Jenkins Committee, in 1962, considered that a general statement of the basic principles underlying the fiduciary relationship of directors towards their companies would be useful to directors and others concerned with company management. The Second Report in Hong Kong in 1973 agreed and so recommended. The SCCLR has also so recommended. Efforts were made to develop a statutory formulation of directors' fiduciary duties in Hong Kong, the most recent being the Companies (Amendment) Bill 1991. The Bill was not enacted due to objections expressed in particular by the Law Society. The Law Society was of the view (among other things) that any attempt to draft a statutory formulation of directors' fiduciary duties would be incomplete and that it was better to continue with the present system where a director should consult his professional advisors whenever a question involving his fiduciary duties to the company arose. When the Bill was withdrawn, the Government encouraged the private sector to draft guidelines to better inform directors of their duties. In 1995 the Hong Kong branch of the Institute of Directors published *Guidelines for Directors* which was, in part, intended to be responsive to the need for some private sector guidelines. Of special interest in this area is the SEHK Listing Rules' Formulation of directors' duties, which demonstrates its affinity to modern statutory formulations. This is a measure which is long overdue and upon which there was considerable consensus in the working party.

There are several issues associated with the statutory formulation of directors' duties. Under the 'negligence' branch (the duty to act with care, diligence and skill), the issues are primarily the level of diligence required and the degree of objectivity of the test. There appears to be a fairly general consensus that the 'gross negligence' standard of the common law is too low and that the test should be an objective one, to this extent displacing the case law. On the other hand, setting too high a standard has been resisted on several grounds: commercial expediency and the ability to attract good business people to fill

directorships. So that although serious consideration has been given to setting a 'professional' standard and in fact encouraging the development of a professional class of directors, these efforts have not materialised. The MBCA rejects the notion of raising the standard to that of professional expertise.

> The reference to 'ordinarily prudent person' embodies long traditions of the common law, in contrast to suggested standards that might call for some undefined degree of expertise, like 'ordinarily prudent businessman'. The phrase recognizes the need for innovation, essential to profit orientation, and focuses on the basic director attributes of common sense, practical wisdom, and informed judgment (MBCA, Official Comment, s.8.30 (a)).

As for the fiduciary branch of directors' duties, the main issues are the breadth of the duty owed, by whom and to whom it is owed (e.g. does it encompass individual or groups of shareholders). There is little quarrel with requiring directors to act honestly, in good faith and in the best interests of the company. Obvious issues of conflict of interests (which under traditional fiduciary standards are dealt with strictly) or duties to a third person may be addressed separately in the legislation. Although it does appear in the New Zealand legislation, care should be taken not to import the 'proper purpose' test into the standards. The 'proper purpose' test was not recommended by the New Zealand Law Commission but included in the resulting legislation at the behest of Parliament. The Law Commission in New Zealand correctly noted that the 'concept of proper purpose was originally derived from the case law on powers and today arguably there is a lack of underpinning objects against which powers could be assessed. On the other hand, recent cases seem to use 'proper purpose' to impose an objective standard where the good faith of directors is accepted' (NZLRC 9, at 119). A proper purpose test is unnecessary given the statutory statement of directors' duties proposed.

Corporate officers are included in the U.S. and Canadian formulation of both branches of the duties, in recognition of the commercial reality of managerial responsibilities. The MBCA makes the duties applicable to corporate officers with 'discretionary authority'. This recommendation suggests applying the standards to those corporate officers appointed directly by the board of

directors. Where most executive officers are also directors, as is often the case in Hong Kong, there would, in fact, be no extension of duties and liabilities.

In connection with the statutory formulation of directors' duties in the United States, there has been a recent flurry of so-called 'stakeholder' or 'constituency' statutes. These statutes widen the range of factors directors may consider in making decisions to include interests such as those of employees, suppliers, customers, the community in which the corporation is situated, and, in some cases, all other 'pertinent factors'. By 1995, twenty-nine states had enacted such provisions. However, of these, only one, Connecticut, had made these considerations mandatory; the others were worded in a permissive fashion.

The stakeholder statutes were not designed to widen the range of persons to whom directors owe fiduciary duties; none permit any of the mentioned classes to take action if boards fail to consider their interests. Rather than to cause a sea of change in corporate decision-making, these statutes were actually intended, as transcripts from state legislatures reveal, to be anti-takeover defences; in the event that none of the other legislative or corporate anti-takeover defences prevail, directors can always cite constituency concerns as reason for rejecting a hostile bid. They may also have reduced directors' potential fiduciary liability. There has been little litigation over these provisions and their effect on American corporate law has been non-existent for all practical purposes. For these reasons, stakeholder or constituency provisions are not being recommended; they are not relevant or appropriate in the Hong Kong context".

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

CAPE TOWN
APRIL 2001

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CHAPTER 15 - THE DISSENTER AND DERIVATIVE ACTIONS

15.1 With clearly defined duties of directors and with prior inspection of records, the dissenter, derivative, and class actions available to the American investor fall into place. The dissenter's British or South African counterparts have no access to minutes of meetings of directors or to the financial records of the company, and can only make educated guesses before embarking on perilous litigation.

15.2 In general, in the **USA** a shareholder who is entitled to vote on a proposed consummation of a plan of merger, share exchange, the sale or exchange of all or substantially all of the property of the corporation other than in its usual and regular course of business or on a proposed amendment to the articles of incorporation which would adversely affect the rights of the shareholder, is entitled to dissent from such proposed action and obtain payment of the fair value of the shares.

15.3 When proposing to take any such action as set out above, the corporation is required to notify shareholders of their rights to dissent , and if notified by shareholders of their intention to dissent, has to pay or offer to pay each dissenter the amount which the corporation estimates the fair value of the shares to be, plus accrued interest.

15.4 As an example, in **South Carolina** (sec. 33-13-250) the payment has to be accompanied by an income statement, a balance sheet and

> "a statement of the corporation's estimate of the fair value of the shares and **an explanation of how the fair value was calculated**".

15.5 Section 33-13-250 reads as follows:

> **"250.** Payment.
>
> (a) Except as provided in Section 33-13-270, as soon as the proposed corporate action is taken, or upon receipt of a payment demand, the corporation shall pay each dissenter who substantially complied with Section 33-13-230 the amount the corporation estimates to be the fair value of his shares, plus accrued interest.
>
> (b) The payment must be accompanied by :
>
> (1) the corporation's balance sheet as of the end of a fiscal year ending not more than sixteen months before the date of payment, an income statement for that year, a statement of changes in shareholders' equity for that year, and the latest available interim financial statements, if any;
>
> (2) a statement of the corporation's estimate of the fair value of the shares and an explanation of how the fair value was calculated;
>
> (3) an explanation of how the interest was calculated;
>
> (4) a statement of the dissenters right to demand additional payment under Section 33-13-280; and
>
> (5) a copy of this chapter".

15.6 If the dissenter requires an additional payment and notifies the corporation accordingly, the corporation usually has to approach the Court for a judicial appraisal of the fair value of the shares.(1)

15.7 Costs pertaining to the judicial appraisal are generally borne by the corporation and are only awarded against the dissenting shareholder if the Court finds that the shareholder has acted arbitrarily, vexatiously or not in good faith.

15.8 Sections 33-13-280, 300 and 310 read as follows:

> **"280.** Procedure if shareholder dissatisfied with payment or offer.
>
> (a) A dissenter may notify the corporation in writing of his own estimate of the fair value of his shares and amount of interest due and demand payment of his estimate (less any payment under Section 33-13-250) or reject the corporation's offer under Section 33-13-270 and demand payment of the fair value of his shares and interest due, if the:
>
> (1) dissenter believes that the amount paid under Section 33-13-250 or offered under Section 33-13-270 is less than the fair value of his shares or that the interest due is calculated incorrectly;
>
> (2) corporation fails to make payment under Section 33-13-250 or to offer payment under Section 33-13-270 within sixty days after the date set for demanding payment; or
>
> (3) corporation, having failed to take the proposed action, does not return the deposited certificates or release the transfer restrictions imposed on uncertificated shares within sixty days after the date set for demanding payment.
>
> **300.** Court action.

(a) If a demand for additional payment under Section 33-13-280 remains unsettled, the corporation shall commence a proceeding within sixty days after receiving the demand for additional payment and petition the court to determine the fair value of the shares and accrued interest. If the corporation does not commence the proceeding within the sixty-day period, it shall pay each dissenter whose demand remains unsettled the amount demanded.

(b) .....

(c) The corporation shall make all dissenters (whether or not residents of this State) whose demands remain unsettled parties to the proceeding as in an action against their shares and all parties must be served with a copy of the petition. Non-residents may be served by registered or certified mail or by publication, as provided by law.

(d) The jurisdiction of the court in which the proceeding is commenced under subsection (b) is plenary and exclusive. The court may appoint persons as appraisers to receive evidence and recommend decisions on the question of fair value. The appraisers have the powers described in the order appointing them or in any amendment to it. The dissenters are entitled to the same discovery rights as parties in other civil proceedings.

310. Court costs and counsel fees.

(a) The court in an appraisal proceeding commenced under Section 33-13-300 shall determine all costs of the proceeding, including the reasonable compensation and expenses of appraisers appointed by the court. The court shall assess the costs against the corporation, except that the court may assess costs against all or some of the dissenters, in amounts the court finds equitable, to the extent the court finds the dissenters acted arbitrarily, vexatiously, or not in good faith in demanding payment under Section 33-13-280".

15.9 Fletcher states the historical background of the dissenter action as follows:

> "At common law unanimous shareholder consent was a prerequisite to fundamental changes in the corporation, thereby making it possible for an arbitrary minority to establish a nuisance value for its shares by refusal to cooperate, and to meet this situation legislatures authorized the making of changes by a majority vote, but this opened the door to victimization of the minority, and therefore to solve this dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares have been widely adopted".(2)

15.10 Fletcher also states that under the 'market exception' some jurisdictions provide that dissenters rights will generally not be available if the shares are listed on a national securities exchange as the shares can be disposed of in an available market.

Whatever the reasons might have been for such exclusion in those jurisdictions, a similar rule should not apply in South Africa.

In the United States shareholders are generally entitled to inspect the records of corporations and the listing requirements of exchanges and the surveillance by regulators are far superior to those in South Africa.

15.11 In contrast, in **South Africa** and the **United Kingdom** dissenters have little, if any, chance to protect their interests.

15.12 As an example, in South Africa in a take-over situation where ninety percent of the holders of shares not already held by the offeror have accepted the offer, the remaining ten percent, if dissatisfied, have the onus to affirmatively establish that the offer is unfair (Section 321).

As the South African dissenter has no access to the books and records of the company, it is virtually impossible to establish whether the offer is fair or unfair.

15.13 In the **United Kingdom** the derivative action is still largely ruled by the dead hand of **Foss** v **Harbottle** (**1843**) 2 Hare 461, a decision which even preceded the first ever general companies act, the **Joint Stock Companies Act** of 1844.

15.14 The late **Professor Gower** said the following (p 610):

> "And fourthly he [Knox, J.] said that he believed 'it would be helpful for there to be specific procedures laid down, whether by way of rules of court or a practice direction.....for the initiative and prosecution of actions by minority shareholders to recover on behalf of a company'. It would indeed; and some of us have been pleading for this for years. But all our pleas — and so far, those of Knox J. — seem to have fallen on deaf ears. The absence of any specific procedural rules (notwithstanding the recognition, at least for the past 16 years that derivative actions are a discrete class of action) is scandalous. One gets the impression that the Bench as a whole likes the Foss v. Harbottle rule so much and derivative actions so little that it is reluctant to recognise any exceptions to the rule when the plaintiff seeks derivative relief (as opposed to personal relief against infringement of personal rights). This is a tenable view for, in the light of the recent cases it can hardly be denied that the derivative action as practised in the United Kingdom is thoroughly unsatisfactory and probably incapable of being made satisfactory short of root-and-branch reforms, of which there seems to be little hope. On the other hand, some remedy is needed, for it cannot be satisfactory that controllers should be able to get away with blue murder". (3)

15.15 This should also be contrasted with the commendable practical approach of the American corporation laws. An example of this

approach can be seen in the **Business Corporation Code** of **Georgia** (following the Model Business Corporation Act).

(Section 14 – 2 - 740 – 746 & 831):

"**14 – 2 – 740**

As used in this part, the term:

(1) 'Derivative proceeding' means a civil suit in the right of a domestic corporation or, to the extent provided in Code Section 14 – 2 – 747, in the right of a foreign corporation.

(2) 'Shareholder' includes a beneficial owner whose shares are held in a voting trust or held by a nominee on the owner's behalf.

14 – 2 – 741

A shareholder may not commence or maintain a derivative proceeding unless the shareholder:

(1) Was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time; and

(2) Fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

14 - 2 – 742

A shareholder may not commence a derivative proceeding until:

(1) A written demand has been made upon the corporation to take suitable action; and

(2) Ninety days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90 day period.

14 – 2 – 743

If the corporation commences an inquiry into the allegations made in the demand or complaint, the court may stay any derivative proceeding for such period as the court deems appropriate.

14 – 2 - 744

(a) The court may dismiss a derivative proceeding if, on motion by the corporation, the court finds that one of the groups specified in subsection (b) of this Code section has made a determination in good faith after conducting a reasonable investigation upon which its conclusions are based that the maintenance of the derivative suit is not in the best interests of the corporation. The corporation shall have the burden of proving the independence and good faith of the group making the determination and the reasonableness of the investigation.

(b) The determination in subsection (a) of this Code section shall be made by:

(1) A majority vote of independent directors present at a meeting of the board of directors if the independent directors constitute a quorum;

(2) A majority vote of a committee consisting of two or more independent directors appointed by a majority vote of independent directors present at a meeting of the board of directors, whether or not such independent directors constitute a quorum; or

(3) A panel of one or more independent persons appointed by the court upon motion by the corporation.

(c) None of the following shall by itself cause a director to be considered not independent for purposes of subsection (b) of this Code section:

(1) The nomination or election of the director by directors who are not independent;

(2) The naming of the director as a defendant in the derivative proceeding; or

(3) The fact that the director approved the action being challenged in the derivative proceeding so long as the director did not receive a personal benefit as a result of the action.

14 – 2 – 745.

A derivative proceeding may not be discontinued or settled without the court's approval. If the court determines that a proposed discontinuance or settlement will substantially affect the interests of the corporation's shareholders or a class of shareholders, the court shall direct that notice be given to the shareholders affected.

14 – 2 – 746.

On termination of the derivative proceeding the court may:

(1) Order the corporation to pay the plaintiff's reasonable expenses (including attorneys' fees) incurred in the proceeding if it finds that the proceeding has resulted in a substantial benefit to the corporation; or

(2) Order the plaintiff to pay any defendant's reasonable expenses (including attorneys' fees) incurred in defending the proceeding if it finds that the proceeding was commenced or maintained without reasonable cause or for an improper purpose.

14 – 2 – 831.

(a) A derivative proceeding, as defined in subsection (a) of Code Section 14 – 2 – 740, may be brought by a shareholder, or an action may be brought by the corporation, against one or more directors or officers of the corporation to procure for the benefit of the corporation a judgment for the following relief:

(1) To compel the defendant to account for official conduct or to decree any other relief called for by his official conduct in the following cases:

(A) The neglect of, failure to perform, or other violation of his duties in the management of the corporation or in the disposition of corporate assets;

(B) The acquisition, transfer to others, loss, or waste of corporate assets due to any neglect of, failure to perform, or other violation of duties; or

(C) The appropriation, in violation of his duties, of any business opportunity of the corporation;

(2) To enjoin a proposed unlawful conveyance, assignment, or transfer of corporate assets or other unlawful transaction where there is sufficient evidence that it will be made; and

(3) To set aside an unlawful conveyance, assignment, or transfer of corporate assets where the transferee knew of its unlawfulness and is made a party to the action.

(b) No action shall be brought for the relief provided in subsection (a) of this Code section more than four years from the time the cause of the action accrued.

(c) This Code section shall not limit any liability otherwise imposed by law upon any director or officer or any third party".(4)

15.16 Probably following American precedent, a statutory derivative action was introduced into the present South African Companies Act.

15.17 Unfortunately the timorous makers and shapers of South African company law, once having left the safe harbour of United Kingdom company law, made the derivative action so unattractive and so costly as to place it beyond the reach of the ordinary shareholder.

> "The present Companies Act introduced a statutory derivative action, which enables a member to bring an action to enforce the company's rights against wrongdoing directors and officers, or past directors and officers; and which empowers the court to order that any resolution ratifying or condoning the wrong in question shall be of no force or effect. To guard against the dangers inherent in permitting the individual member to institute such proceedings, the action involves a dual screening procedure. Firstly the court must be persuaded on application that there is a *prima facie* case of wrongdoing which will justify the appointment of a provisional curator *ad litem* to investigate and report on the matter. Secondly, on the return day, the court, after a consideration of that report, may either discharge the provisional order or confirm the appointment of the curator *ad litem* and issue directions for the institution of proceedings by him in the name of the company".(5)

15.18 It is to be noted that if the action proceeds, the *curator ad litem* becomes the plaintiff and the member who has suffered the wrong has no further say in whether the proceedings should be continued, withdrawn or settled.

His role is relegated to little more than a 'whistle-blower', but a 'whistle-blower' who faces enormous financial risks. Not only could he be ordered to pay the costs of unsuccessful proceedings but would probably be ordered to furnish security for costs even before the action commences.

15.19 **Section 268** of the South African Companies Act provides that

> ".....if it appears that there is reason to believe that the applicant in respect of an application under section 266 (2) will be unable to pay the costs of the respondent company if successful in its opposition, require sufficient security to be given for those costs and costs of the provisional *curator ad litem* before a provisional order is made".

15.20 It is to be noted that the order for the provision of security for costs is not dependent on the prospects of success or the contents of the report of the *curator ad litem* but solely on the financial means of the shareholder.

15.21 This is in stark contrast to modern views which are expressed in the American, Canadian and New Zealand company laws.

15.22 The approach of many States of the **United States** is summarised by the Official Reporter of the **South Carolina Business Corporation Act** commenting on section 33-7-400 (h) (Derivative Proceedings):

> **"Plaintiffs are not required to post bond as security for expenses."**
>
> "Earlier versions of the Model Act and the statutes of many states required a plaintiff to give security for reasonable expenses, including attorneys' fees, if his holdings of shares did not reach a specified size or value - five percent of the outstanding shares or a value of $25,000 in the earlier version of the Model Act. This requirement has been deleted. The security for expenses requirement, to the extent it was based on the size or value of the plaintiff's holdings rather than on the apparent good faith of his claim, was subject to criticism that it unreasonably discriminated against small shareholders.
>
> The basic policy question with respect to the requirement of a bond for small shareholders is how far to go in protecting the corporation and its officers and directors from suits. The choice is between making the right to sue widely available, without obstacles except in obviously baseless cases, or imposing obstacles in the way of the small shareholder without imposing a similar obstacle in the way of the large shareholder. Moreover, no bond requirement exists for class actions, antitrust cases, or individual actions for actions for personal injury, all of which involve the corporation in substantial expense of defending against suit.

> Several states have concluded on the basis of these considerations that the bond requirement for small plaintiffs should be repealed or not adopted".

15.23 Even in a State such as **California** which has retained the provision for security for costs (maximum 50 000 dollars), the Court will only order security after having determined —

> "(1) That there is no reasonable possibility that the prosecution of the cause of action alleged in the complaint against the moving party will benefit the corporation or its shareholders.
>
> (2) That the moving party, if other than the corporation, did not participate in the transaction complained of in any capacity".
> **California Corporations Code Section 800(c)**

15.24 In the State of **New York** only shareholders who hold less than five percent of the shares or whose shares are worth less than 50 000 dollars could be required to furnish security (sec. 627).

15.25 In **Canada**, section 242(3) of the **Business Corporation Act** provides that —

> "A complainant is not required to give security for costs in any application made or action brought or intervened in under this part". (derivative action)

15.26 In **New Zealand** (section 166) —

> "The court shall, on the application of the shareholder or director to whom leave was granted under section 165 of this Act to bring or intervene in the proceedings, order that the whole or part of the reasonable costs of bringing or intervening in the proceedings, including any costs relating to any settlement, compromise or discontinuance approved under section 168 of this Act, must be met by the company unless the Court considers that it would be unjust or inequitable for the company to bear those costs".

15.27 The dissenter and derivative actions available to the minority shareholder in South Africa thus

— offer very little protection against victimization by majority shareholders;

— are prohibitively costly;

— have not kept abreast with modern developments.

15.28 It is recommended that the South African Companies Act be suitably amended to provide for

(a) (i) a dissenter action by a shareholder of who is entitled to vote on a proposed acquisition of the shares, or summation of a plan of merger, share exchange, the sale or exchange of all or substantially all of the property of the corporation other than in its usual and regular course of business or on a proposed amendment to the articles of incorporation which would adversely affect his rights, which entitles the shareholder to dissent from such proposed action and to obtain payment of the fair value of the shares.

(ii) a procedure to be followed, including

— notification of the right to dissent;

— notification of the intention to dissent;

— **offer to pay and payment of the amount which the company or other offeror estimates the fair value of the shares to be;**

— **an explanation of how the fair value was calculated, accompanied by the latest available financial statements, both annual and interim;**

— **a right to approach a court to determine the fair value of the shares, the cost of the determination only to be awarded against the dissenters to the extent the court finds that the dissenters have acted arbitrarily, vexatiously or not in good faith.**

(b) (i) A derivative proceeding by a shareholder personally or representing the company in an action against one or more past or present directors or officers of the company to procure for the benefit of the company a judgment (following the Revised Model Corporations Act)

(1) To compel the defendant to account for official conduct or to decree any other relief called for by his official conduct in the following cases:

(A) The neglect of, failure to perform, or other violation of his duties in the management of the corporation or in the disposition of corporate assets;

(B) The acquisition, transfer to others, loss, or waste of corporate assets due to any neglect of, failure to perform, or other violation of duties; or

(C) The appropriation, in violation of his duties, of any business opportunity of the corporation;

(2) To enjoin a proposed unlawful conveyance, assignment, or transfer of corporate assets or other unlawful transaction where there is sufficient evidence that it will be made; and

(3) To set aside an unlawful conveyance, assignment, or transfer of corporate assets where the transferee knew of its unlawfulness and is made a party to the action.

(ii) A procedure to be followed, including on the application of the company

— **the appointment by the court of a panel of one or more independent persons to conduct an investigation into the allegations made by the shareholder;**

— **the dismissal of the derivative proceeding, if on the application of the company, the court finds that the panel has in good faith and after having conducted a reasonable investigation concluded that the derivative proceedings would not be in the best interests of the company;**

— **the giving of notice and the obtaining of the approval of the court for the discontinuance or settlement of a derivative proceeding;**

— **an award of costs against the shareholder if the proceeding was commenced and continued without reasonable cause or for an improper purpose;**

— **an award of costs against the company if the shareholder is not able to recover an award of costs against the defendants, unless the court considers that it would be unjust or inequitable for the company to bear such costs.**

.....

NOTES

1. **In New Zealand** the determination of ' a fair and reasonable price' is referred to arbitration (section 112).

2. **Fletcher, W.M. :** Fletcher Cyclopedia of the Law of Private Corporations, par 5906.10, Note 1 (Clark, Boardman, Callaghan, New York, 1990).

3. **Gower, L.C.B. :** The Principles of Modern Company Law.

4. **See** also the Revised Model Business Corporations Act, par. 7.40-7.46.

5. **Blackman, M.S. :** 'Companies' Lawsa - Vol 4, part 2, par. 210 s, Butterworths, Durban, 1996).

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CHAPTER 16 - CLASS ACTIONS AND PUBLIC INTEREST ACTIONS

16.1 In its First Report the Commission deplored the fact that class actions were not available to the thousands of participation bond investors, holders of debentures and other creditors who had lost hundreds of millions of rands in companies such as the Masterbond Group, Supreme Bond, Owen Wiggins, Fancourt and Marina Martinique.

The people who suffered most were often elderly, not wealthy and individually did not have the means or the courage to litigate.

> "Had a class action been available to them there is little doubt that actions with more than a fair chance of success would have been instituted by them against all the directors and auditors of all the Masterbond companies, the directors and auditors of Fancourt, the directors and auditors of Marina Martinique, the directors and auditors of Owen Wiggins, the directors and auditors of the Supreme Group of Companies and all the intermediaries who advised their clients to invest in entities such as Masterbond, Fancourt, Marina Martinique and the Supreme Group".(1)

16.2 The Commission is convinced that the introduction of a class action into the South African law is essential for the protection and empowerment of investors.

16.3 Although section 38 of the South African Constitution (Act 108 of 1996) provided for the introduction of a class action when a right protected by the Bill of Rights has been infringed or is threatened, no procedure for such an action has been formulated.

16.4 Section 38 of the Constitution reads as follows

> "Anyone listed in this section has the right to approach a competent court, *alleging that a right in the Bill of Rights* (own emphasis) has been infringed or threatened, and the court may grant appropriate relief, including a declaration of rights. The persons who may approach a court are -

a) anyone acting in their own interest;

b) anyone acting on behalf of another person who cannot act in their own name;

c) anyone acting as a member of, or in the interest of, a group or class of persons;

d) anyone acting in the public interest;

e) an association acting in the interest of its members".

16.5 Pursuant to a request in 1992 by the then Minister of Justice, the South African Law Commission undertook an investigation into the possible introduction of class actions into the South African law.

16.6 In 1995 the South African Law Commission released a working paper 'The Recognition of a Class Action in South African Law' and in August 1998 submitted a proposed draft bill with its Report 'The Recognition of Class Actions and Public Interest Actions in South African Law'.

16.7 The Commission is of the view that the contents of the draft bill recommended by the South African Law Commission do not fulfil all the needs associated with class actions and do not address some of the problems which have arisen in other jurisdictions.

16.8 To enable the Commission to report on the introduction of class actions and to make recommendations regarding suitable procedures therefor, critical analyses and researches were conducted into class actions and proposed class actions as formulated in the United States, Canada, the United Kingdom, Sweden, Israel, Australia and South Africa.(2)

16.9 For ease of reference and because of their importance for purposes of comparison

— the Proposed draft bill of the **South African Law Commission**;

— the **United States Rule 23 of the Federal Rules** of Civil Procedure, 1966;

— the **Ontario** Class Proceedings Act, 1992;

— the **Australian** Federal Court of Australia Act, 1976;

— the Proposed draft bill of the Uniform Law Conference of **Canada**;

— the Proposed Class Proceedings Act of the **Manitoba Law Reform Commission**;

— the **North Dakota** Supreme Court Rule 23; and

— the Revised Statutes, Chapter 5, Section 1, Article 591-597 of **Louisiana**

are annexed and marked as Annexures "A" – "H".

A comparative study of American class actions is included in the Notes.[3]

16.10 The history of class actions in England has been sketched as follows:[4]

> "The modern era of class actions began with the passage of the *Supreme Court of Judicature Act, 1873* in England, and the fusion of law and equity. As indicated, prior to this time, the class action device could be employed only in the court of Chancery and, therefore, only equitable remedies, such as an accounting, a declaration, and an injunction, could be claimed in a representative action. Damages, being a common law remedy, were not available in an action brought in class form in the Court of Chancery. In other words, the nineteenth century forms of action determined when and how the class action device could be employed, despite the functional similarity of a claim for an accounting, for example, and a suit asserting a right to damages.
>
> The merger of the common law courts and the courts of equity resulted in the adoption of a single set of procedural rules applicable to all civil proceedings. Included in these rules was a Rule for representative or class actions. Rule 10 of the Rules of Procedure scheduled to the *Supreme Court of Judicature Act, 1873* provided as follows:
>
> > 10. Where there are numerous parties having the same interests in one action, one or more of such parties may sue or be sued or may be authorised by the court to defend in such action on behalf of or for the benefit of all parties so interested".

16.11 The present rules (Order 15, Rule 12, 1965) which have also been adopted by New South Wales (Australia), read as follows:

"12. (1) Where numerous persons have the same interests in any proceedings, not being such proceedings as are mentioned in Rule 13, the proceedings may be begun, and, unless the Court otherwise orders, continued, by or against any one or more of them as representing all or as representing all except one or more of them.

(2) At any stage of proceedings under this Rule the Court may, on the application of the plaintiff, and on such terms, if any, as it thinks fit, appoint any one or more of the defendants or other persons as representing whom the defendants are sued to represent all, or all except one or more, of those persons in the proceedings; and where, in exercise of the power conferred by this paragraph, the Court appoints a person not named as a defendant, it shall make an order under Rule 6 adding that person as a defendant.

(3) A judgment or order given in proceedings under this Rule shall be binding on all the persons as representing whom the plaintiffs sue or, as the case may be, the defendants are sued, but shall not be enforced against any person not a party to the proceedings except with the leave of the Court.

(4) An application for the grant of leave under paragraph (3) must be made by summons which must be served personally on the person against whom it is thought to enforce the judgment or order.

(5) Notwithstanding that a judgment or order to which any such application relates is binding on the person against whom the application is made, that person may dispute liability to have the judgment or order enforced against him on the ground that by reason of facts and matters particular to his case he is entitled to be exempted from such liability.

(6) The Court hearing an application for the grant of leave under paragraph (3) may order the question whether the judgment or order is enforceable against the person against whom the application is made to be tried and determined in any manner in which any issue or question in an action may be tried and determined".

16.12 Formalised 'class actions' as known today had their origin in the United States[5] and are known as

— 'class action' in the **United States** (Rule 23 of the Federal Rules of Civil Procedure) and in **Quebec** (Book IX of the Code of Civil Procedure);

— 'class proceedings' in **British Columbia** (British Columbia Class Proceedings Act, 1996) and in **Ontario** (Ontario Class Proceedings Act, 1992);

— 'group actions' in **Sweden** (Group Actions and the Role of the Courts – A European Perspective – The Forum Internationale No. 23, May, 1996);

— 'multi-party actions' in the **United Kingdom** (Final Report of Lord Woolf's Review 'Access to Justice', 1996);

— 'representative action' in the **European Union** (The Intergovernmental Conference of 1996 of the Consumers' Association in a report 'The IGC and consumer policy');

— 'representative proceeding' in **Australia** (Part IV A of the Federal Court of Australia, Act 1976) and in the state of **Victoria** (Sections 34 – 35 of the Supreme Court Act (Vic) 1986).

16.13 The introduction of a class action has three main objectives, namely

— to provide access to justice for those who would otherwise be excluded from access to the courts;

— the more efficient use of judicial resources;

— the modification of the behaviour of actual or potential wrongdoers who might otherwise be tempted to ignore public obligations.

16.14 Access to justice has been described as 'the cornerstone of class proceedings' —

> "One of the recurring themes in recent years in jurisdictions around the world has been that of 'access to justice'. This has been evidenced by, for example, Lord Woolf's Report, *Access to Justice*, in the United Kingdom (Interim Report June 1995, Final Report July 1996); the Australian Access to Justice Advisory Committee Report, *Access to Justice: An Action Plan* (1994); the Canadian Bar

Association Systems of Civil Justice Task Force *Report* (August 1996); and the Ontario Civil Justice Review (*First Report* March 1995, *Supplemental and Final Report* November 1996). Closer to home, the Manitoba government commissioned the Manitoba Civil Justice Review Task Force, which delivered its *Report* in September of 1996.

A finding common to all of these reports, and others, is that the 'average citizen's' access to justice is unacceptably limited in a number of ways. One of the ways in which access has been limited has been the difficulty encountered by individuals who may collectively have experienced significant loss, but who individually cannot justify the cost of litigation to obtain compensation. As the Civil Justice Review Task Force noted in 1996:

> 'One of the recurring themes the Task Force heard during the course of public meetings held in Winnipeg and other centres throughout Manitoba was that it takes too long and costs too much to litigate disputes in court.
>
> The Task Force heard expressions of frustration from many persons who had been embroiled in legal disputes, the delays that occur, the cost of the litigation and the pressure that the litigation itself brings to bear on parties'.

Nor are financial disincentives the only factors inhibiting redress in many cases; often there are social or psychological reasons why people fail to pursue legal remedies to which they are entitled. In Australia, a recent report stated:

> 'In recent years there has been heightened awareness of the sad reality that, for most members of the public, access to the courts is beyond their reach as a result of the high cost of litigation. Class actions can enhance access to justice by opening the 'doors' of our courts to those with individually non-recoverable claims or whose claims would not have led to individual proceedings because of social or psychological barriers'.

The South African Law Commission noted in 1995:

> 'Class actions ..... are part of the worldwide movement to make access to justice a reality. This movement commenced in the early 1970s and recognises that it is of little use for people to have legally enforceable rights if they are unable to enforce such rights. Uneducated and unsophisticated people generally do not understand what their rights are, do not know how to go about enforcing rights of which they are aware, do not know where to get legal advice or assistance and cannot afford lawyers' fees. More sophisticated people, who do have a better understanding, frequently allow claims to go unenforced because the value of their claims [does] not warrant the high legal costs....The result is that people who breach the law to the detriment of others often get away with their illegal actions and those who suffer harm as a result have no redress.
>
> Class actions ... make it possible for concerned individuals and organizations to approach the court in order to claim relief ... on behalf of others who, for the reasons mentioned above, would not be able to enforce their rights themselves'.

The need for a mechanism to deal with these problems is growing. As the National Consumer Council said in its submission to Lord Woolf's Inquiry:

> 'As we become an increasingly mass producing and mass consuming society, one product or service with a flaw has the potential to injure or cause other loss to more and more people. Yet our civil justice system has not adapted to mass legal actions. We still largely treat them as a collection of individual cases, with the findings in one case having only limited relevance in law to all of the others'.

In jurisdictions around the world the response to this issue of limited access to justice has been, increasingly, the introduction of legislation to facilitate — indeed, to permit — the bringing of class proceedings by representative individuals. Lord Woolf suggested that the legal system in England and

Wales required overhaul in order to deal properly with multi-party actions. He stated:

> 'Unlike the position in some other common law countries, there are no specific rules of court in England and Wales for multi-party actions. This causes difficulties when actions involving many parties are brought. In addition to the existing procedures being difficult to use, they have proved disproportionately costly. It is now generally recognised, by judges, practitioners and consumer representatives, that there is a need for a new approach both in relation to court procedures and legal aid. The new procedures should achieve the following objectives:
>
> (a) provide access to justice where large numbers of people have been affected by another's conduct, but individual loss is so small that it makes an individual action economically unviable;
>
> (b) provide expeditious, effective and proportionate methods of resolving cases, where individual damages are large enough to justify individual action but where the number of claimants and the nature of the issues involved mean that the cases cannot be managed satisfactorily in accordance with normal procedure;
>
> (c) achieve a balance between the normal rights of claimants and defendants, to pursue and defend cases individually, and the interests of a group of parties to litigate the action as a whole in an effective manner'.

While access to justice is only one of the three goals listed by Lord Woolf, it is a key goal and one that is clearly shared by many law reformers and governments. The Commission is of the opinion that the potential for enhancing access to justice for the citizens of Manitoba, and accomplishing the other goals set out by Lord Woolf, through the introduction of class

> proceedings legislation merits careful consideration, and to that end has prepared this Report".(6)

16.15 The more efficient use of judicial resources as another goal of class actions was stated by the **Ontario** Law Reform Commission:

> "There is no real disagreement that class actions can achieve judicial economy where all class members have individually recoverable claims .... Class actions aggregating individually recoverable claims are beneficial not only to plaintiffs, but also to defendants, since such actions reduce defence costs by eliminating the need to assert common defenses in each individual suit".(7)

Manitoba commented:

> "Joining together people who have suffered similar losses arising out of similar events and litigating the common issues not only has the advantage of avoiding inconsistent outcomes, but is an effective and efficient use of judicial resources.
>
> Class proceedings do require significant judicial involvement and implicitly result in less autonomy for lawyers. As the lawyer is representing not just the plaintiff but a plaintiff who is representative of the class, the court will scrutinize many aspects of the case including modifying discovery rules, approving fee arrangements, and monitoring settlements. The U.S. Federal Rule even requires the court to determine whether counsel has the wherewithal to undertake the case!".(8)

16.16 Modification of the behaviour of actual or potential wrongdoers as the third goal of class actions was thus stated by the **Ontario** Attorney General's Advisory Committee on Class Action reform:

> "....the presence of effective remedies of any sort inevitably must contribute to a sharper sense of obligation to the public by those whose actions affect large

numbers of people... An effective class action procedure has the potential to contribute to improved compliance with such obligations".(9)

16.17 The introduction of class actions into the South African law will not create any new or additional legal liabilities. As pointed out, the prime goal of the introduction of such a procedure is to facilitate access to justice.

16.18 A defendant class action may be as advantageous to defendants as a plaintiff class action might be to plaintiffs.

Ontario, Quebec and **United States** legislation provides for defendant class actions.

Ontario **"4. Classing defendants.** — Any party to a proceeding against two or more defendants may, at any stage of the proceeding, make a motion to a judge of the court for an order certifying the proceeding as a class proceeding and appointing a representative defendant".

Quebec **"1002.** A member cannot institute a class action except with the prior authorization of the court, obtained on motion....."

United States "One or more members of a class may sue or be sued as representative parties on behalf of all only if ....."

This is appropriate when the proceedings against a number of defendants are similar, or where they have a similar defence. Legislation of Ontario and British Columbia provides for the certification of a plaintiff class action at the initiative of the defendant.

Ontario **"3. Defendant's Class Proceedings** — A defendant to two or more proceedings may make a motion to a judge of the court for an

order certifying the proceedings as a class proceeding and appointing a representative plaintiff".

British Columbia Similar to Ontario.

In the **United States** defendant class actions are commonly used in challenging the constitutionality of laws or practices. Defendant class actions have also been used in patent infringement cases where there are a number of alleged violators of the patent. Defendant class actions have also been certified in anti-trust, securities, land title, environmental and trade union cases.

Examples of areas where defendant class actions may be used in South Africa are situations where municipalities face a number of 'flat rate' proceedings, where summonses are issued by the SABC against those who refuse to pay their TV licences, and in actions based on the interpretation of standard contracts used on an industry-wide basis.

16.19 The first requisite for the institution of a class action is the existence of a class and a plaintiff or a defendant who will represent the other members of the class.

16.20 To have the necessary *locus standi* to represent others, the plaintiff or defendant

- must have an interest similar to the others in the outcome of the proceedings; or

- in some jurisdictions, can also be an 'ideological' plaintiff or defendant, i.e. a person who represents the class without having a personal interest in the outcome of the proceedings. This is

allowed because it is believed that in certain circumstances a particular individual or entity may have special abilities, experience or resources which could significantly benefit the class.

16.21 Some of the jurisdictions which require a personal interest similar to the interest of the others are

Australia "A person referred to in paragraph 33C(1)(a) who has a sufficient interest to commence a proceeding on his or her own behalf against another person has a sufficient interest to commence a representative proceeding against that other person on behalf of other persons referred to in that paragraph".

(Although the Federal Court Act requires personal *locus standi*, the Trade Practices Act enabled the Trade Practices Commission (now the Australian Competition and Consumer Commission) to represent victims of wrongful trade practices in representative actions.)

Israel 'on any grounds for which the plaintiff can use his own name, and against every defendant whom the plaintiff can sue in his own name'.

Ontario 'One or more members of a class of persons may commence a proceeding in court on behalf of the members of the class'.

United States 'The claims or defenses of the representative parties are typical of the claims or defenses of the class'.

(Although Federal Rule 23 requires a person who is a member of a class to initiate a class action, the Unfair Competition Act has no such requirement.)

Victoria 'Despite any Act, law, rule or practice to the contrary, in the circumstances referred to in Section 34, a proceeding may be

commenced by any one or more of those persons as representing some or all of them'.

'A proceeding may be commenced, and, unless the Court otherwise orders, continued, by or against any one or more persons having the same interest as representing some or all of them'.

16.22 Jurisdictions which allow or where it is proposed to allow an 'ideological' plaintiff or defendant include

British Columbia "If it is necessary to do so to avoid a substantial injustice to the class".

Canada Uniform Law Conference "If it is necessary to do so to avoid a substantial injustice to the class".

India 'The Indian courts have recognised that traditional notions of standing should not be allowed to stand in the way of access to the courts, and have gone so far as to initiate through the court itself proceedings in the interests of disadvantaged sections of the community. In 1976 the Indian Supreme Court held that the plea of 'no *locus standi*' would not necessarily non-suit an interested public body which had brought a wrong-doer before court. Since that time public interest litigation, or, as it is more appropriately called, social action litigation, has been conducted on a regular basis by individuals and organizations on behalf of poor and disadvantaged persons'.

Manitoba 'representative parties should be required to satisfy the court that they will be able to 'fairly and adequately' represent the class. They need not, however, necessarily be members of the class themselves'

Quebec

'**1048.** A legal person governed by Part III of the *Companies Act* (R.S.Q. c. C-38, a cooperative governed by the *Cooperative Act* (R.S.Q. c. C-67.2) or an association of employees within the meaning of the *Labour Code* (R.S.C. c. C-27), may apply for the status of representative if:

(1) one of its members designated by it is a member of the group on behalf of which it intends to bring a class action; and

(2) the interest of that member is linked to the objects for which the legal person or association has been constituted."

Sweden Certain organizations in consumer and environmental cases.

16.23 Further primary criteria for the institution of a class action vary considerably.

In a Discussion Paper prepared by Ruth Rogers for the Uniform Law Conference of Canada, some of the criteria are described as follows(10)

- commonality "... that the action must raise questions of fact or law common to the members of the class in order to qualify as a class action".

- numerosity "... a representative proceeding ... (may) ... be brought where 'numerous' persons have the same interest".

- preliminary merits "... more rigorous scrutiny of the merits of class actions at the certification stage than is available for ordinary actions".

– superiority "... that the action ... (must) ... be superior to other procedural alternative..."

– typicality "... the claims of the representative parties must be typical of the claims of the class".

16.24 Variations of primary criteria required are illustrated in the following schedule

CRITERIA	TEST
—The pleadings disclose **a cause of action** (Ontario; British Columbia)	CAUSE OF ACTION
—An identifiable class of **two or more persons** that would be represented; (Ontario; British Columbia) **—Three or more persons** have the right to the same relief against the same person; (Victoria) **—7 or more persons** have claims against same person; (Australia) **—Size of group** justifies class action (Israel).	NUMEROSITY TEST
—Claims/defences of the class raise **common issues;** (Ontario, British Columbia) **—Questions of law or fact common to class;** (United States, Victoria) —Recourses of members raise **identical, similar or related questions of fact or law**; (Quebec) —Claims of all persons arise out of the **same, similar or related circumstances;** (Australia) —Claims give rise to a **substantial common issue of fact or law;** (Australia **—Substantive factual and legal questions common** to the class (Israel).	COMMONALITY TEST
—Class procedure is **preferable procedure** for resolution of the common issues; (Ontario, British Columbia) —Class is so numerous that **joinder is impracticable**; (United States) —Composition of group makes **joinder or traditional representative proceeding impracticable;** (Quebec) **—Class action is most effective and fairest method** to decide the controversy (Israel).	SUPERIORITY TEST
—Availability of **representative** to present group adequately; (Ontario, British Columbia, Quebec, United States) —Reasonable grounds to assume **plaintiff represents** group in a suitable manner (Israel).	REPRESENTATIVE
—Claims/defences of representatives are **typical of claims/defences** of the class; (United States)	TYPICALITY TEST
—Suit was filed in **good faith** and there is a **reasonable possibility of success** (Israel).	PRELIMINARY MERITS TEST

—All persons who are represented **consented in writing** to being represented (Victoria).	CONSENT

16.25 To enable the court to prevent frivolous class actions and to protect the interests of other members of a class, most jurisdictions require or propose to require authorization of the court. This is generally referred to as 'certification'.

16.26 Some examples of the criteria for certification are

British Columbia

"4. Class certification

(1) The court must certify a proceeding as a class proceeding on an application under section 2 or 3 if all the following requirements are met:

(a) the pleadings disclose a cause of action;

(b) there is an identifiable class of 2 or more persons;

(c) the claims of the class members raise common issues, whether or not those common issues predominate over issues affecting only individual members;

(d) a class proceeding would be the preferable procedure for the fair and efficient resolution of the common issues;

(e) there is a representative plaintiff who

(i) would fairly and adequately represent the interests of the class;

(ii) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the class and of notifying class members of the proceeding;

(iii) does not have, on the common issues, an interest that is in conflict with the interests of other class members.

(2) In determining whether a class proceeding would be the preferable procedure for the fair and efficient resolution of the common issues, the court must consider all relevant matters including the following:

(a) whether questions of fact or law common to the members of the class predominate over any questions affecting only individual members;

(b) whether a significant number of the members of the class have a valid interest in individually controlling the prosecution of separate actions;

(c) whether the class proceeding would involve claims that are or have been the subject of any other proceedings;

(d) whether other means of resolving the claims are less practical or less efficient;

(e) whether the administration of the class proceeding would create greater difficulties than those likely to be experienced if relief were sought by other means".

Israel

"Court Approval

54B. A class action requires approval by a court, and it shall not approve it unless it is convinced that the following conditions are met:

(1) the suit was filed in good faith and there is a reasonable possibility that substantive factual and legal questions common to the class will, in the course of the trial, be decided in the class's favour;

(2) the size of the group justifies submission of the claim as a class action;

(3) class action is the most effective and fairest method to decide the controversy under the circumstances of the case;

(4) there are reasonable grounds to assume that the plaintiff represents the case of all members of the group in a suitable manner".

Ontario

"5. Certification

(1) The court shall certify a class proceeding on a motion under section 2, 3 or 4 if,

(a) the pleadings or the notice of application discloses a cause of action;

(b) there is an identifiable class of two or more persons that would be represented by, the representative plaintiff or defendant;

(c) the claims or defences of the class members raise common issues;

(d) a class proceeding would be the preferable procedure for the resolution of the common issues; and

(e) there is a representative plaintiff or defendant who,

(i) would fairly and adequately represent the interests of the class,

(ii) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the class and of notifying class members of the proceeding, and

(iii) does not have, on the common issues for the class, an interest in conflict with the interests of other class members".

Quebec

"1003. The court authorizes the bringing of the class action and ascribes the status of representative to the member it designates if of the opinion that:

(a) the recourses of the members raise identical, similar or related questions of law or fact;

(b) the facts alleged seem to justify the conclusions sought;

(c) the composition of the group makes the application of article 59 or 67 difficult or impracticable; and

(d) the member to whom the court intends to ascribe the status of representative is in a position to represent the members adequately".

United States (Federal Rule 23)

"**(a) Prerequisites to a Class Action.**

One or more members of a class may sue or be sued as representative parties on behalf of all only if

(1) the class is so numerous that joinder of all members is impracticable

(2) there are questions of law or fact common to the class,

(3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and

(4) the representative parties will fairly and adequately protect the interests of the class".

"**(b) Class Actions Maintainable.**

An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class; or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and

efficient adjudication of the controversy. The matters pertinent to these findings include :

(A) the interest of members of the class in individually controlling the prosecution or defense of separate actions;

(B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class;

(C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum;

(D) the difficulties likely to be encountered in the management of a class action".

16.27 In contrast thereto, the **Federal Court of Australia Act 1976** does not require certification, as the Australian Reform Commission believed it to be a costly step with a strong risk of appeal. Instead it provides for applications by respondents for orders that the proceedings should not be allowed to proceed as representative proceedings.

"Sect 33– **Order that proceeding not continue as representative proceeding where costs excessive etc.**

(1) the Court may, on application by the respondent or of its own motion, order that a proceeding no longer continue under this Part where it is satisfied that it is in the interests of justice to do so because:

(a) the costs that would be incurred if the proceeding were to continue as a representative proceeding are likely to exceed the costs that would be incurred if each group member conducted a separate proceeding; or

(b) all the relief sought can be obtained by means of a proceeding other than a representative proceeding under this Part; or

(c) the representative proceeding will not provide an efficient and effective means of dealing with the claims of group members; or

(d) it is otherwise inappropriate that the claims be pursued by means of a representative proceeding.

(2) If the Court dismisses an application under this section, the Court may order that no further application under this section be made by the respondent except with the leave of the Court.

(3) Leave for the purposes of subsection (2) may be granted subject to such conditions as to costs as the Court considers just".

16.28 A recommendation by the **United Kingdom**'s Lord Chancellor's Department reads as follows :

> "It is proposed that an application for an MPS (multi-party situation) to be certified should be made only by parties (or potential parties), their solicitors, **or by the Court raising it of its own motion** *(own emphasis)*(for example where an "obvious case (or cases) come before it)".

Ontario, British Columbia, Quebec and **Israel** do not provide for such an option. **Maryland** provides for certification of an action on the motion of any party or on the court's own initiative, but such provision is absent from **United States** Federal Rule 23.

16.29 Several jurisdictions deemed it necessary to specify factors which should not be regarded as a bar to the certification of an action. The South African Law Commission referred to these factors as the 'avoidance of doubt' provisions.

Ontario

"6. **Certain matters not bar to certification.**– The court shall not refuse to certify a proceeding as a class proceeding solely on any of the following grounds:

1. The relief claimed includes a claim for damages that would require individual assessment after determination of the common issues.

2. The relief claimed relates to separate contracts involving different class members.

3. Different remedies are sought for different class members.

4. The number of class members or the identity of each class member is not known.

5. The class includes a subclass whose members have claims or defences that raise common issues not shared by all class members".

British Columbia and Manitoba

British Columbia has the same provision as Ontario. The only exception British Columbia made to the Ontario model was the inclusion of the phrase *"... one or more of the following"* in order to ensure that the presence of more than one of the elements would not be a bar to certification.

The provisions in the proposed Class Proceedings Act of **Manitoba** is similar to those of **British Colombia**.

Australia

"Section 33C(2) A representative proceeding may be commenced:

(a) whether or not the relief sought :

(i) is, or includes, equitable relief; or

(ii) consists of, or includes, damages; or

(iii) includes claims for damages that would require individual assessment; or

(iv) is the same for each person represented; and

(b) whether or not the proceeding :

(i) is concerned with separate contracts or transactions between the respondent in the proceeding and individual group members; or

(ii) involves separate acts or omissions of the respondents done or omitted to be done in relation to individual group members".

It must be borne in mind that these factors are not barriers to certification as no certification is required in Australian legislation. The provisions ensure that the action is not barred at some later stage.

Victoria

"Section 35(6) A representative proceeding may be brought even if-

(a) the relief to which each person is entitled is or includes damages; or

(b) any damages to which any person is entitled will need to be assessed individually; or

(c) any person being represented could join or be added as plaintiff in the proceeding under any Act, law, rule or practice.

16.30 Once a certification order has been made, notice to absent members of the class becomes important. Notice could be the only way that absent class members could learn about the existence of the action, their options in regard to the litigation, the progress of the action and the recovery of their portion of the damages, if any. Notice has, however, cost implications.

16.31 A central policy issue in class action legislation is whether class members should be required to "opt in" to the class proceeding in order to be bound by any judgment or settlement or whether they should be bound unless they explicitly "opt out".

The 'opt out' option has been adopted or is being proposed for adoption in most jurisdictions.

Jurisdictions	Option	Time limit to option
Ontario	Opt out	Yes
British Columbia	Opt out Opt in for non-residents	Yes Yes
Quebec	Opt out	Yes
United States	Opt out	Yes
Australia	Opt out	Yes
Victoria	Opt in Opt out proposed	Yes
Israel	Opt out	Yes
Manitoba	Opt out Opt in for non-residents	Yes Yes

16.32 Practical considerations led the courts in most jurisdictions to split the resolution of class actions into the determination of the common issues and the determination of individual issues. Generally the common issues will be determined first.

16.33 The Lord Chancellor's Department in the United Kingdom proposed in paragraph 27 :[11]

> "The court will still be able to try an issue which affects a large number of claimants by means of one or more test cases, with the case proceeding as an individual claim outside any new Rules of Court designed for MPS actions (multi-party situations). Alternatively, the judge may consider that matters should be conducted by certifying an MPS but within that framework using the test case approach. The new MPS rule could have the flexibility to allow a test case but with wider powers to make decisions in the test case binding on any subsequent group".

It was recommended that different approaches could be followed, for example subclassing and agreements on lead cases or sampling.

> "The Lloyds litigation gives an example of what can be achieved. At an early stage the court identified and decided on a number of preliminary issues of principle common to one or more categories of cases. With the active cooperation of the Court of Appeal and the House of Lords, appeals were expedited. The court selected from cases in a particular category lead or pilot cases for trial as to liability and principles relating to quantum in the hope that decisions in these cases would provide firm guidance in relation to other cases in the same category".

16.34 One of the methods used by courts to manage complex class actions is subclassing. This allows the court to certify an action as a class action where some class members have common issues which are not shared by all members of the class. In this process the larger class is divided into more distinct and representative groups. Subclassing is also seen as an effective tool to ensure that the interests of absent class members are protected.

16.35 A widely accepted mechanism for the treatment of monetary claims is an aggregate assessment. Aggregate assessment is the determination of the total amount to which a class or a part thereof is entitled when the defendant's liability to some or all class members can reasonably be determined without proof by the individual members.

Jurisdictions which provide for aggregate assessments are **Ontario, British Columbia, Quebec** (in the form of 'collective recovery'), **Australia** and **Israel**.

16.36 A problem which may arise is the disposition of unclaimed funds which were aggregately awarded. In **Ontario** and **British Columbia** the court has the power to order that

funds which remain undistributed after a time specified by the court may be disposed of in a manner which benefits other members of the class.

16.37 Another option would be to order the funds to be paid into a Class Action Fund.

Jurisdictions which make provision for the establishment of a Class Action Fund to provide intending class action members with financial assistance are **Ontario, Quebec, Victoria** and **Australia** (as proposed by the Australian Law Reform Commission and the Victoria Attorney General Law Reform Advisory Council). **Israel** relies on its legal aid scheme for financial assistance.

16.38 In some jurisdictions existing cost rules pose barriers to the effective use of class actions.

The **Ontario Law Reform Commission** stated as follows (p. 647):

> "The question of costs is the single most important issue ... [to be] considered in designing an expanded class action procedure ... the matter of costs will not merely affect the efficacy of class actions, but in fact will determine whether this procedure will be utilised at all".

16.39 In the **United Kingdom, Canada, Australia** and **South Africa** the costs of a successful party are generally borne by the unsuccessful party. In this regard "costs" encompasses both the legal representative's professional fees and the disbursements. In South Africa these costs are referred to as "party and party" costs and usually represent approximately two thirds of the total costs actually incurred by the successful party.

16.40 In contrast the **United States** generally follows the rule that both parties bear their own costs whether successful or unsuccessful. The philosophy underlying the **American rule** is that litigation is at best uncertain and that a person should not be penalized for trying to obtain justice.

16.41 The **Victorian** Attorney General's Law Reform Advisory Council criticised the Commonwealth Parliament for enacting the Australian Federal Act without recognising that the existing costs rules, if applied unaltered, could constitute a disincentive to the bringing of class actions.

16.42 The following cost rules apply or are being proposed in the various jurisdictions:

JURISDICTION	COST RULE IN CLASS DISCRETION
Ontario	Court's decision
British Columbia	American rule, unless : vexatious, frivolous or abusive conduct; or improper or unnecessary application or step for purposes of delay or increasing costs or any other improper purpose; or exceptional circumstances
Quebec	Costs indemnity rule
United States	American Rule
Australia	Costs indemnity rule
Victoria	Costs indemnity rule American rule proposed
Manitoba	American rule, unless: vexatious, frivolous or abusive conduct; improper or unnecessary application or step for purposes of delay or increasing costs or any other improper purpose; or exceptional circumstances

16.43 There are three major types of contingency fee arrangements. The first type, called a speculative fee, is the payment of a lawyer's normal fee in the event of the successful outcome of the case. The second type, called the 'uplift-fee' is the normal fee plus an uplift (a fixed sum,

or percentage or multiplier) to cover the risk of loss. The third type is the percentage fee, a fixed or 'sliding' percentage of the compensation awarded to the client.

16.44 In **Canada, Australia** and **South Africa**, contingency fee agreements were only legalised during the last decade. Legal representatives in **South Australia, New South Wales** and **England** are permitted to enter into uplift fee arrangements. Percentage fee and uplift fee arrangements are generally permitted in the **United States** and in some provinces of **Canada**.

16.45 Another method of dealing with costs is by the judicial determination of the legal representative's remuneration. In some courts in the **United States** a practice has developed of almost automatically awarding 30-40% of what the class obtains as a result of a judgment or a settlement, regardless of the costs actually incurred. A proposed reform is a requirement that the award should be based on the time devoted and expenses incurred by the class lawyer.

16.46 **Ontario** and **British Columbia's** legislation contain provisions for the judicial approval of fee agreements. **Israeli** legislation requires that the court has to determine the attorney's fee, notwithstanding any agreement between the attorney and the client, and also provides that the attorney is precluded from accepting a fee in excess of the amount determined by the court.

16.47 Legislation in **Australia** and **Israel** also provides for the compensation of the representative plaintiff based on time spent by the representative for the benefit of the class.

16.48 After a specified period of time an action usually becomes prescribed. The running of the period of prescription is normally suspended when an action is commenced. In most jurisdictions the filing of an application for certification suspends the running of prescription for all members of the class.

Ontario (Section 28)

> "**Limitations.**
>
> (1) Subject to subsection (2), any limitation period applicable to a cause of action asserted in a class proceeding is suspended in favour of a class member on the commencement of the class proceeding and resumes running against the class member when,
>
> (a) the member opts out of the class proceeding;

(b) an amendment that has the effect of excluding the member from the class is made to the certification order;

(c) a decertification order is made under section 10;

(d) the class proceeding is dismissed without an adjudication on the merits;

(e) the class proceeding is abandoned or discontinued with the approval of the court; or

(f) the class proceeding is settled with the approval of the court, unless the settlement provides otherwise.

(2) *Idem*—Where there is a right of appeal in respect of an event described in clauses (1)(a) to (f), the limitation period resumes running as soon as the time for appeal has expired without an appeal being commenced or as soon as any appeal has been finally disposed of".

British Columbia

British Columbia adopted the same provision as Ontario.

Quebec (Section 2897)

"Limitation Periods

2897. An interruption which results from the bringing of a class action benefits all the members of the group who have not requested their exclusion from the group.

2908. A motion for leave to bring a class action suspends prescription in favour of all the members of the group for whose benefit it is made or, as the case may be, in favour of the group described in the judgment granting the motion. The suspension lasts until the motion is dismissed or annulled or until the judgment granting the motion is set aside; however, a member requesting to be excluded from the action or who is excluded therefrom by the description of the group made by the judgment on the motion, an interlocutory judgment or the judgment on the action ceases to benefit from the suspension of

prescription. In the case of a judgment, however, prescription runs again only when the judgment is no longer susceptible of appeal".

Australia (Section 33ZE)

"Suspension of limitation periods

(1) Upon the commencement of a representative proceeding, the running of any limitation period that applies to the claim of a group member to which the proceeding relates is suspended.

(2) The limitation period does not begin to run again unless either the member opts out of the proceeding under section 33J or the proceeding, and any appeals arising from the proceeding, are determined without finally disposing of the group member's claim".

16.49 The proposed Draft Bill submitted by the South African Law Commission is lacking in some material aspects, including provisions regarding

— the contents of an application for certification;

— guidelines for the court in deciding whether a class action would be superior to other proceedings;

— the contents of the certification order;

— time limits for the option to be excluded from the class action;

— the contents of the notice of certification;

— the ability of the court to *mero motu* certify an action as a class action;

— the ability of the court to *mero motu* appoint a representative; subclasses;

— the appointment of representatives for subclasses;

— the effect of certification on prescription;

— counter claims;

— apportionment of costs;

— the contents of a notice of settlement, abandonment or discontinuance of the action.

16.50 A Proposed Bill for the institution of class actions and public interest actions has been drafted by the Commission and its acceptance is recommended.

The contents of the Proposed Bill follow.

BILL

To make provision for the institution of class actions and public interest actions; to regulate the conduct of class actions and public interest actions; and to provide for matters connected therewith.

TO BE INTRODUCED BY THE MINISTER OF JUSTICE

BE IT ENACTED by the Parliament of the Republic of South Africa, as follows:-

CHAPTER 1 : DEFINITIONS

Definitions

1. In this Act, unless the context otherwise indicates -

"action" means any proceedings, whether in convention or in reconvention instituted or defended in a court;

"certify" means to grant leave to conduct an action as a class action;

"class" means a number of persons with common issues and includes a subclass;

"class action" means an action conducted by a representative on behalf of a class, whether the representative is a member of the class or not;

"common issues" means

(a) common but not necessarily identical issues of fact; and/or

(b) common but not necessarily identical issues of law which arise from common but not necessarily identical facts or issues of law;

"court" means the High Court of South Africa and any other court designated by the Minister in terms of section 16 of this Act;

"Legal Aid Board" means the Legal Aid Board established in terms of section 2 of the Legal Aid Act, 1969;

"legal practitioner" means a practising advocate or practising attorney;

"Minister" means the Minister of Justice;

"representative" means a person appointed by the court as the representative of the plaintiffs or defendants in a class action;

"subclass" means one or more members of a class in respect of whom an issue of fact or law is raised in a class action and which is not identical to the issues of fact or law raised by the other members of the class.

CHAPTER 2 : CLASS ACTIONS

Instituting a class action

2. (1) Any person, whether a member of the class concerned or not, may apply to an appropriate court for leave to institute, defend and conduct an action as a class action and for a representative to be appointed.

(2) No action shall be instituted or defended and conducted as a class action unless the court has certified the action as a class action and has appointed a representative.

(3) No application for leave to institute or defend and conduct an action as a class action may be brought in a court if a similar application relating to the same common issues has been brought in or has already been adjudicated upon by another court.

Application

3. Any application in terms of section 2(2) shall be supported by:

(1) an affidavit by the applicant which shall contain the following :

(a) the applicant's interest in the action, if any;

(b) the cause of action or defence on which it is intended to rely in the class action;

(c) the material facts relating to the cause of action or defence;

(d) the nature of the relief to be claimed or defences to be raised;

(e) a description of the class to which the action relates;

(f) the reasons why a class action would be the appropriate procedure.

(2) In the event of the applicant also seeking appointment as the representative, the affidavit shall also contain —

(a) the reasons therefor;

(b) information regarding the ability of the applicant to represent the best interests of the members of the class and the reasons therefor;

(c) particulars regarding any other class action in which the applicant has served or is serving as a representative, and particulars of any other litigation in which the applicant has been involved or is involved.

(3) In the event of the applicant not seeking appointment as the representative, the affidavit shall also contain

(a) the name of the person proposed by the applicant;

(b) the reasons for such proposal;

(c) information regarding the ability of such person to represent the best interests of the members of the class and the reasons therefor;

and shall be accompanied by an affidavit by the person proposed as the representative, and which shall contain

(i) such person's interest in the action, if any;

(ii) whether such person agrees with the contents of the applicant's affidavit;

(iii) whether such person is willing and has the ability to represent the best interests of the members of the class and the reasons therefor;

(iv) particulars regarding any other class action in which such person has served or is serving as a representative, and any other litigation in which such person has been involved or is involved.

Certification

4. (1) At the hearing of the application in terms of section 2(2) the court may make such order as it deems fit including the issue of a rule **nisi** calling upon any interested person to show cause on the return day why the action should not be certified as a class action and/or why a particular person should not be appointed as the representative of the class.

(2) In the event of any dispute upon the return day, the Court may require any issue of fact or law to be tried upon pleadings, or make such other order as it deems fit to determine the dispute in a speedy and inexpensive manner.

(3) In deciding whether to certify an action as a class action, the court may take into account —

(a) the existence of a class whose members are so numerous that joinder of all the members would be impracticable;

(b) the existence of a class of which all the members are not known;

(c) that the class is or may be defined objectively in terms of ascertainable criteria which would enable the court to determine the composition of the class for purposes of a binding judgment;

(d) that the claims or defences of the members of the class would raise common issues, whether or not the common issues predominate over other issues which would affect individual members only;

(e) the interests of justice; and

(f) whether a class action would be superior to other available methods for the fair and efficient adjudication of the claims or defences, taking the following factors into consideration:

(i) the interest of members of the class in individually controlling the conduct of their own separate actions;

(ii) the risk of inconsistent or varying judgments if separate actions are conducted by or against individual members of the class and which could establish unreasonable standards of conduct for a party opposing the class action;

(iii) the risk being created by adjudications in respect of individual members of the class which could substantially impair or impede the ability of other members, not party to such adjudications, to protect their interests;

(iv) the extent and nature of any litigation concerning common issues already commenced by or against members of the class;

(v) the difficulties likely to be encountered in the management of the class action;

(vi) the practical ability of members of a class to individually pursue their claims or defences without class certification;

(4) The court shall not be precluded from certifying an action as a class action merely by reason of one or more of the following factors :

(a) that there are issues pertaining to the claims or defences of all or some of the members of the class which would require individual determination;

(b) that there are distinct subclasses with claims or defences which could differ from those of other members of the class;

(c) that the number of members of the class or the identities of all members of the class are not known.

(5) When appropriate an action may be certified as a class action with respect to particular issues, or a class may be divided into subclasses.

(6) If during the course of any proceedings the court becomes satisfied that it will be in the interest of justice, it may take such steps and issue such directions as it deems appropriate in order to certify the action as a class action and to appoint a representative.

(7) An order certifying an action as a class action shall

(i) describe the class in respect of which the order is made;

(ii) state the name and address of the representative of the class;

(iii) state the nature of the claims or defences asserted on behalf of the class;

(iv) set out the relief sought by or from the class;

(v) set out the common issues for the class;

(vi) state the time within which a class member may by written notice opt out of the proceedings;

(vii) include any other provision the court may deem necessary.

(8) An order certifying an action as a class action shall not be a determination of the merits of the action and shall not be subject to appeal.

(9) The court which certifies an action as a class action may give directions as to the appropriate court in which the action is to be heard.

(10) If satisfied that it will be in the interest of justice the court may **mero motu** or on application of any interested person alter, amend or withdraw the

certification order at any stage before judgment and make such order as it may deem fit relating to

(a) the addition, deletion or substitution of parties;

(b) the amendment of the pleadings or notices;

(c) any further order it considers appropriate.

The representative in a class action

5. (1) When appointing a person as a representative the court shall take into account -

(a) the ability of such person to adequately represent the best interests of all the members of the class;

(b) the ability of such person to manage the class action;

(c) any conflict or potential conflict of interest between such person and the members of the class;

(d) the ability of such person to make satisfactory arrangements with regard to the funding of the class action and the satisfaction of any order as to costs or for the furnishing of security for costs.

(2) In the event of

(a) the Court not being satisfied that the applicant or any other person seeking appointment as the representative would be suitable to be appointed as such; or

(b) in the absence of an application for the appointment of a representative in terms of sections 3(2) or 3(3); and

if the Court is satisfied that it would be in the interests of justice to appoint a representative, the Court may make such order as it deems fit to secure such appointment.

(3) In the event of the Court deeming it necessary additional representatives may be appointed for subclasses.

(4) The representative appointed by the court shall conduct the class action in the best interests of the members of the class concerned and in accordance with the directions of the court, if any.

(5) At any stage before judgment the court may *mero motu* or on the application of any interested person and on good cause shown remove the representative and appoint another suitable person.

Notice in class actions

6. (1) The court which certifies an action as a class action may give directions with regard to -

(a) the giving of notice of the action as soon as practicable to the members or potential members of the class concerned;

(b) the manner in which such notice is to be communicated to the members of the class.

(c) the giving of such notice to the defendant;

(d) the contents of the notice and the form which such notice should take;

(2) In considering which directions would be appropriate, the court may take into account —

(a) the extent to which the members of the class might be prejudiced by being bound by a judgment given in an action which may not come to their attention;

(b) the potential size of the class;

(c) the general level of education of the members of the class;

(d) the ease with which members of the class can be identified;

(e) the relief claimed;

(f) where monetary relief is claimed, the amount of the claim of each member of the class if it is reasonably possible to reasonably quantify the claims at that stage;

(g) any other relevant factor.

(3) Such notice shall include :

(a) a copy of the order certifying the action as a class action;

(b) the possible financial consequences of the proceedings for the class;

(c) a statement that the judgment, whether favourable or not, will be binding on all members who do not exclude themselves from the action by written notice before or on a specified date;

(d) a statement that any member of the class who will be bound by the judgment in the class action may apply for leave to intervene in the action in order to protect his or her own interests or the interests of the class or any section thereof;

(e) a statement that a member of the class may be required by the court to take further action in order to participate in any recovery by the class;

(f) the address to which inquiries may be directed;

(g) any other information that the court deems necessary.

(4) The court may, after due notice and to establish the identities and whereabouts of members of a class, order any person to furnish the names, addresses and other relevant information pertaining to such members.

Procedure in class actions

7. (1) The court in which the class action is to be heard may -

(a) give directions as to the procedure to be followed in the conduct of the class action to prevent undue repetition of evidence or argument;

(b) delineate the common issues to be decided in the class action;

(c) determine whether there are individual issues that require separate adjudication and, if so, give directions as to the procedure to be followed in order to adjudicate such issues;

(d) determine, where the claims are for damages or any other form of monetary relief, whether the individual claims of the members of the class should be assessed as one aggregate amount or whether the claims of the members of the class should be determined individually;

(e) determine how any aggregate award is to be distributed among the members of a class, and appoint a person to be responsible for the administration of such distribution, and give directions as to matters incidental thereto.

(2) Any member of a class who will be bound by a judgment in a class action may apply for leave to intervene in the action in order to protect his or her own interests or the interests of the class or any section thereof.

Conduct of a class action

8. In the conduct of a class action, the court may

(1) order that notice or additional notice relating to any matter be given to members of the class;

(2) impose conditions on the representative of the class or any member thereof who has intervened in the action;

(3) set time limits for the filing of pleadings and other documents;

(4) make any other order it may deem necessary.

Judgment

9. (1) The court may first give judgment on the common issues and then adjudicate upon individual issues.

(2) Judgment of the court on issues which concern all members of a class or all members of a subclass shall be binding on all members of the class or subclass, whether or not favourable to them, except in respect of those members

(a) who have excluded themselves from the action in terms of section 6(3)(d);

(b) who were significantly prejudiced by the fact that the institution of the class action or their membership of the class had not come to their attention.

Costs

10. (1) In addition to its ordinary powers, the court may -

(a) order the members of the class to contribute towards the costs of the action;

(b) apportion the liability for the payment of costs amongst the members of the class.

(2) When an award is made in a class action in respect of which funds have been made available by the Legal Aid Board the court may order the representative or any member of the class to contribute a percentage of the award to the Legal Aid Board.

Contingency fees

11. (1) The provisions of the Contingency Fee Act 66 of 1997 will apply **mutatis mutandis** to class actions.

(2) Any contingency fee agreement entered into must be filed with the court without delay.

Settlement, abandonment and discontinuance

12. (1) A class action commenced under this Act shall not be settled, abandoned or discontinued without the prior approval of the court and upon such terms and conditions, including a notice or otherwise, as the court may deem necessary.

(2) Such notice shall include

(a) the reason for the proposed settlement, abandonment or discontinuance;

(b) particulars of any agreement made in connection with the proposed settlement, abandonment or discontinuance;

(c) particulars of any payment made or to be made in connection with the proposed settlement, abandonment or discontinuance;

(d) particulars of the anticipated effect of the proposed settlement, abandonment or discontinuance on the members of the class;

(e) a description and evaluation of any alternatives to the proposed settlement, abandonment or discontinuance.

Interruption of the period of Prescription

13. (1) The running of prescription shall be interrupted in favour of all members of a class

(a) on the filing of the application to institute the action as a class action;

(b) on the certification of the action as a class action in terms of section 4(7).

(2) Prescription shall commence to run again against all members of the class if and when

(a) the court refuses to certify the action as a class action;

(b) the certification order is withdrawn in terms of section 4(9);

(c) the class action is dismissed, abandoned, discontinued or settled.

(3) Prescription shall commence to run again against a particular member if and when

(a) such member excludes him- or herself from the action in terms of section 6(3)(d);

(b) such member is excluded from the class action by a specific order of the court.

CHAPTER 3 : PUBLIC INTEREST ACTIONS

Instituting a public interest action

14. Any person may institute an action in a court claiming relief in the interest of the public generally or in the interest of any particular section thereof, and irrespective of whether such person has any personal interest in the relief claimed or not.

CHAPTER 4 : GENERAL

Appointment of a commissioner

15. (1) In a class action or in a public interest action the court may **mero motu** or on the application of any party appoint a commissioner to enquire and report on

(a) issues which require documentary, scientific, technical or local investigation and which in the opinion of the court cannot be conveniently conducted by it;

(b) the aggregate or individual assessment of the monetary claims in a class action.

(2) For the purpose of such enquiry the commissioner shall have such powers and conduct the enquiry in such manner as prescribed by of the court or by the rules of court.

(3) The commissioner shall submit the report to the court.

Designation of court by Minister

17. The Minister may by notice in the Gazette, designate additional courts in which class actions and public interest actions may be instituted.

Short title

18. This Act shall be called the Class and Public Interest Actions Act, 20...

.....

NOTES

1. **Nel Commission of Inquiry,** Masterbond Report. Vol. 1, p. 114.

2. **Eizenga, Michael A et al :** 'Class Action Law and Practice' : 1999. (Butterworths, Canada).

   Manitoba Law Reform Commission : Report No. 100 - 'Class Proceedings' January 1999.

   Uniform Law Conference of Canada : Discussion Paper - 'A Uniform Class Actions Statute', August 1995;

   Ontario Law Reform Commission : 'Report on Class Actions', 1982.

   Lord Woolf : Final Report - 'Access to Justice', 1995.

   Professor Hendrik Lindblom : 'Group Actions and the Role of the Courts – A European Perspective'. Forum International No. 23, May 1996, Hague.

   International Securities Regulation, Release 97-6, Israel Booklet. Documents September 1997. (Oceana Publications).

   Australian Law Reform Commission : Discussion Paper 62 - 'Review of the Federal Civil Justice System', 1999.

   Australian Law Reform Commission : Report 89 - 'Managing Justice : A Review of the Federal Justice System' 2000.

   Victorian Attorney General's Law Reform Advisory Council : Expert Report 2 – 'Class Actions in Victoria : Time for a New Approach', 1997

   South African Law Commission : Report - 'The Recognition of Class Actions and Public Interest Actions in South African Law', August 1998.

3. Class Actions in the United States of America

1. Introduction

In addition to the Federal Class Action provided for by Federal Civil Procedure Rule 23, each State (with the exception of Mississippi and Virginia) has its own class action.

Some of the States adopted a verbatim version of Federal Rule 23:

Alabama (Rule 23)
Colorado (Rule 23)
Hawaii (Rule 23)
Idaho (Rule 23)
Missouri (Rule 52.08)
Nevada (Rule 23)
Utah (Rule 23)
Wyoming (Rule 23)

Other States have adopted versions which differ from Federal Rule 23 :

Arkansas (Rule 23)
California (§382)
Connecticut (Section 52-105)
Georgia (Section 9-11-23)
Illinois (Section 2-801 – 2-806)
Iowa (Rule 42)
Louisiana (Article 591-597)
Maryland (Rule 2-231)
Minnesota (Rule 5000.1100)
Montana (Rule 23)
New Jersey (Rule 4.32
North Carolina (Rule 23)
North Dakota (Rule 23)
Ohio (Rule 23)
Oklahoma (§12-2023)
Oregon (Rule 32)
Pennsylvania (Rule 1701-1716)
South Dakota (Rule 15-6-23)
West Virginia (Rule 23)
Wisconsin (Section 803.08)

Iowa and **North Dakota** adopted the Model Class Actions Rule drafted by the **National Conference of Commissioners of the United States of America** as the Uniform Class Actions Act, 1976, amended in 1987.

Comparison of the Federal class action with the class actions of some of the other States will follow the basic structure of Federal Rule 23, namely

— Prerequisites (primary) - Federal Rule 23(a)

— Additional prerequisites (to maintain a class action) - Federal -Rule 23(b)

— Certification order - Federal Rule 23(c)(1)

— Notice and exclusion- Federal Rule 23(c)(2)

— Judgment - Federal Rule 23(c)(3)

— Subclassing - Federal Rule 23(c)(4)

— Conduct of Action - Federal Rule 23(d)

— Dismissal or compromise - Federal Rule 23(e)

2. Prerequisites

2.1 Federal Rule 23(a) reads as follows :

> "**(a) Prerequisites to a Class Action.**
>
> One or more members of a class may sue or be sued as representative parties on behalf of all only if
>
> (1) the class is so numerous that joinder of all members is impracticable,
>
> (2) there are questions of law or fact common to the class,
>
> (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and
>
> (4) the representative parties will fairly and adequately protect the interests of the class".

2.2 Federal Rule 23(a) states that "one or more members of a class may sue or be sued as representative parties on behalf of all". This means that a regulator, ombudsman or other entity with no personal claim or defence cannot sue or be sued on behalf of others.

As it is the duty of a regulator or ombudsman to protect the interests of the public, class action proceedings should be at their disposal.

2.3 **Louisiana** added a fifth prerequisite, article 591A(5)

> "the class is or may be defined objectively in terms of ascertainable criteria, such that the court may determine the constituency of the class for purposes of the conclusiveness of any judgment that may be rendered in the case".

Oregon added a fifth prerequisite, Rule 32A(5),

> "in an action for damages, the representative parties have complied with the prelitigation notice provisions of section H of this rule".

The prelitigation notice involves a prior letter of demand to the potential defendant.

South Dakota added a fifth prerequisite, §15-6-23(a)(5)

> "the suit is not against this state for recovery of tax ..."

Iowa and North Dakota deviated from Federal Rule 23 by substituting the typicality test with a prerequisite that

> "the court must be of the opinion that a class action should be permitted to ensure the fair and efficient adjudication of the controversy". (Rule 42.1-42.2 and Rule 23(a)-(b)).

They also excluded 'damages fixed by a minimum measure of recovery provided by any statute', to be recovered in class actions.

Pennsylvania added a fifth prerequisite, Rule 1702(5)

> "a class action provides for a fair and efficient adjudication of the controversy under the criteria set forth in Rule 1708".

Illinois added in terms of Section 2-801 to Federal Rule 23(a) (2)

> ".....which common questions predominate over any questions affecting only individual members".

also substituting, similar to Iowa and North Dakota, the typicality test with the prerequisite

> "The class action is an appropriate method for the fair and efficient adjudication for the controversy".

3. Additional prerequisites (to maintain an action as a class action)

3.1 The additional prerequisites of Federal Rule 23(b) are the following:

"(b) **Class Actions Maintainable.** An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class; or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to these findings include :

(A) the interest of members of the class in individually controlling the prosecution or defense of separate actions;

(B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class;

(C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum;

(D) the difficulties likely to be encountered in the management of a class action".

3.2 Federal Rule 23(b) as a whole primarily directs the court to decide whether to favour the class action procedure above the joinder procedure or individual action procedure.

3.3 The first part of Federal Rule 23(b)(3) reads

> "The court finds that the questions of fact or law common to the members of the class predominate over any questions affecting only individual members"

and is called the predominancy test.

3.4 The second part of Federal Rule 23(b)(3) reads

> ".. and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy"

and is called the superiority test.

3.5 **Arkansas** limited the additional prerequisites to the predominancy and superiority test, formulated similarly to Federal Rule 23(b)(3)

Rule 23(b) reads:

> "An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy....."

Minnesota included the three additional prerequisites of Federal Rule 23(b) in the alternative as part of the primary prerequisites.

> **"Subpart 1.** Prerequisites
>
> With the permission of the charging party, the commissioner may sue on behalf of a class only if: there are questions of law or fact common to the class, and the claims of members of the class are of sufficient similarity that a fair hearing of them is possible in a class action, and the commissioner will fairly and adequately protect the interests of the class, and one of the following three conditions exists:
>
> A. the prosecution of separate actions by the commissioner on behalf of individual members of the class would create a risk of inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

B. the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate relief that includes final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

C. the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: the interest of members of the class in individually affecting the prosecution of separate actions; the extent and nature of any litigation concerning the controversy already commenced by members of the class; the desirability or undesirability of concentrating the litigation of the claims in the administrative hearing; the difficulties likely to be encountered in the management of a class action".

Louisiana (Art. 591 B(3)) added two further criteria which the court should consider, namely

"(e) the practical ability of individual class members to pursue their claims without class certification;

(f) the extent to which the relief plausibly demanded on behalf of or against the class, including the vindication of such public policies or legal rights as may be implicated, justifies the costs and burdens of class litigation".

3.6 **Louisiana** also added another interesting provision (591B(4))

"The parties to a settlement request certification under Subparagraph B(3) for purposes of settlement, even though the requirements of Subparagraph B(3) might not otherwise be met".

This provision applies to situations where settlement is reached prior to certification of the action as a class action. The notion of a "settlement class" was developed by the courts where the courts approve the settlement at the

same time as the certification. Although the certification is exempt from the additional criteria contained in Federal Rule 23(b)(3), it is not exempt from the primary criteria referred to in Federal Rule 23(a).

3.7 **Louisiana** also added 591C to the Federal Rule 23. It reads

> "Certification shall not be for the purpose of adjudicating claims or defenses dependent for their resolution on proof individual to a member of the class".

4. Certification order

4.1 **Federal Rule** 23(c) reads as follows :

"(c) **Determination by Order Whether Class Actions to be Maintained.**

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits".

4.2 **Maryland** introduced the concept that the court may certify a class action on its own initiative. Rule 2-231 (c) also provides for the giving of reasons.

It reads as follows:

> "(c) *Certification*.- On motion of any party or on the court's own initiative, the court shall determine by order as soon as practicable after commencement of the action whether it is to be maintained as a class action. A hearing shall be granted if requested by any party. The order shall include the court's findings and reasons for certifying or refusing to certify the action as a class action. The order may be conditional and may be altered or amended before the decision on the merits".

4.3 **Oregon** (Rule 32C(1)) basically adopted a similar provision to Federal Rule 23(c)(1) but added that the order should state in respect of which claims or issues the class action has been certified and should also set out the facts and conclusions thereon.

C(1) reads:

> "As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether and with respect to what claims or issues it is to be so maintained and shall find the facts specially and state separately its conclusions thereon. An order under this section may be conditional, and may be altered or amended before the decision on the merits".

It also added Rule 32C(2) which reads as follows

> "C(2) Where a party has relied upon a statute or law which another party seeks to have declared invalid, or where a party has in good faith relied upon any legislative, judicial, or administrative interpretation or regulation which would necessarily have to be voided or held inapplicable if another party is to prevail in the class action, the court may postpone a determination under subsection (1) of this section until the court has made a determination as to the validity or applicability of the statute, law, interpretation, or regulation".

4.4 **Louisiana** adopted a very lengthy Article 592 which provides for the procedure to be followed for certification.

Article 592A(1) and 592A(2) specifies that the application for certification should be filed within 90 days after commencement of an action. It also provides for the consequence of failure to file an application for certification within the time period.

Article 592A(1) reads as follows :

> "A(1) Within ninety days after service on all adverse parties of the initial pleading demanding relief on behalf of or against a class, the proponent of the class shall file a motion to certify the action as a class action. The delay for filing the motion may be extended by stipulation of the parties or on motion for good cause shown.

(2) If the proponent fails to file a motion for certification within the delay allowed by section 3(1), any adverse party may file a notice of the failure to move for certification. On the filing of such a notice and after hearing thereon, the demand for class relief may be stricken. If the demand for class relief is stricken, the action may continue between the named parties alone. A demand for class relief stricken under this subsection may be reinstated upon a showing of good cause by the proponent".

Article 592A(3) provides for the service of the motion for certification on adverse parties and for discovery on class certification issues.

"(3)(a) No motion to certify an action as a class action shall be granted prior to a hearing on the motion. Such hearing shall be held as soon as practicable, but in no event before :

(i) All named adverse parties have been served with the pleading containing the demand for class relief or have made an appearance or, with respect to unserved defendants who have not appeared, the proponent of the class has made due and diligent effort to perfect service of such pleading; and

(ii) The parties have had a reasonable opportunity to obtain discovery on class certification issues, on such terms and conditions as the court deems necessary".

(b) If the court finds that the action should be maintained as a class action, it shall certify the action accordingly. If the court finds that the action should not be maintained as a class action, the action may continue between the named parties".

4.5 **Iowa and North Dakota** provided as follows regarding the content of the order, the statement of reasons for the court's ruling, the appealability of non-

certification and the effect of non-certification on the action, as well as amendment of such order

"**Order on certification.**

a. *T*he order of certification shall describe the class and state: (1) the relief sought; (2) whether the action is maintained with respect to particular claims or issues; and (3) whether subclasses have been created.

b. The order certifying or refusing to certify a class action shall state the reasons for the court's ruling and its findings on the facts listed in R.C.P. 42.3(a).

c. An order certifying or refusing to certify an action as a class action is appealable.

d. Refusal of certification does not terminate the action, but does not preclude it from being maintained as a class action.

Amendment of certification order.

a. The court may amend the certification order at any time before entry of judgment on the merits. The amendment may: (1) establish subclasses; (2) eliminate from the class any member who was included in the class as certified; (3) provide for an adjudication limited to certain claims or issues; (4) change the relief sought; or (5) make any other appropriate change in the order.

b. If notice of certification has been given pursuant to R.C.P. 42.7, the court may order notice of the amendment of the certification order to be given in terms and to any members of the class the court directs.

c. The reasons for the court's ruling shall be set forth in the amendment of the certification order.

d. An order amending the certification order is appealable. An order denying the motion of a member of a defendant class, not a representative party, to amend the certification order is appealable if the court certifies if for immediate appeal".

4.6 **Pennsylvania** deviated from Federal Rule 23(c) by providing for the commencement of a class action only by the filing of a complaint, the form of such complaint and the process to be followed for the motion for certification.

"RULE 1703. COMMENCEMENT OF ACTION. ASSIGNMENT TO A JUDGE.

(a) A class action shall be commenced only by the filing of a complaint with the prothonotary.

(b) Upon the filing of the complaint the action shall be assigned forthwith to a judge who shall be in charge of it for all purposes.

RULE 1704. FORM OF THE COMPLAINT.

(a) The complaint shall include in its caption the designation "Class Action".

(b) The complaint shall contain under a separate heading, styled "Class Action Allegations", averments of fact in support of the prerequisites of Rule 1702 and the criteria specified in Rules 1708 and 1709 on which the plaintiff relies.

(c) The plaintiff may join in the complaint claims for equitable, declaratory and monetary relief arising out of the same transaction or occurrence or series of transactions or occurrences.

RULE 1705. PRELIMINARY OBJECTIONS.

All preliminary objections to the complaint permissible under Rule 1028(a) shall be raised at one time. Issues of fact with respect to the

Class Action Allegations may not be raised by preliminary objections but shall be raised by the answer.

RULE 1706. FORM OF THE ANSWER

In all actions the averments of fact under "Class Action Allegations" shall be deemed admitted unless denied in conformity with Rule 1029.

RULE 1706.1. JOINDER OF ADDITIONAL DEFENDANTS.

Any defendant or additional defendant may only join as an additional defendant any person, whether or not a party to the action, who may be

1. solely liable on the plaintiffs cause of action; or

2. liable over to the joining party on the plaintiffs cause of action, or

3. jointly or severally liable with the joining party on the plaintiffs cause of action.

RULE 1707. MOTION FOR CERTIFICATION OF CLASS ACTION. TIME FOR FILING. HEARING.

(a) Within thirty (30) days after the pleadings are closed or within thirty (30) days after the last required pleading was due, the plaintiff shall move that the action be certified as a class action. The court may extend the time for cause shown. If the plaintiff fails to move for certification, the court if so notified shall promptly set a date for a certification hearing.

(b) The court may postpone the hearing to a later date pending the disposition of other motions or to permit discovery with respect to the class action issues.

(c) The hearing shall be limited to the Class Action Allegations. In determining whether to certify the action

as a class action the court shall consider all relevant testimony, depositions, admissions and other evidence."

5. Notice and exclusion

5.1. Federal Rule 23(c)(2) reads :

"**Notice**

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that:

(A) the court will exclude him from the class if the member so requests by a specified date;

(B) the judgment, whether favourable or not will include all members who do not request exclusion; and

(C) any member who does not request exclusion may, if the member desires, enter an appearance through his counsel".

5.2 **Iowa and North Dakota** (Rule 42.7-42.8 and Rule 23(g)-(h)) deviated from Federal Rule 23 by dealing extensively with the notice requirement.

"(b) The notice, based on the certification order and any amendment of the order, shall include:

(1) A general description of the action, including the relief sought, and the names and addresses of the representative parties;

(2) A statement of the right of a member of the class under R.C.P. 42.8 to be excluded from the action by

filing an election to be excluded, in the manner specified, by a certain date;

(3) A description of possible financial consequences on the class;

(4) A general description of any counterclaim being asserted by or against the class, including the relief sought;

(5) A statement that the judgment, whether favorable or not, will bind all members of the class who are not excluded from the action;

(6) A statement that any member of the class may enter an appearance either personally or through counsel;

(7) An address to which inquiries may be directed; and

(8) Other information the court deems appropriate".

Personal notice has to be given to a member whose potential recovery will exceed $100 if his whereabouts is known.

It reads as follows :

"**Rule 42.8. Exclusion.**

a. A member of a plaintiff class may elect to be excluded from the action unless: (1) that member is a representative party; (2) the certification order contains an affirmative finding under paragraph (1), (2), or (3) of R.C.P. 42.3(a); or (3) a counterclaim under R.C.P. 42.11 is pending against the member or that member's class or subclass.

b. Any member of a plaintiff class entitled to be excluded under subdivision (a) who files an election to be excluded, in the manner and in the time specified in the notice, is

excluded from and not bound by the judgment in the class action.

c. The elections shall be made a part of the record in the action.

d. **A member of a defendant class may not elect to be excluded.** [Report 1980; Court Order October 31, 1997, effective January 24, 1998]".

5.3 **Arkansas** added an additional factor to be included in the notice, namely, a description of the action and the members' rights therein.

".....The notice shall:

(1) describe the action and the members' rights in it;

(2) advise each member that the court will exclude the member from the class if the member so requests by a specified date;

(3) advise each member that the judgment, whether favourable or not, will include all members who do not request exclusion; and

(4) state that any member who does not request exclusion, if the member desires, participate in the litigation, either in person or through counsel".

Arkansas also deals with the costs of the notice which are borne by the representative parties, unless otherwise agreed upon or ordered by the court (Rule 23(c)).

"The cost of such notice shall be borne by the representative parties; provided, however, that the court may shift all or part of such cost to the opposing party or parties if the case is settled or the class representative substantially prevails on the merits".

5.4 **New Jersey** added that the notice should be consistent with due process of law and excluded a representative from the option of exclusion from the

action. It also deals with the cost of the notice, which the court can assess against any party present before the court (Rule 4:32-2(b)). It reads:

> "In any class action maintained under Rule 4 : 30-1(b)(3) the court shall direct to the members of the class the best notice practicable under the circumstances, consistent with due process of law. The notice shall advise that
>
> (1) each member, not present as representative, will be excluded from the class by the court upon request by a specified date;
>
> (2) the judgment, whether favourable or not, will bind all members who do not request exclusion; and
>
> (3) any member who does not request exclusion may enter an appearance.
>
> The cost of notice may be assessed against any party present before the court, pending final disposition of the cause".

5.5 **Oklahoma** included

> ".....but the members to whom individual notice is not directed shall be given notice in such a manner as the court shall direct, which may include publishing notice in newspapers, magazines, trade journals or other publications, pasting it in appropriate places, and taking other steps that are reasonably calculated to bring the notice to the attention of such members, provided that the cost of giving such notice shall be reasonable in view of the amounts that may be recovered by the class members who are being notified".

It distinguished between members who received individual notice and who have a time-limit to opt out and those members who did not receive individual notice and who may opt-out at any stage before the issue of liability is determined. It also provides that the commencement of an individual action before the issue of liability is determined should be the equivalent of requesting exclusion from the class (§12-2023C(2)). It reads as follows:

"Members to whom individual notice was not directed may request exclusion from the class at any time before the issue of liability is determined, and commencing an individual action before the issue of liability is determined shall be the equivalent of requesting exclusion from the class".

5.6 **Oregon** (Rule 32 F) also deals with the notice and exclusion on an extensive basis. It provides for 6 factors which the court should take into account when the decision regarding the notice is made, namely :

(a) the nature of the controversy and the relief sought;

(b) the extent and nature of any member's injury or liability;

(c) the interest of the party opposing the class in securing a final resolution of the matters in controversy;

(d) the inefficiency or impracticality of separately maintained actions to resolve the controversy

(e) the cost of notifying the members of the class; and

(f) the possible prejudice to members to whom notice is not directed".

Rule 32F(2), (3) and (4) deal with the submission of a statement by a member requesting affirmative relief, as well as information regarding the nature of the loss, injury, claim, transactional relationship, or damage. It provides for factors which the court have to take into account when deciding on the form of the statement, and limits the total amount of damages. It also deals with the consequence of a failure to file a statement and the costs attendant on the notice.

It reads as follows :

"F(2) Prior to the entry of a final judgment against a defendant the court shall request members of the class who may be entitled to individual monetary recovery to submit a statement in a form prescribed by the court requesting affirmative relief which may also, where appropriate, require information

regarding the nature of the loss, injury, claim, transactional relationship, or damage. The statement shall be designed to meet the ends of justice. In determining the form of the statement, the court shall consider the nature of the acts of the defendant, the amount of knowledge a class member would have about the extent of such member's damages, the nature of the class including the probable degree of sophistication of its members, and the availability of relevant information from sources other than the individual class members. The amount of damages assessed against the defendant shall not exceed the total amount of damages determined to be allowable by the court for each individual class member who has filed a statement required by the court, assessable court costs, and an award of attorney fees, if any, as determined by the court.

F(3) Failure of a class member to file a statement required by the court will be grounds for entry of judgment dismissing such class member's claim for individual monetary recovery without prejudice to the right to maintain an individual, but not a class, action for such claim.

F(4) Plaintiffs shall bear costs of any notice ordered prior to a determination of liability. The court may, however, order that defendant bear all or a specified part of the costs of any notice included with a regular mailing by defendant to its current customers or employees. The court may hold a hearing to determine how the costs of such notice shall be apportioned".

5.7 **Louisiana**'s Article 592B(1) which requires the notice to be given as soon as practicable after certification, but in any event early enough for class members to exercise the option to be excluded before commencement of the trial.

It reads as follows:

"B(1) In any class action maintained under Article 591(B)(3), the court shall direct to the members of the class the best notice

practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. This notice, however given, shall be given as soon as practicable after certification, but in any event early enough that a delay provided for the class members to exercise an option to be excluded from the class will have expired before commencement of the trial on the merits of the common issues".

Article 592B(2) provides for the content of the notice and is similar to the corresponding sections of Iowa and North Dakota.

6. Judgment

6.1 Federal Rule 23(c) reads as follows :

"(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favourable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favourable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class".

6.2 **New Jersey** added (Rule 4:32-2(c)) :

"In any class action, the judgment may, consistent with due process of law, confer benefits upon a fluid class, whose members may be, but need not have been members of the class in suit";

6.3 **Oregon** (Rule 32M) :

"If a money judgment is entered in favour of a class it shall when possible identify by name each member of the class and the amount to be recovered thereby".

7. Subclassing

7.1 Federal Rule 23(c)(4) reads as follows :

> "Actions Conducted Partially as Class Actions
>
> (4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly".

7.2 **Arkansas, Minnesota, North Carolina, Georgia** and **Wisconsin** did not make any provision for subclassing.

7.3 **Oregon** (Rule 232G) exempted the subclass from the prerequisite that it has to be so numerous that joinder of all members is impracticable. It reads as follows :

> "Each subclass must separately satisfy all requirements of this rule except for subsection A(1)".

7.4 **Iowa and North Dakota** (Rule 42.2(c) and Rule 23(b)(3) deviate from the basic structure of Federal Rule 23 and deal with subclassing as part of the process of certification. Federal Rule 23 deals with subclassing in the context of management and conduct of the class action.

8. Conduct of the action

8.1 Federal Rule 23(d) reads as follows :

> "(d) **Orders in Conduct of Actions.** In the conduct of actions to which this rule applies, the court may make appropriate orders:
>
> (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument;

(2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action;

(3) imposing conditions of the representative parties or on intervenors;

(4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly;

(5) dealing with similar procedural matters.

The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time".

8.2 **Louisiana** (Art. 592E(5)) elaborated on Federal Rule 23(d)(5) by referring to matters such as

— consolidation

— duties of counsel

— pre- and post certification discovery.

It reads as follows :

"(5) Dealing with similar procedural matters, including but not limited to case management orders providing for consolidation, duties of counsel, the extent and the scheduling of and the delays for pre-certification and post-certification discovery, and other matters which affect the general order of proceedings; however, the court may not

order the class-wide trial of issues dependent for their resolution on proof individual to a member of the class, including but not limited to the causation of the member's injuries, the amount of the member's special or general damages, the individual knowledge or reliance of the member, or the applicability to the member of individual claims or defenses".

Oregon (Rule 32E(1)) added

"... precertification determination of a motion made by any party pursuant to Rules 21 or 47 if the court concludes that such determination will promote the fair and efficient adjudication of the controversy and will not cause undue delay".

A motion pursuant to Rule 21 is a motion for judgment on the pleadings, and Rule 47 is a motion for summary judgment.

8.3 **Iowa & North Dakota** added a provision which allows the court to invite the attorney-general to participate in the question of adequacy of class representation (Rule 42.9(a)(4) and Rule 23((i)(1)(d):

"(i) **Conduct of Action.**

(1) The court on motion of a party or its own motion may make or amend any appropriate order dealing with the conduct of the action including, but not limited to, the following:

(A) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument;

(B) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given as the court directs, of

(i) any step in the action,

(ii) the proposed extent of the judgment, or

(iii) the opportunity of members to signify whether they consider the representation fair and adequate, to enter an appearance and present claims defenses, or otherwise to participate in the action;

(C) imposing conditions on the representative parties or on intervenors;

(D) inviting the attorney-general to participate with respect to the question of adequacy of class representation;

(E) making any other order to assure that the class action proceeds only with adequate class representation; and

(F) making any order to assure that the class action proceeds only with competent representation by the attorney for the class.

(2) A class member not a representative party may appear and be represented by separate counsel".

9. Dismissal or Compromise (settlement)

9.1 Federal Rule 23(e) reads as follows :

"A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs".

9.2 **Oregon** (Rule 32D) added an exception, namely that notice is not required if the dismissal

— is to be without prejudice; or

— is with prejudice against the class representative only; or

— if no compensation has been paid or promised to the representative or his attorney.

It reads as follows :

> "Notice of the proposed dismissal or compromise shall be given to some or all members of the class in such manner as the court directs, except that if the dismissal is to be without prejudice or with prejudice against the class representative only, then such dismissal may be ordered without notice if there is a showing that no compensation in any form has passed directly or indirectly from the party opposing the class to the class representative or to the class representative's attorney and that no promise of such compensation has been made. If the statute of limitations has run or may run against the claim of any class member, the court may require appropriate notice".

9.3 **Iowa and North Dakota** (Rule 42.12 and Rule 23(l)) added a provision in respect of the contents of the notice:

> "Notice given under subdivision (B) shall include a full disclosure of the reasons for the dismissal or compromise including, but not limited to :
>
> (1) any payments made or to be made in connection with the dismissal or compromise;
>
> (2) the anticipated effect of the dismissal or compromise on the class members;

(3) any agreement made in connection with the dismissal or compromise;

(4) a description and evaluation of alternatives considered by the representative parties; and

(5) an explanation of any other circumstances giving rise to the proposal.

The notice shall include a description of the procedure available for modification of the dismissal or compromise".

9.4 **Louisiana** included a provision which allows all class members to be heard in regard to the proposed settlement. The court also has the authority to review the attorney's fees decided upon in a settlement agreement. Article 594B reads as follows :

"(2) After notice of the proposed compromise has been provided to the members of the class, the court shall order a hearing to determine whether the proposed compromise is fair, reasonable, and adequate for the class. At such hearing, all parties to the action, including members of the class, shall be permitted an opportunity to be heard".

An interesting provision, Article 594E, provides for the court to ensure the safekeeping of funds of persons under a disability.

It reads as follows :

"If the terms of the proposed compromise provide for the adjudged creation of a settlement fund to be disbursed to and among members of the class in accordance with the terms thereof, the court having jurisdiction over the class action is empowered to approve the compromise settlement of the class action as a whole and issue a final judgment accordingly, following a finding that the compromise is fair, reasonable, and adequate for the class, and to order the distribution of the settlement fund accordingly, without the necessity of prior qualification of representatives of minors, interdicts, successions, or other incompetents or absentees, or prior approval of the terms of the settlement or the distribution thereof by another

court; provided, that in such cases the court having jurisdiction over the class action shall include in the orders of settlement and distribution of the settlement fund appropriate provisions to ensure that all funds adjudicated to or for the benefit of such incompetents, successions, or absentees are placed in appropriate safekeeping pending the completion of appointment, qualification, and administrative procedures otherwise applicable in this Code to the interests and property of incompetents, successions, and absentees".

10. Additional provisions

Some States added provisions which are not included in Federal Rule 23. **Montana, Ohio** and **Alabama** added one additional provision to the basic structure of Federal Rule 23.

Montana included a provision on security for costs (Rule 23(f));

"Security for Costs

Security for costs and charges, which may be awarded against a representative party, may be required by an opposing party. When required, all proceedings in the action must be stayed until an undertaking, executed by two or more persons, is filed with the clerk, to the effect that they will pay such costs and charges as may be awarded against the representative party by judgment, or in the progress of the action, not exceeding the sum of $1 000. A new or an additional undertaking may be ordered by the court or judge, upon proof that the original undertaking is insufficient security, and proceedings in the action stayed until such new or additional undertaking is executed and filed".

Ohio included a provision on the aggregation of claims (Rule 23F):

"(F) Aggregation of claims

The claims of the class shall be aggregated in determining the jurisdiction of the court".

Alabama exempted Rule 23 from district courts (Rule 23(dc)).

> "(dc) **District Court Rules**
>
> Rule 23 does not apply in the district courts".

11. Prescription

11.1 **Iowa, North Dakota, Oregon** and **Louisiana** included provisions with regard to the effect of certification on the statute of limitations.

The standard provision adopted regarding prescription reads as follows :

> "The statute of limitations is tolled for all class members upon the commencement of an action asserting a class action. The statute of limitations resumes running against a member of a class :
>
> (1) Upon filing of an election of exclusion by such class member;
>
> (2) Upon entry of an order of certification, or of an amendment thereof, eliminating the class member from the class;
>
> (3) Except as to representative parties, upon entry of an order under Section C of this rule refusing to certify the class as a class action; and
>
> (4) Upon dismissal of the action without an adjudication on the merits".

11.2 **Iowa & North Dakota** (Rule 42.18 and Rule 23(r)) adopted a provision to the effect that the commencement of an action asserting a class action suspends the statute of limitations. The application for certification itself will suspend prescription.

11.3 **Oregon** (Rule 32O) adopted a similar provision.

11.4 **Louisiana** adopted a similar provision, although worded differently.

12. Attorneys' Fees and Costs

12.1 **Oregon** (Rule 32N) adopted a provision on attorney's fees, costs, disbursements and litigation expenses. It reads as follows :

"N(1)(a) Attorney fees for representing a class are subject to control of the court.

N(1)(b) If under an applicable provision of law a defendant or defendant class is entitled to attorney fees, costs, or disbursements from a plaintiff class, only representative parties and those members of the class who have appeared individually are liable for those amounts. If a plaintiff is entitled to attorney fees, costs, or disbursements from a defendant class, the court may apportion the fees, costs, or disbursements among the members of the class.

N(1)(c) If the prevailing class recovers a judgment that can be divided for the purpose, the court may order reasonable attorney fees and litigation expenses of the class to be paid from the recovery.

N(1)(d) The court may order the adverse party to pay to the prevailing class its reasonable attorney fees and litigation expenses if permitted by law in similar cases not involving a class".

It requires the court to consider five factors in determining attorneys' fees, namely :

"(i) The time and effort expended by the attorney in the litigation, including the nature, extent and quality of the services rendered;

(ii) Results achieved and benefits conferred upon the class;

(iii) The magnitude, complexity, and uniqueness of the litigation;

(iv) The contingent nature of success; and

(v) Appropriate criteria in OR2-106 of the Oregon Code of Professional Responsibility".

It also requires the representative parties and the attorney acting for the class to file with the court prior to the certification hearing :

"N(2)(a) A statement showing any amount paid or promised them by any person for the services rendered or to be rendered in connection with the action or for the costs and expenses of the litigation and the source of all of the amounts;

N(2)(b) A copy of any written agreement, or a summary of any oral agreement, between the representative parties and their attorney concerning financial arrangement or fees; and

N(2)(c) A copy of any written agreement, or a summary of any oral agreement, by the representative parties or the attorney to share these amounts with any person other than a member, regular associate, or an attorney regularly of counsel with the law firm of the representative parties' attorney. This statement shall be supplemented promptly if additional arrangements are made".

12.2 **Iowa & North Dakota** (Rule 42.14, 42.16-42.17 and Rule 23(n), Rule 23(p)-(q)) adopted three independent provisions on costs, attorneys' fees and arrangements for attorneys' fees and expenses.

"(n) Costs.

(1) Only the representative parties and those members of the class who have appeared individually are liable for costs assessed against a plaintiff class.

(2) The court shall apportion the liability for costs assessed against a defendant class.

(3) Expenses of notice advanced under subdivision (g) are taxable as costs in favor of the prevailing party.

(p) Attorney's Fees.

(1) Attorney's fees for representing a class are subject to control of the court.

(2) If under an applicable provision of law a defendant or defendant class is entitled to attorney's fees from a plaintiff class, only representative parties and those members of the class who have appeared individually are liable for those fees. If a plaintiff is entitled to attorney's fees from a defendant class, the court may apportion the fees among the members of the class.

(3) If a prevailing class recovers a judgment for money or other award that can be divided for the purpose, the court may order reasonable attorney's fees and litigation expenses of the class to be paid from the recovery.

(4) If the prevailing class is entitled to declaratory or equitable relief the court may order the adverse party to pay to the class its reasonable attorney's fees and litigation expenses if permitted by law in similar cases not involving a class or the court finds that the judgment has vindicated an important public interest. However, if any monetary award is also recovered, the court may allow reasonable attorney's fees and litigation expenses only to the extent that a reasonable proportion of that award is insufficient to defray the fees and expenses.

(5) In determining the amount of attorney's fees for a prevailing class the court shall consider the following factors:

(A) the time and effort expended by the attorney in the litigation, including the nature, extent, and quality of the services rendered;

(B) results achieved and benefits conferred upon the class;

(C) the magnitude, complexity, and uniqueness of the litigation;

(D) the contingent nature of success;

(E) in cases awarding attorney's fees and litigation expenses under paragraph (4) because of the vindication on an important public interest, the economic impact on the party against whom the award is made; and

(F) appropriate criteria included in the North Dakota Code of Professional Responsibility.

(q) Arrangements for Attorney's Fees and Expenses.

(1) Before a hearing under subdivision (b)(1) or at any other time the court directs, the representative parties and the attorney for the representative parties shall file with the court, jointly or separately:

(A) a statement showing any amount paid or promised them by any person for the services rendered or to be rendered in connection with the action or for the costs and expenses of the litigation and the source of all of the amounts;

(B) a copy of any written agreement, or a summary of any oral agreement, between the representative parties and their attorney concerning financial arrangements or fee; and

(C) a copy of any written agreement, or a summary of any oral agreement, by the representative parties or the attorney to share these amounts with any person other than a member, regular associate, or an attomey regularly of counsel with his law firm. This statement

shall be supplemented promptly if additional arrangements are made.

(2) Upon a determination that the costs and litigation expenses of the action cannot reasonably and fairly be defrayed by the representative parties or by other available sources, the court by order may authorize and control the solicitation and expenditure of voluntary contributions for this purpose from members of the class, advances by the attorneys or others, or both, subject to reimbursement from any recovery obtained for the class. The court may order any available funds so contributed or advanced to be applied to the payment of any costs taxed in favor of a party opposing the class".

Iowa and **North Dakota** also provide that only the representative parties and class members who appeared individually are liable for costs. In the event of costs being awarded against a defendant class the costs are apportioned amongst the defendants. Costs of notice is taxable as costs in favour of the successful party.

These states also adopted provisions similar to those of Oregon in respect of attorneys' fees, but included a provision that the court may allow more than only reasonable attorneys' fees and litigation costs if the monetary award is recovered and it is found that such an award is insufficient to defray the fees and expenses of the successful party.

12.3 **Louisiana** adopted a more compact version on expenses of litigation and security for costs. It reads :

"(1) The court may allow the representative parties their reasonable expenses of litigation, including attorney's fees, when as a result of the class action a fund is made available, or a recovery or compromise is had which is beneficial, to the class;

(2) The court, on contradictory motion at any stage of the proceeding in the trial court prior to judgment, may require the plaintiff in a class action to furnish security for the court costs which a defendant may be compelled to pay. This security for costs may be increased or decreased by the court, on contradictory motion of any interested

party, on a showing that the security furnished has become inadequate or excessive".

13. Discovery

Maryland, Iowa and **North Dakota** adopted similar provisions regarding discovery. In essence, it states that discovery may by used against a representative party. Discovery against a member of the class can only be obtained by an order of the court. Normal civil procedure rules will deal with discovery by or against representative parties (respectively Rules 2-231(g); Rule 42.10 and Rule 23(j)).

14. Interesting Additional Provisions

14.1 **Iowa** and **North Dakota** (Rule 42.11 and Rule 23(k)) adopted interesting provisions on **counterclaims**, reading as follows:

"Rule 42.11. Counterclaims.

a. A defendant in an action brought by a class may plead as a counterclaim any claim the court certifies as a class action against the plaintiff class. On leave of court, the defendant may plead as a counterclaim a claim against a member of the class or a claim the court certifies as a class action against a subclass.

b. Any counterclaim in an action brought by a plaintiff class must be asserted before notice is given under R.C.P. 42.7.

c. If a judgment for money is recovered against a party on behalf of a class, the court rendering judgment may stay distribution of any award or execution of any portion of a judgment allocated to a member of the class against whom the losing party has pending an action in or out of state for a judgment for money, and continue the stay so long as the losing party in the class action pursues the pending action with reasonable diligence.

d. A defendant class may plead as a counterclaim any claim on behalf of the class that the court certifies as a class action against the plaintiff. The court may certify as a class action a counterclaim

against the plaintiff on behalf of a subclass or permit a counterclaim by a member of a class. The court shall order that notice of the counterclaim by the class, subclass, or member of the class be given to the members of the class as the court directs, in the interest of justice.

e. A member of a class or subclass asserting a counterclaim shall be treated as a member of a plaintiff class for the purpose of exclusion under R.C.P. 42.8.

f. The court's refusal to allow, or the defendant's failure to plead, a claim as a counterclaim in a class action does not bar the defendant from asserting the claim in a subsequent action. [Report 1980]".

14.2 **Oregon** (Rule 32L) adopted interesting provisions in respect of the **coordination of pending class actions.** It reads as follows:

"When class actions sharing a common question of fact or law are pending in different courts, the presiding judge of any such court, upon motion of any party or on the courts own initiative, may request the Supreme Court to assign a Circuit Court, Court of Appeals, or Supreme Court judge to determine whether coordination of the actions is appropriate, and a judge shall be so assigned to make that determination".

It further provides the following guidelines for a judge to consider when deciding whether coordination of class actions would be appropriate :

"L(1)(b) Coordination of class actions sharing a common question of fact or law is appropriate if one judge hearing all of the actions for all purposes in a selected site or sites will promote the ends of justice taking into account whether the common question of fact or law is predominant and significant to the litigation, the convenience of parties, witnesses, and counsel, the relative development of the actions and the work product of counsel, the efficient utilization of judicial facilities and personnel, the calendar of the courts, the disadvantages of duplicative and inconsistent rulings, orders, or judgments; and the

likelihood of settlement of the actions without further litigation should coordination be denied".

If it is decided that such coordination is appropriate, the Chief Justice of the Supreme Court will assign a judge to hear and determine the actions. The provision reads as follows :

"L(2) If the assigned judge determines that coordination is appropriate, such judge shall order the actions coordinated, report that fact to the Chief Justice of the Supreme Court, and the Chief Justice shall assign a judge to hear and determine the actions in the site or sites the Chief Justice deems appropriate.

L(3) The judge of any court in which there is pending an action sharing a common question of fact or law with coordinated actions, upon motion of any party or on the court's own initiative, may request the judge assigned to hear the coordinated action for an order coordinating such actions. Coordination of the action pending before the judge so requesting shall be determined under the standards specified in subsection (1) of this section.

L(4) Pending any determination of whether coordination is appropriate, the judge assigned to make the determination may stay any action being considered for, or affecting any action being considered for, coordination.

L(5) Notwithstanding any other provision of law, the Supreme Court shall provide by rule the practice and procedure for coordination of class actions in convenient courts, including provision for giving notice and presenting evidence".

14.3 **Iowa and North Dakota** (Rule 42.15 and Rule 23(o)) also adopted interesting provisions on the **distribution** of monies recovered.

The monies recovered are distributed as follows :

"(1) The parties shall list as expeditiously as possible all members of the class whose identity can be determined without expending a disproportionate share of the recovery;

(2) The reasonable expense of identification and distribution shall be paid, with the court's approval, from the funds to be distributed;

(3) The court may order steps taken to minimize the expense of identification.

(4) The court shall supervise, and may grant or stay the whole or any portion of the execution of the judgment and the collection and distribution of funds to the members of the class as their interests warrant;

(5) The court shall determine what amount of the funds available for the payment of the judgment cannot be distributed to members of the class individually because they could not be identified or located or because they did not claim or prove the right to money apportioned to them. The court after a hearing shall distribute that amount, in whole or in part, to one or more states as unclaimed property or to the defendant.

(6) In determining the amount, if any, to be distributed to a state or to the defendant, the court shall consider the following criteria:

(i) any unjust enrichment of the defendant;

(ii) the willfulness or lack of willfulness on the part of the defendant;

(iii) the impact on the defendant of the relief granted;

(iv) the pendency of other claims against the defendant;

(v) any criminal sanction imposed on the defendant; and

(vi) the loss suffered by the plaintiff class.

(7) The court, in order to remedy or alleviate any harm done, may impose conditions respecting the use of the money distributed to the defendant.

Any amount to be distributed to a state shall be distributed as unclaimed property to any state in which are located the last-known addresses of the members of the class to whom distribution could not be made. If the last-known addresses cannot be ascertained with reasonable diligence, the court may determine by other means what portion of the unidentified or unlocated members of the class were residents of a state. A state shall receive that portion of the distribution that its residents would have received had they been identified and located. Before entering an order distributing any part of the amount to a state, the court shall give written notice of its intention to make distribution to the attorney general of the state of the residence of any person given notice under R.C.P.42.7 or 42.12 and shall afford the attorney general an opportunity to move for an order requiring payment to the state".

15. Securities class actions

As Federal Rule 23 did not contain any provisions in regard to the representative or the process of selecting such representative, a need arose for such a provision, and the legislator introduced The Private Securities Litigation Reform Act of 1995.

The **Private Securities Litigation Reform Act of 1995** in the United States introduced new requirements to Section 27 and 21(D)(a) of the Federal Securities Act of 1933. These new requirements were introduced as a countermeasure to problems such as incentives to file "strike suits", the accompanying "race to the courthouse", and the notion of "professional plaintiffs" and class action attorneys, which were generally experienced in the United States.

The Reform Act concentrated on new criteria for selecting the lead plaintiff who essentially controls the litigation. It was intended by the legislature that the control of the litigation should be placed in the hands of large institutional

investors and administrators of pension funds.

Section 27(a)(2)A provides that every plaintiff who seeks to serve as a representative must submit an affidavit which

"(i) states that the plaintiff has reviewed the complaint and authorized its filing;

(ii) states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action arising under this title;

(iii) states that the plaintiff is willing to serve as a representative party on behalf of a class, including providing testimony at deposition and trial, if necessary;

(iv) sets forth all of the transactions of the plaintiff in the security that is the subject of the complaint during the class period specified in the complaint;

(v) identifies any other action under this title, filed during the 3-year period preceding the date on which the certification is signed by the plaintiff, in which the plaintiff has sought to serve, or served, as a representative party on behalf of a class; and

(vi) states that the plaintiff will not accept any payment for serving as a representative party on behalf of a class beyond the plaintiff's pro rata share of any recovery, except as ordered or approved by the court in accordance with paragraph (4)".

4. **Ontario Law Reform Commission** : ' Report on Class Actions', 1982, p.6 – 7.

5. **Manitoba Law Reform Commission :** Report No. 100, 1999, p. 13.

6. **Manitoba Law Reform Commission :** Report No. 100, 1999, p. 1 – 3.

7. **Ontario Law Reform Commission** : 'Report on Class Actions', 1982, p. 118.

8. **Manitoba Law Reform Commission** : Report No. 100, 1999, p. 25.

9. **Manitoba Law Reform Commission** : Report No.100, 1999, p. 28.

10. **Uniform Law Conference of Canada** : Discussion Paper – 'A Uniform Class A Uniform Class Action Statute', August 1995.

11. **Lord Chancellor's** Department : Discussion Paper – 'Proposed new procedures for multi-party situations', 1996.

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ANNEXURE A:

SOUTH AFRICAN LAW COMMISSION'S DRAFT BILL

BILL

To make provision for the institution of public interest and class actions; to regulate the conduct of public interest and class actions; and to provide for matters connected therewith.

TO BE INTRODUCED BY THE MINISTER OF JUSTICE

BE IT ENACTED by the Parliament of the Republic of South Africa, as follows:-

CHAPTER 1: DEFINITIONS

Definitions

1 In this Act, unless the context otherwise indicates -

"action" means any proceeding instituted in a court, whether by way of summons or notice of motion;

"certify" means to permit an action to be maintained as a class action, but does not mean to approve the merits of the action except to the extent provided for by section 6(2) of this Act;

"class action" means an action instituted by a representative on behalf of a class of persons in respect of whom the relief claimed and the issues involved are substantially similar in respect of all members of the class, and certified as a class action in terms of section 6 of this Act;

"common issues" means common but not necessarily identical issues of fact, or common but not necessarily identical issues of law that arise from common but not necessarily identical facts;

"court" means the Supreme Court of Appeal, the Constitutional Court of South Africa, the High Court of South Africa, the Land Claims Court, the Labour Court, and any other court designated by the Minister in terms of section 15 of this Act;

"Legal Aid Board" means the Legal Aid Board established in terms of section 2 of the Legal Aid Act, 1969;

"legal practitioner" means a practising advocate or practising attorney;

"members of a class" means two or more persons with a common interest in the class action;

"Minister" means the Minister of Justice;

"person" includes an association of persons, whether vested with legal personality or not;

"public interest action" means an action instituted by a representative in the interest of the public generally, or in the interest of a section of the public, but not necessarily in that representative's own interest;

"representative" means a person designated by the court as the representative of the plaintiffs or defendants in a public interest action or class action.

CHAPTER 2: PUBLIC INTEREST ACTIONS

Instituting a public interest action

2 (1) Any person may institute action in a court claiming by way of a public interest action relief in the interest of the public generally or of any particular section thereof, irrespective of whether or not such person has any direct, indirect or personal interest in the relief claimed.

(2) The person who institutes a public interest action shall identify the action as such and nominate either himself or herself or any other suitable person as representative of those on whose behalf the relief is claimed.

(3) The court may give directions to the representative as to the appropriate person or persons to be served as respondents.

(4) Unless the court holds otherwise, judgment in a public interest action shall not be binding on the person or persons in whose interest the action is brought.

The representative in public interest actions

3 (1) If the court is satisfied that it is proper that the action should proceed by way of a public interest action, it shall appoint as the representative a person who, in the court's opinion, is suitably qualified to represent the public interest in the matter concerned.

(2) The court may at any stage before judgment **mero motu** or on application of any interested person remove any representative and appoint another suitably qualified representative on good cause shown.

Costs

4 (1) In a public interest action the court shall not make an order as to costs or order the representative to provide security for costs unless special circumstances apply.

(2) The court may authorise a public interest action and appoint the representative subject to the rendering or making available of legal aid by the Legal Aid Board.

CHAPTER 3: CLASS ACTIONS

Instituting a class action

5 Any person, whether a member of the class concerned or not, may apply to a court for leave to institute or defend an action as a class action.

Certification

6 (1) No action shall proceed as a class action unless the court has certified the action as a class action.

(2) In deciding to certify an action as a class action, the court may take into account -

(a) evidence of the existence of an identifiable class of persons;

(b) the existence of a **prima facie** cause of action or defence;

(c) issues of fact or law which are common to the claims or defences of individual members of a class;

(d) the availability of a suitable representative or representatives to represent the interests of the members of the class;

(e) the interests of justice; and

(f) whether, having regard to all relevant circumstances, a class action would be the appropriate method of proceeding with the action.

(3) The court may **mero moto** or on application of any interested person withdraw the certification order at any stage before judgment if the criteria in subsection (2) are no longer met.

(4) The court which certifies an action as a class action may give directions as to the appropriate court in which the action should be prosecuted.

(5) The court shall not be precluded from certifying an action as a class action merely by reason of the fact that there are issues pertaining to the claims of all or some of the members of the class which will require individual determination or that different class members seek different relief.

(6) The refusal of the court to certify an action as a class action shall be subject to appeal.

The representative in a class action

7 (1) The court which certifies an action as a class action shall appoint one or more persons as representative or representatives of the class.

(2) The court may appoint the applicant, or any other suitable person, as representative in a class action.

(3) When appointing a person as the representative the court shall take into account -

(a) the suitability of that person adequately to represent the best interests of the members of the class;

(b) any conflict or potential conflict of interest between the representative and the members of the class;

(c) the ability of the representative to make satisfactory arrangements with regard to the funding of the class action and the satisfaction of any order as to costs; or for security for costs; and

(d) the ability of the representative to manage the class action.

(4) A representative appointed by the court shall conduct the class action in the best interests of the members of the class concerned and in accordance with the directions of court.

(5) The court may at any stage before judgment **mero motu** or on application of any interested person remove any representative and appoint another suitably qualified representative on good cause shown.

Notice in class actions

8 (1) The court which certifies an action as a class action may give directions to the representative with regard to -

(a) the giving of notice of the action to the members or potential members of the class concerned;

(b) the form which such notice should take;

(c) the way in which such notice is to be communicated to the members of the class.

(2) In considering the question whether notice should be given to the members of a class and, if so, what directions are appropriate in respect thereof, the court shall take into account-

(a) the extent to which the members of the class might be prejudiced by being bound by a judgment given in an action which may not have come to their attention;

(b) the potential size of the class;

(c) the general level of education and development of the members of the class;

(d) the ease with which members of the class can be identified;

(e) the type of relief claimed;

(f) where monetary relief is claimed, the amount of the claim of each member of the class;

(g) the difficulties likely to be encountered by members of the class in enforcing their actions individually;

(h) any other relevant factor.

(3) The court may -

(a) require from those members of the class who do not wish to be bound by the judgment written notice of their exclusion as members of the class;

(b) require from those members of the class who wish to be bound by the judgment written notice of their inclusion as members of the class; or

(c) order that no notice to members of the class is necessary.

Procedure in class actions

9 (1) The court in which the class action is prosecuted shall -

(a) give directions as to the procedure to be followed in the conduct of the class action;

(b) delineate the common issues to be decided in the class action;

(c) determine whether there are individual issues that require separate adjudication and, if so, give directions as to the procedure to be followed in order to adjudicate such issues;

(d) determine, where the claims are for damages or any other form of monetary relief, whether the individual claims of the members of the class should be assessed as one aggregate amount or whether the claims of the members of the class should be proved individually;

(e) determine how any aggregate award is to be distributed among the members of a class, appoint a person responsible for the administration of such distribution, and give directions as to matters incidental thereto.

(2) Any member of a class who stands to be bound by a judgment in a class action may apply for leave to intervene in the action in order to protect his or her own interests or the interests of the class or any section thereof.

Conduct of a class action

10 (1) The court in which the class action is prosecuted may first give judgment on the common issues and then adjudicate the individual issues.

(2) The court may order consolidation of actions where a number of claims are based on substantially the same cause of action.

(3) Judgment of the court in respect of a class action shall be binding on the members of the class, unless the court is of the opinion, after consideration of the factors listed in section 8(2), that members of the class may be significantly prejudiced by the fact that they will be bound by a judgment given in a class action which may not have come to their notice.

Costs

11 (1) In a class action the court shall not order the representative to provide security for costs unless special circumstances apply.

(2) The court may-

(a) authorize a class action and appoint the representative subject to the rendering or making available of legal aid by the Legal Aid Board;

(b) order those members of the class who elected to give written notice in terms of section 8(3)(b) to contribute towards and, where appropriate, to provide security for costs.

(3) When an award is made in a class action in respect of which funds have been made available by the Legal Aid Board the court may order the representative or any member of the class to contribute a percentage of the award to the Legal Aid Board.

Contingency fees

12 (1) Subject to the Contingency Fees Act 66 of 1997, a legal practitioner may make an arrangement in writing with the appointed representative stipulating for the payment of fees or fees and disbursements, in respect of a class action commenced under this Act only in the event of success in the action.

(2) For the purpose of this section, success in the action includes a judgment in favour of some or all members of the class on the questions of fact or law common to such members or a settlement that benefits some or all members of the class.

CHAPTER 4: GENERAL

Appointment of commissioner

13 (1) In a public interest action or a class action the court may appoint a commissioner for the purpose of -

(a) collating evidence;

(b) making a recommendation, including a recommendation relating to individual issues or the individual assessment of monetary claims in a class action.

(2) The commissioner shall report his or her findings or recommendation to the court.

(3) The findings or recommendations of the commissioner shall be subject to review by the court.

Settlement, abandonment, and discontinuance

14 An action commenced under this Act shall not be settled, abandoned or discontinued without the prior approval of the court first being obtained, and upon such terms and conditions, including notice or otherwise, as the court considers proper.

Designation of court by Minister

15 The Minister may designate by way of notice in the Gazette those courts in which public interest actions and class actions may be instituted.

Short title

16 This Act shall be called the Public Interest and Class Actions Act, 19..

ANNEXURE B

UNITED STATES OF AMERICA : FEDERAL RULE 23

FEDERAL RULES OF CIVIL PROCEDURE

(U.S. Fed. R. Civ. P. 23)

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if

(1) the class is so numerous that joinder of all members is impracticable,

(2) there are questions of law or fact common to the class,

(3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and

(4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to these findings include:

(A) the interest of members of the class in individually controlling the prosecution or defense of separate actions;

(B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class;

(C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum;

(D) the difficulties likely to be encountered in the management of a class action.

(c) Determination by Order Whether Class Actions to be Maintained.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

Notice

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that:

(A) the court will exclude him from the class if the member so requests by a specified date;

(B) the judgment, whether favorable or not, will include all members who do not request exclusion; and

(C) any member who does not request exclusion may, if the member desires, enter an appearance through his counsel.

Judgment

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

Actions Conducted Partially as Class Actions

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

(d) Orders in Conduct of Actions. In the conduct of actions to which this rule applies, the court may make appropriate orders:

(1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument;

(2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action;

(3) imposing conditions of the representative parties or on intervenors;

(4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly;

(5) dealing with similar procedural matters.

The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(e) Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

ANNEXURE C

ONTARIO CLASS PROCEEDINGS ACT, 1992

(S.O. 1992, c. 6)

1. Definitions. In this Act,

"common issues" means,

(a) common but not necessarily identical issues of fact, or

(b) common but not necessarily identical issues of law that arise from common but not necessarily identical facts;

"court" means the Ontario Court (General Division) but does not include the Small Claims Court;

"defendant" includes a respondent;

"plaintiff includes an applicant.

2. Plaintiff's class proceeding.-

(1) One or more members of a class of persons may commence a proceeding in the court on behalf of the members of the class.

(2) *Motion for certification.* A person who commences a proceeding under subsection (1) shall make a motion to a judge of the court for an order certifying the proceeding as a class proceeding and appointing the person representative plaintiff.

(3) *Idem.* A motion under subsection (2) shall be made,

(a) within ninety days after the later of,

(i) the date on which the last statement of defence, notice of intent to defend or notice of appearance is delivered, and

(ii) the date on which the time prescribed by the rules of court for delivery of the last statement of defence, notice of intent to defend or a notice of appearance expires without its being delivered; or

(b) subsequently, with leave of the court.

3. Defendant's class proceedings.-

A defendant to two or more proceedings may, at any stage of one of the proceedings, make a motion to a judge of the court for an order certifying the proceedings as a class proceeding and appointing a representative plaintiff.

4. Classing defendants.-

Any party to a proceeding against two or more defendants may, at any stage of the proceeding, make a motion to a judge of the court for an order certifying the proceeding as a class proceeding and appointing a representative defendant.

5. Certification.-

(1) The court shall certify a class proceeding on a motion under section 2, 3 or 4 if,

(a) the pleadings or the notice of application discloses a cause of action;

(b) there is an identifiable class of two or more persons that would be represented by the representative plaintiff or defendant;

(c) the claims or defences of the class members raise common issues;

(d) a class proceeding would be the preferable procedure for the resolution of the common issues; and

(e) there is a representative plaintiff or defendant who,

(i) would fairly and adequately represent the interests of the class,

(ii) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the class and of notifying class members of the proceeding; and

(iii) does not have, on the common issues for the class, an interest in conflict with the interests of other class members.

(2) *Idem. Subclass protection.* Despite subsection (1), where a class includes a subclass whose members have claims or defences that raise common issues not shared by all the class members, so that, in the opinion of the court, the protection of the interests of the subclass members requires that they be separately represented, the court shall not certify the class proceeding unless there is a representative plaintiff or defendant who,

(a) would fairly and adequately represent the interests of the subclass;

(b) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the subclass and of notifying subclass members of the proceeding; and

(c) does not have, on the common issues for the subclass, an interest in conflict with the interests of other subclass members.

(3) *Evidence as to size of class.* Each party to a motion for certification shall, in an affidavit filed for use on the motion, provide the party's best information on the number of members in the class.

(4) *Adjournments.* The court may adjourn the motion for certification to permit the parties to amend their materials or pleadings or to permit further evidence.

(5) *Certification not a ruling on merits.* An order certifying a class proceeding is not a determination of the merits of the proceeding.

6. Certain matters not bar to certification.-

The court shall not refuse to certify a proceeding as a class proceeding solely on any of the following grounds:

1. The relief claimed includes a claim for damages that would require individual assessment after determination of the common issues.

2. The relief claimed relates to separate contracts involving different class members.

3. Different remedies are sought for different class members.

4. The number of class members or the identity of each class member is not known.

5. The class includes a subclass whose members have claims or defences that raise common issues not shared by all class members.

7. Refusal to certify: proceeding may continue in altered form.-

Where the court refuses to certify a proceeding as a class proceeding, the court may permit the proceeding to continue as one or more proceedings between different parties and, for the purpose, the court may,

(a) order the addition, deletion or substitution of parties;

(b) order the amendment of the pleadings or notice of application; and

(c) make any further order that it considers appropriate.

8. Contents of certification order-

(1) An order certifying a proceeding as a class proceeding shall

(a) describe the class;

(b) state the names of the representative parties;

(c) state the nature of the claims or defences asserted on behalf of the class;

(d) state the relief sought by or from the class;

(e) set out the common issues for the class; and

(f) specify the manner in which class members may opt out of the class proceeding and a date after which class members may not opt out.

(2) Subclass protection. Where a class includes a subclass whose members have claims or defences that raise common issues not shared by all the class members, so that, in the opinion of the court, the protection of the interests of the subclass members requires that they

be separately represented, subsection (1) applies with necessary modifications in respect of the subclass.

(3) Amendment of certification order. The court, on the motion of a party or class member, may amend an order certifying a proceeding as a class proceeding.

9. Opting out.-

Any member of a class involved in a class proceeding may opt out of the proceeding in the manner and within the time specified in the certification order.

10. Where it appears conditions for certification not satisfied.-

(1) On the motion of a party or class member, where it appears to the court that the conditions mentioned in subsections 5(1) and (2) are not satisfied with respect to a class proceeding, the court may amend the certification order, may decertify the proceeding or may make any other order it considers appropriate.

(2) *Proceeding may continue in altered form.* Where the court makes a decertification order under subsection (1), the court may permit the proceeding to continue as one or more proceedings between different parties.

(3) *Powers of court.* For the purposes of subsections (1) and (2), the court has the powers set out in clauses 7(a) to (c).

11. Stages of class proceedings.-

(1) Subject to section 12, in a class proceeding,

(a) common issues for a class shall be determined together;

(b) common issues for a subclass shall be determined together; and

(c) individual issues that require the participation of individual class members shall be determined individually in accordance with sections 24 and 25.

(2) *Separate judgments* The court may give judgment in respect of the common issues and separate judgments in respect of any other issue.

12. Court may determine conduct of proceeding.-

The court, on the motion of a party or class member, may make any order it considers appropriate respecting the conduct of a class proceeding to ensure its fair and expeditious determination and, for the purpose, may impose such terms on the parties as it considers appropriate.

13. Court may stay any other proceeding.-

The court, on its own initiative or on the motion of a party or class member, may stay any proceeding related to the class proceeding before it, on such terms as it considers appropriate.

14. Participation of class members.-

(1) In order to ensure the fair and adequate representation of the interest of the class or any subclass or for any other appropriate reason, the court may, at any time in a class proceeding, permit one or more class members to participate in the proceeding.

(2) *Idem.* Participation under subsection (1) shall be in whatever manner and on whatever terms, including terms as to costs, the court considers appropriate.

15. Discovery of parties.-

(1) Parties to a class proceeding have the same rights of discovery under the rules of court against one another as they would have in any other proceeding.

(2) *Discovery of class members with leave.* After discovery of the representative party, a party may move for discovery under the rules of court against other class members.

(3) *Idem.* In deciding whether to grant leave to discover other class members, the court shall consider,

(a) the stage of the class proceeding and the issues to be determined at that stage;

(b) the presence of subclasses;

(c) whether the discovery is necessary in view of the claims or defences of the party seeking leave;

(d) the approximate monetary value of individual claims, if any;

(e) whether discovery would result in oppression or in undue annoyance, burden or expense for the class members sought to be discovered; and

(f) any other matter the court considers relevant.

(4) *Idem.* A class member is subject to the same sanctions under the rules of court as a party for failure to submit to discovery.

16. Examination of class members before a motion or application.-

(1) A party shall not require a class member other than a representative party to be examined as a witness before the hearing of a motion or application, except with leave of the court.

(2) *Idem.* Subsection 15(3) applies with necessary modifications to a decision whether to grant leave under subsection (1).

17. Notice of certification.-

(1) Notice of certification of a class proceeding shall be given by the representative party to the class members in accordance with this section.

(2) *Court may dispense with notice.* The court may dispense with notice if, having regard to the factors set out in subsection (3), the court considers it appropriate to do so.

(3) *Order respecting notice.* The court shall make an order setting out when and by what means notice shall be given under this section and in so doing shall have regard to,

(a) the cost of giving notice;

(b) the nature of the relief sought;

(c) the size of the individual claims of the class members;

(d) the number of class members;

(e) the places of residence of class members; and

(f) any other relevant matter.

(4) *Idem.* The court may order that notice be given,

(a) personally or by mail;

(b) by posting, advertising, publishing or leafleting;

(c) by individual notice to a sample group within the class; or

(d) by any means or combination of means that the court considers appropriate.

(5) *Idem.* The court may order that notice be given to different class members by different means.

(6) *Contents of notice.* Notice under this section shall, unless the court orders otherwise,

(a) describe the proceeding, including the names and addresses of the representative parties and the relief sought;

(b) state the manner by which and time within which class members may opt out of the proceeding;

(c) describe the possible financial consequences of the proceeding to class members;

(d) summarize any agreements between representative parties and their solicitors respecting fees and disbursements;

(e) describe any counterclaim being asserted by or against the class, including the relief sought in the counterclaim;

(f) state that the judgment, whether favorable or not, will bind all class members who do not opt out of the proceeding;

(g) describe the right of any class member to participate in the proceeding;

(h) give an address to which class members may direct inquiries about the proceeding; and

(i) give any other information the court considers appropriate.

(7) *Solicitations of contribution.* With leave of the court, notice under this section may, include a solicitation of contributions from class members to assist in paying solicitor's fees and disbursements.

18. Notice where individual participation is required.-

(1) When the court determines common issues in favour of a class and considers that the participation of individual class members is required to determine individual issues, the representative party shall give notice to those members in accordance with this section.

(2) *Idem.* Subsections 17(3) to (5) apply with necessary modifications to notice given under this section.

(3) *Contents of notice.* Notice under this section shall,

(a) state that common issues have been determined in favour of the class;

(b) state that class members may be entitled to individual relief;

(c) describe the steps to be taken to establish an individual claim;

(d) state that failure on the part of a class member to take those steps will result in the member not being entitled to assert an individual claim except with leave of the court;

(e) give an address to which class members may direct inquiries about the proceeding; and

(f) give any other information that the court considers appropriate.

19. Notice to protect interests of affected persons.-

(1) At any time in a class proceeding, the court may order any party to give such notice as it considers necessary to protect the interests of any class member or party or to ensure the fair conduct of the proceeding.

(2) *Idem.* Subsections 17(3) to (5) apply with necessary modifications to notice given under this section.

20. Approval of notice by the court.-

A notice under section 17, 18 or 19 shall be approved by the court before it is given.

21. Delivery of notice.-

The court may order a party to deliver, by whatever means are available to the party, the notice required to be given by another party under section 17, 18 or 19, where that is more practical.

22. Costs of notice-

(1) The court may make any order it considers appropriate as to the costs of any notice under section 17, 18 or 19, including an order apportioning costs among parties.

(2) *Idem.* In making an order under subsection (1), the court may have regard to the different interests of a subclass.

23. Statistical evidence.-

(1) For the purposes of determining issues relating to the amount or distribution of a monetary award under this Act, the court may admit as evidence statistical information that would not otherwise be admissible as evidence, including information derived from sampling, if the information was compiled in accordance with principles that are generally accepted by experts in the field of statistics.

(2) *Idem.* A record of statistical information purporting to be prepared or published under the authority of the Parliament of Canada or the legislature of any province or territory of Canada may be admitted as evidence without proof of its authenticity.

(3) *Notice.* Statistical information shall not be admitted as evidence under this section unless the party seeking to introduce the information has,

(a) given reasonable notice of it to the party against whom it is to be used, together with a copy of the information;

(b) complied with subsections (4) and (5); and

(c) complied with any requirement to produce documents under subsection (7).

(4) *Contents of notice.* Notice under this section shall specify the source of any statistical information sought to be introduced that,

(a) was prepared or published under the authority of the Parliament of Canada or the legislature of any province or territory of Canada;

(b) was derived from market quotations, tabulations, lists, directories or other compilations generally used and relied on by members of the public; or

(c) was derived from reference material generally used and relied on by members of an occupational group.

(5) *Idem.* Except with respect to information referred to in subsection (4), notice under this section shall,

(a) specify the name and qualifications of each person who supervised the preparation of statistical information sought to be introduced; and

(b) describe any documents prepared or used in the course of preparing the statistical information sought to be introduced.

(6) *Cross-examination.* A party against whom statistical information is sought to be introduced under this section may require, for the purposes of cross-examination, the attendance of any person who supervised the preparation of the information.

(7) *Production of documents.* Except with respect to information referred to in subsection (4), a party against whom statistical information is sought to be introduced under this section may require the party seeking to introduce it to produce for inspection any document that was prepared or used in the course of preparing the information, unless the document discloses the identity of persons responding to a survey who have not consented in writing to the disclosure.

24. Aggregate assessment of monetary relief.-

(1) The court may determine the aggregate or a part of a defendant's liability to class members and give judgment accordingly where,

(a) monetary relief is claimed on behalf of some or all class members;

(b) no questions of fact or law other than those relating to the assessment of monetary relief remain to be determined in order to establish the amount of the defendant's monetary liability; and

(c) the aggregate or a part of the defendant's liability to some or all class members can reasonably be determined without proof by individual class members.

(2) *Average or proportional application.* The court may order that all or a part of an award under subsection (1) be applied so that some or all individual class members share in the award on an average or proportional basis.

(3) *Idem.* In deciding whether to make an order under subsection (2), the court shall consider whether it would be impractical or inefficient to identify the class members entitled to share in the award or to determine the exact shares that should be allocated to individual class members.

(4) *Court to determine whether individual claims need to be made.*-When the court orders that all or a part of an award under subsection (1) be divided among individual class members, the court shall determine whether individual claims need to be made to give effect to the order.

(5) *Procedures for determining claims.* Where the court determines under subsection (4) that individual claims need to be made, the court shall specify procedures for determining the claims.

(6) *Idem.* In specifying procedures under subsection (5), the court shall minimize the burden on class members and, for the purpose, the court may authorize,

(a) the use of standardized proof of claim forms;

(b) the receipt of affidavit or other documentary evidence; and

(c) the auditing of claims off a sampling or other basis.

(7) *Time limits for making claims.* When specifying procedures under subsection (5) the court shall set a reasonable time within which individual class members may make claims under this section.

(8) *Idem.* A class member who fails to make a claim within the time set under subsection (7) may not later make a claim under this section except with leave of the court.

(9) *Extension of time.* The court may give leave under subsection (8) if it is satisfied that,

(a) there are apparent grounds for relief;

(b) the delay was not caused by any- fault of the person seeking the relief; and

(c) the defendant would not suffer substantial prejudice if leave were given.

(10) *Court may amend subs. (1) judgment.* The court may amend a judgment given under subsection (1) to give effect to a claim made with leave under subsection (8) if the court considers it appropriate to do so.

25. Individual issues.-

(1) When the court determines common issues in favour of a class and considers that the participation of individual class members is required to determine individual issues, other than those that may, be determined under section 24, the court may,

(a) determine the issues in further hearings presided over by the judge who determined the common issues or by another judge of the court;

(b) appoint one or more persons to conduct a reference under the rules of court and report back to the court; and

(c) with the consent of the parties, direct that the issues be determined in any other manner.

(2) *Directions as to procedure.* The court shall give any necessary directions relating to the procedures to be followed in conducting hearings, inquiries and determinations under subsection (1), including directions for the purpose of achieving procedural conformity.

(3) *Idem.* In giving directions under subsection (2), the court shall choose the least expensive and most expeditious method of determining the issues that is consistent with justice to class members and the parties and, in so doing, the court may,

(a) dispense with any procedural step that it considers unnecessary; and

(b) authorize any special procedural steps, including steps relating to discovery, and any special rules, including rules relating to admission of evidence and means of proof, that it considers appropriate.

(4) *Time limits for making claims.* The court shall set a reasonable time within which individual class members may make claims under this section.

(5) *Idem.* A class member who fails to make a claim within the time set under subsection (4) may, not later make a claim under this section except with leave of the court.

(6) *Extension of time* Subsection 24(9) applies with necessary modifications to a decision whether to give leave under subsection (5).

(7) *Determination under cl. (1)(c) deemed court order.* A determination under clause (1)(c) is deemed to be an order of the court.

26. Judgment distribution.-

(1) The court may direct any means of distribution of amounts awarded under section 24 or 25 that it considers appropriate.

(2) *Idem.* In giving directions under subsection (1), the court may order that,

(a) the defendant distribute directly to class members the amount of monetary relief to which each class member is entitled by any means authorized by the court, including abatement and credit;

(b) the defendant pay into court or some other appropriate depository the total amount of the defendant's liability to the class until further order of the court; and

(c) any person other than the defendant distribute directly to class members, the amount of monetary relief to which each member is entitled by any means authorized by the court.

(3) *Idem.* In deciding whether to make an order under clause (2)(a), the court shall consider whether distribution by the defendant is the most practical way of distributing the award for any reason, including the fact that the amount of monetary relief to which each class member is entitled can be determined from the records of the defendant.

(4) *Idem.* The court may order that all or a part of an award under section 24 that has not been distributed within a time set by the court be applied in any manner that may reasonably be expected to benefit class members, even though the order does not provide for monetary relief to individual class members, if the court is satisfied that a reasonable number of class members who would not otherwise receive monetary relief would benefit from the order.

(5) *Idem.* The court may make an order under subsection (4) whether or not all class members can be identified or all of their shares can be exactly determined.

(6) *Idem.* The court may make an order under subsection (4) even if the order would benefit

(a) persons who are not class members; or

(b) persons who may otherwise receive monetary relief as a result of the class proceeding.

(7) *Supervisory role of the court.* The court shall supervise the execution of judgments and the distribution of awards under section 24 or 25 and may stay the whole or any part of an execution or distribution for a reasonable period on such terms as it considers appropriate.

(8) *Payment of awards.* The court may order that an award made under section 24 or 25 be paid,

(a) in a lump sum, forthwith or within a time set by the court; or

(b) in instalments, on such terms as the court considers appropriate.

(9) *Costs of distribution.* The court may order that the costs of distribution of an award under sections 24 or 25, including the costs of notice associated with the distribution and the fees payable to a person administering the distribution, be paid out of the proceeds of the judgment or may make such other order as it considers appropriate.

(10) *Return of unclaimed amounts.* Any part of an award for division among individual class members that remains unclaimed or otherwise undistributed after a time set by the court shall be returned to the party against whom the award was made, without further order of the court.

27. Contents of judgment on common issues.-

(1) A judgment on common issues of a class or subclass shall

(a) set out the common issues;

(b) name or describe the class or subclass members;

(c) state the nature of the claims or defences asserted on behalf of the class or subclass; and

(d) specify the relief granted.

(2) *Effect of judgment on common issues.* A judgment on common issues of a class or subclass does not bind,

(a) a person who has opted out of the class proceeding; or

(b) a party to the class proceeding in any subsequent proceeding between the party and a person mentioned in clause (a).

(3) *Idem.* A judgment on common issues of a class or subclass binds every class member who has not opted out of the class proceeding, but only to the extent that the judgment determines summon issues that,

(a) are set out in the certification order;

(b) relate to claims or defences described in the certification order; and

(c) relate to relief sought by or from the class or subclass as stated in the certification order.

28. Limitations.-

(1) Subject to subsection (2), any limitation period applicable to a cause of action asserted in a class proceeding is suspended in favour of a class member on the commencement of the class proceeding and resumes running against the class member when,

(a) the member opts out of the class proceeding;

(b) an amendment that has the effect of excluding the member from the class is made to the certification order;

(c) a decertification order is made under section 10;

(d) the class proceeding is dismissed without an adjudication on the merits;

(e) the class proceeding is abandoned or discontinued with the approval of the court; or

(f) the class proceeding is settled with the approval of the court, unless the settlement provides otherwise.

(2) *Idem.* Where there is a right of appeal in respect of an event described in clauses (1)(a) to (f), the limitation period resumes running as soon as the time for appeal has expired without an appeal being commenced or as soon as any appeal has been finally disposed of.

29. Discontinuance and abandonment.-

(1) A proceeding commenced under this Act and a proceeding certified as a class proceeding under this Act may be discontinued or abandoned only with the approval of the court, on such terms as the court considers appropriate.

(2) *Settlement without court approval not binding.* A settlement of a class proceeding is not binding unless approved by the court.

(3) *Effect of settlement.* A settlement of a class proceeding that is approved by the court binds all class members.

(4) *Notice. Dismissal, discontinuance, abandonment or settlement.* In dismissing a proceeding for delay or in approving a discontinuance, abandonment or settlement, the court shall consider whether notice should be given under section 19 and whether any notice should include,

(a) an account of the conduct of the proceeding;

(b) a statement of the result of the proceeding; and

(c) a description of any plan for distributing settlement funds.

30. Appeals: refusals to certify and decertification orders.-

(1) A party may appeal to the Divisional Court from an order refusing to certify a proceeding as a class proceeding and from an order decertifying a proceeding.

(2) *Appeals. Certification orders.* A party may appeal to the Divisional Court from an order certifying a proceeding as a class proceeding, with leave of the Ontario Court (General Division) as provided in the rules of court.

(3) *Appeals. Judgments on common issues and aggregate awards.* A party may appeal to the Court of Appeal from a judgment on common issues and from an order under section 24, other than an order that determines individual claims made by class members.

(4) *Appeals by class members on behalf of the class.* If a representative party does not appeal or seek leave to appeal as permitted by subsection (1) or (2), or if a representative party abandons an appeal under subsection (1) or (2), any class member may make a motion to the court for leave to act as the representative party for the purposes of the relevant subsection.

(5) *Idem.* If a representative party does not appeal as permitted by subsection (3), or if a representative party abandons an appeal under subsection (3), any class member may make a motion to the Court of Appeal for leave to act as the representative party for the purposes of subsection (3).

(6) *Appeals. Individual awards.* A class member may appeal to the Divisional Court from an order under sections 24 or 25 determining an individual claim made by the member and awarding more than $3,000 to the member.

(7) *Idem.* A representative plaintiff may appeal to the Divisional Court from an order under section 24 determining an individual claim made by a class member and awarding more than $3,000 to the member.

(8) *Idem.* A defendant may appeal to the Divisional Court from an order under section 25 determining an individual claim made by a class member and awarding more than $3,000 to the member.

(9) *Idem.* With leave of the Ontario Court (General Division) as provided in the rules of court, a class member may appeal to the Divisional Court from an order under sections 24 or 25,

(a) determining an individual claim made by the member and awarding $3,000 or less to the member; or

(b) dismissing an individual claim made by the member for monetary relief.

(10) *Idem.* With leave of the Ontario Court (General Division) as provided in the rules of court, a representative plaintiff may appeal to the Divisional Court from an order under section 24,

(a) determining an individual claim made by a class member and awarding $3,000 or less to the member; or

(b) dismissing an individual claim made by a class member for monetary relief.

(11) *Idem.* With leave of the Ontario Court (General Division) as provided in the rules of court, a defendant may appeal to the Divisional Court from an order under section 25,

(a) determining an individual claim made by a class member and awarding $3,000 or less to the member; or

(b) dismissing an individual claim made by a class member for monetary relief.

31. Costs.-

(1) In exercising its discretion with respect to costs under subsection 131(1) of the *Courts of Justice Act*, the court may consider whether the class proceeding was a test case, raised a novel point of law or involved a matter of public interest.

(2) *Liability of class members for costs.* Class members, other than the representative party, are not liable for costs except with respect to the determination of their own individual claims.

(3) *Small Claims.* Where an individual claim under section 24 or 25 is within the monetary jurisdiction of the Small Claims Court where the class proceeding was commenced, costs related to the claim shall be assessed as if the claim had been determined by the Small Claims Court.

32. Agreements respecting fees and disbursements.-

(1) An agreement respecting fees and disbursements between a solicitor and a representative party shall be in writing and shall,

(a) state the terms under which fees and disbursements shall be paid;

(b) give an estimate of the expected fee, whether contingent on success in the class proceeding or not; and

(c) state the method by which payment is to be made, whether by lump sum, salary or otherwise.

(2) *Court to approve agreements.* An agreement respecting fees and disbursements between a solicitor and a representative party is not enforceable unless approved by the court, on the motion of the solicitor.

(3) *Priority of amounts owed under approved agreement.* Amounts owing under an enforceable agreement are a first charge on any settlement funds or monetary award.

(4) *Determination of fees where agreement not approved.* If an agreement is not approved by the court, the court may,

(a) determine the amount owing to the solicitor in respect of fees and disbursements;

(b) direct a reference under the rules of court to determine the amount owing; or

(c) direct that the amount owing be determined in any other manner.

33. Agreements for payment only in the event of success.-

(1) Despite the *Solicitors Act* and *An Act Respecting Champerty*, being chapter 327 of Revised Statutes of Ontario, 1897, a solicitor and a representative party may enter into a written agreement providing for payment of fees and disbursements only in the event of success in a class proceeding.

(2) *Interpretation: success in a proceeding.* For the purpose of subsection (1), success in a class proceeding includes,

(a) a judgment on common issues in favour of some or all class members; and

(b) a settlement that benefits one or more class members.

(3) *Definitions.* For the purposes of subsections (4) to (7); "base fee" means the result of multiplying the total number of hours worked by an hourly rate; "multiplier" means a multiple to be applied to a base fee.

(4) *Agreements to increase fees by a multiplier.* An agreement under subsection (1) may permit the solicitor to make a motion to the court to have his or her fees increased by a multiplier.

(5) *Motion to increase fee by a multiplier.* A motion under subsection (4) shall be heard by a judge who has

(a) given judgment on common issues in favour of some or all class members; or

(b) approved a settlement that benefits any class member.

(6) *Idem* Where the judge referred to in subsection (5) is unavailable for any reason, the regional senior judge shall assign another judge of the court for that purpose.

(7) *Idem* On the motion of a solicitor who has entered into an agreement under subsection (4), the court,

(a) shall determine the amount of the solicitor's base fee;

(b) may apply a multiplier to the base fee that results in fair and reasonable compensation to the solicitor for the risk incurred in undertaking and continuing the proceeding under an agreement for payment only in the event of success; and

(c) shall determine the amount of disbursements to which the solicitor is entitled, including interest calculated on the disbursements incurred, as totalled at the end of each six-month period following the date of the agreement.

(8) *Idem.* In making a determination under clause (7)(a), the court shall allow only a reasonable fee.

(9) *Idem.* In making a determination under clause (7)(b), the court may consider the manner in which the solicitor conducted the proceeding.

34. Motions.

(1) The same judge shall hear all motions before the trial of trial common issues.

(2) *Idem.* Where a judge who has heard motions under subsection (1) becomes unavailable for any reason, the regional senior judge shall assign another judge of the court for the purpose.

(3) *Idem.* Unless the parties agree otherwise, a judge who hears motions under subsections (1) or (2) shall not preside at the trial of the common issues.

35. Rules of Court. The rules of court apply to class proceedings.

36. Crown bound. This Act binds the Crown.

37. Application of Act.-

This Act does not apply to

(a) a proceeding that may be brought in a representative capacity under another Act;

(b) a proceeding required by law to be brought in a representative capacity; and

(c) a proceeding commenced before this Act comes into force.

38. Commencement.-

This Act comes into force on a day to be named by proclamation of the Lieutenant Governor. [Note: Act effective January 1, 1993.]

39. Short title.-

The short title of this Act is the Class Proceedings Act, 1992.

ANNEXURE D

FEDERAL COURT OF AUSTRALIA ACT 1976.

Part IVA; Representative proceedings

Division 1: Preliminary

SECT 33A
Interpretation

In this Part, unless the contrary intention appears:

"group member" means a member of a group of persons on whose behalf a representative proceeding has been commenced.

"representative party" means a person who commences a representative proceeding.

"representative proceeding" means a proceeding commenced under section 33C.

"respondent" means a person against whom relief is sought in a representative proceeding.

"sub-group member" means a person included in a sub-group established under section 33Q.

"sub-group representative party" means a person appointed to be a sub-group representative party under section 33Q.

SECT 33B
Application

A proceeding may only be brought under this Part in respect of a cause of action arising after the commencement of the "Federal Court of Australia Amendment Act 1991".

Division 2: Commencement of representative proceeding

SECT 33C
Commencement of proceeding

(1) Subject to this Part, where:

(a) 7 or more persons have claims against the same person; and

(b) the claims of all those persons are in respect of, or arise out of, the same, similar or related circumstances; and

(c) the claims of all those persons give rise to a substantial common issue of law or fact;

a proceeding may be commenced by one or more of those persons as representing some or all of them.

(2) A representative proceeding may be commenced:

(a) whether or not the relief sought:

(i) is, or includes, equitable relief; or

(ii) consists of, or includes, damages; or

(iii) includes claims for damages that would require individual assessment; or

(iv) is the same for each person represented; and

(b) whether or not the proceeding:

(i) is concerned with separate contracts or transactions between the respondent in the proceeding and individual group members; or

(ii) involves separate acts or omissions of the respondent done or omitted to be done in relation to individual group members.

SECT 33D

Standing

(1) A person referred to in paragraph 33C(1)(a) who has a sufficient interest to commence a proceeding on his or her own behalf against another person has a sufficient interest to commence a representative proceeding against that other person on behalf of other persons referred to in that paragraph.

(2) Where a person has commenced a representative proceeding, the person retains a sufficient interest:

(a) to continue that proceeding; and

(b) to bring an appeal from a judgment in that proceeding; even though the person ceases to have a claim against the respondent.

SECT 33E

Is consent required to be a group member?

(1) The consent of a person to be a group member in a representative proceeding is not required unless subsection (2) applies to the person.

(2) None of the following persons is a group member in a representative proceeding unless the person gives written consent to being so:

(a) the Commonwealth, a State or a Territory;

(b) a Minister or a Minister of a State or Territory;

(c) a body corporate established for a public purpose by a law of the Commonwealth, of a State or of a Territory, other than an incorporated company or association; or

(d) an officer of the Commonwealth, of a State or of a Territory, in his or her capacity as such an officer.

SECT 33F

Persons under disability

(1) It is not necessary for a person under disability to have a next friend or committee merely in order to be a group member.

(2) A group member who is under disability may only take a step in the representative proceeding, or conduct part of the proceeding, by his or her next friend or committee, as the case requires.

SECT 33G

Representative proceeding not to be commenced in certain circumstances

A representative proceeding may not be commenced if the proceeding would be concerned only with claims in respect of which the Court had jurisdiction solely by virtue of the "Jurisdiction of Courts (Cross-vesting) Act 1987" or a corresponding law of a State or Territory.

SECT 33H

Originating process

(1) An application commencing a representative proceeding, or a document filed in support of such an application, must, in addition to any other matters required to be included:

(a) describe or otherwise identify the group members to whom the proceeding relates; and

(b) specify the nature of the claims made on behalf of the group members and the relief claimed; and

(c) specify the questions of law or fact common to the claims of the group members.

(2) In describing or otherwise identifying group members for the purposes of subsection (1), it is not necessary to name, or specify the number of the group members.

SECT 33J

Right of group member to opt out

(1) The Court must fix a date before which a group member may opt out of a representative proceeding.

(2) A group member may opt out of the representative proceeding by written notice given under the Rules of court before the date so fixed.

(3) The Court, on the application of a group member, the representative party or the respondent in the proceeding, may fix another date so as to extend the period during which a group member may opt out of the representative proceeding.

(4) Except with the leave of the Court, the hearing of a representative proceeding must not commence earlier than the date before which a group member may opt out of the proceeding.

SECT 33K

Causes of action accruing after commencement of representative proceeding

(1) The Court may at any stage of a representative proceeding, on application made by the representative party, give leave to amend the application commencing the representative proceeding so as to alter the description of the group.

(2) The description of the group may be altered so as to include a person:

(a) whose cause of action accrued after the commencement of the representative proceeding but before such date as the Court fixes when giving leave; and

(b) who would have been included in the group, or, with the consent of the person would have been included in the group, if the cause of action had accrued before the commencement of the proceeding.

(3) The date mentioned in paragraph (2)(a) may be the date on which leave is given or another date before or after that date.

(4) Where the court gives leave under subsection (1), it may also make any other orders it thinks just, including an order relating to the giving of notice to persons who, as a result of the amendment, will be included in the group and the date before which such persons may opt out of the proceeding.

SECT 33L

Situation where fewer than 7 group members

If, at any stage of a representative proceeding, it appears likely to the Court that there are fewer than 7 group members, the Court may, on such conditions (if any) as it thinks fit:

(a) order that the proceeding continue under this Part; or

(b) order that the proceeding no longer continue under this Part.

SECT 33M

Cost of distributing money etc. excessive

Where:

(a) the relief claimed in a representative proceeding is or includes payment of money to group members (otherwise than in respect of costs); and

(b) on application by the respondent, the court concludes that it is likely that, if judgment were to be given in favour of the representative party, the cost to the respondent of identifying the group members and distributing to them the amounts ordered to be paid to them would be excessive having regard to the likely total of those amounts;

the Court may, by order:

(c) direct that the proceeding no longer continue under this Part; or

(d) stay the proceeding so far as it relates to relief of the kind mentioned in paragraph (a).

SECT 33N

Order that proceeding not continue as representative proceeding where costs excessive etc.

(1) The Court may, on application by the respondent or of its own motion, order that a proceeding no longer continue under this Part where it is satisfied that it is in the interests of justice to do so because:

(a) the costs that would be incurred if the proceeding were to continue as a representative proceeding are likely to exceed the costs that would be incurred if each group member conducted a separate proceeding; or

(b) all the relief sought can be obtained by means of a proceeding other than a representative proceeding under this Part; or

(c) the representative proceeding will not provide an efficient and effective means of dealing with the claims of group members; or

(d) it is otherwise inappropriate that the claims be pursued by means of a representative proceeding.

(2) If the Court dismisses an application under this section, the Court may order that no further application under this section be made by the respondent except with the leave of the Court.

(3) Leave for the purposes of subsection (2) may be granted subject to such conditions as to costs as the Court considers just.

SECT 33P

Consequences of order that proceeding not continue under this Part

Where the Court makes an order under section 33L, 33M or 33N that a proceeding no longer continue under this Part:

(a) the proceeding may be continued as a proceeding by the representative party on his or her own behalf against the respondent; and

(b) on the application of a person who was a group member for the purposes of the proceeding, the court may order that the person be joined as an applicant in the proceeding.

SECT 33Q

Determination of issues where not all issues are common

(1) If it appears to the Court that determination of the issue or issues common to all group members will not finally determine the claims of all group members, the Court may give directions in relation to the determination of the remaining issues.

(2) In the case of issues common to the claims of some only of the group members, the directions given by the Court may include directions establishing a sub-group consisting of those group members and appointing a person to be the sub-group representative party on behalf of the sub-group members.

(3) Where the Court appoints a person other than the representative party to be a sub-group representative party, that person, and not the representative party, is liable for costs associated with the determination of the issue or issues common to the sub-group members.

SECT 33R

Individual issues

(1) In giving directions under section 33Q, the Court may permit an individual group member to appear in the proceeding for the purpose of determining an issue that relates only to the claims of that member.

(2) In such a case, the individual group member, and not the representative party, is liable for costs associated with the determination of the issue.

SECT 33S

Directions relating to commencement of further proceedings

Where an issue cannot properly or conveniently be dealt with under section 33Q or 33R, the Court may:

(a) if the issue concerns only the claim of a particular member, give directions relating to the commencement and conduct of a separate proceeding by that member; or

(b) if the issue is common to the claims of all members of a sub-group, give directions relating to the commencement and conduct of a representative proceeding in relation to the claims of those members.

SECT 33T

Adequacy of representation

(1) If, on an application by a group member, it appears to the Court that a representative party is not able adequately to represent the interests of the group members, the Court may substitute another group member as representative party and may make such other orders as it thinks fit.

(2) If, on an application by a sub-group member, it appears to the Court that a sub-group representative party is not able adequately to represent the interests of the sub-group members, the Court may substitute another person as sub-group representative party and may make such other orders as it thinks fit.

SECT 33U

Stay of execution in certain circumstances

Where a respondent in a representative proceeding commences a proceeding in the Court against a group member, the Court may order a stay of execution in respect of any relief awarded to the group member in the representative proceeding until the other proceeding is determined.

SECT 33V

Settlement and discontinuance; representative proceeding

(1) A representative proceeding may not be settled or discontinued without the approval of the Court.

(2) If the Court gives such an approval, it may make such orders as are just with respect to the distribution of any money paid under a settlement or paid into the Court.

SECT 33W

Settlement of individual claim of representative party

(1) A representative party may, with leave of the Court, settle his or her individual claim in whole or in part at any stage of the representative proceeding.

(2) A representative party who is seeking leave to settle, or who has settled, his or her individual claim may, with leave of the Court, withdraw as representative party.

(3) Where a person has sought leave to withdraw as representative party under subsection (2), the Court may, on the application of a group member, make an order for the substitution of another group member as representative party and may make such other orders as it thinks fit.

(4) Before granting a person leave to withdraw as a representative party:

(a) the Court must be satisfied that notice of the application has been given to group members in accordance with subsection 33X(1) and in sufficient time for them to apply to have another person substituted as the representative party; and

(b) any application for the substitution of another group member as a representative party has been determined.

(5) The Court may grant leave to a person to withdraw as representative party subject to such conditions as to costs as the Court considers just.

Division 3: Notices

SECT 33X

Notice to be given of certain matters

(1) Notice must be given to group members of the following matters in relation to a representative proceeding:

(a) the commencement of the proceeding and the right of the group members to opt out of the proceeding before a specified date, being the date fixed under subsection 33J(1);

(b) an application by the respondent in the proceeding for the dismissal of the proceeding on the ground of want of prosecution;

(c) an application by a representative party seeking leave to withdraw under section 33W as representative party.

(2) The Court may dispense with compliance with any or all of the requirements of subsection (1) where the relief sought in a proceeding does not include any claim for damages.

(3) If the Court so orders, notice must be given to group members of the bringing into Court of money in answer to a cause of action on which a claim in the representative proceeding is founded.

(4) Unless the Court is satisfied that it is just to do so, an application for approval of a settlement under section 33V must not be determined unless notice has been given to group members.

(5) The Court may, at any stage, order that notice of any matter be given to a group member or group members.

(6) Notice under this section must be given as soon as practicable after the happening of the event to which the notice relates.

SECT 33Y

Notices: Ancillary provisions

(1) This section is concerned with notices under section 33X.

(2) The form and content of a notice must be as approved by the Court.

(3) The Court must, by order, specify:

(a) who is to give the notice; and

(b) the way in which the notice is to be given;

and the order may include provision:

(c) directing a party to provide information relevant to the giving of the notice; and

(d) relating to the costs of notice.

(4) An order under subsection (3) may require that notice be given by means of press advertisement, radio or television broadcast, or by any other means.

(5) The Court may not order that notice be given personally to each group member unless it is satisfied that it is reasonably practicable, and not unduly expensive, to do so.

(6) A notice that concerns a matter for which the Court's leave or approval is required must specify the period within which a group member or other person may apply to the Court, or take some other step, in relation to the matter.

(7) A notice that includes or concerns conditions must specify the conditions and the period, if any, for compliance.

(8) The failure of a group member to receive or respond to a notice does not affect a step taken, an order made, or a judgment given, in a proceeding.

Division 4: Judgment etc.

SECT 33Z

Judgment: Powers of the Court

(1) The Court may, in determining a matter in a representative proceeding, do any one or more of the following:

(a) determine an issue of law;

(b) determine an issue of fact;

(c) make a declaration of liability;

(d) grant any equitable relief;

(e) make an award of damages for group members, sub-group members or individual group members, being damages consisting of specified amounts or amounts worked out in such manner as the court specifies;

(f) award damages in an aggregate amount without specifying amounts awarded in respect of individual group members;

(g) make such other order as the Court thinks just.

(2) In making an order for an award of damages, the Court must make provision for the payment or distribution of the money to the group members entitled.

(3) Subject to section 33V, the Court is not to make an award of damages under paragraph (1)(f) unless a reasonably accurate assessment can be made of the total amount to which group members will be entitled under the judgment.

(4) Where the court has made an order for the award of damages, the Court may give such directions (if any) as it thinks just in relation to:

(a) the manner in which a group member is to establish his or her entitlement to share in the damages; and

(b) the manner in which any dispute regarding the entitlement of a group member to share in the damages is to be determined.

SECT 33ZA

Constitution etc. of fund

(1) Without limiting the operation of subsection 33Z(2), in making provision for the distribution of money to group members, the Court may provide for:

(a) the constitution and administration of a fund consisting of the money to be distributed; and

(b) either:

(i) the payment by the respondent of a fixed sum of money into the fund; or

(ii) the payment by the respondent into the fund of such instalments, on such terms, as the Court directs to meet the claims of group members; and

(c) entitlements to interest earned on the money in the fund.

(2) The costs of administering a fund are to be borne by the fund, or by the respondent in the representative proceeding, as the Court directs.

(3) Where the Court orders the constitution of a fund mentioned in subsection (1), the order must:

(a) require notice to be given to group members in such manner as is specified in the order; and

(b) specify the manner in which a group member is to make a claim for payment out of the fund and establish his or her entitlement to the payment; and

(c) specify a day (which is 6 months or more after the day on which the order is made) on or before which the group members are to make a claim for payment out of the fund; and

(d) make provision in relation to the day before which the fund is to be distributed to group members who have- established an entitlement to be paid out of the fund.

(4) The Court may allow a group member to make a claim after the day fixed under paragraph (3)(c) if :

(a) the fund has not already been fully distributed; and

(b) it is just to do so.

(5) On application by the respondent in the representative proceeding after the day fixed under paragraph (3)(d), the Court may make such orders as are just for the payment from the fund to the respondent of the money remaining in the fund.

SECT 33ZB

Effect of judgment

A judgment given in a representative proceeding:

(a) must describe or otherwise identify the group members who will be affected by it; and

(b) binds all such persons other than any person who has opted out of the proceeding under section 33J.

Division 5: Appeals

SECT 33ZC

Appeals to the Court

(1) The following appeals under Division 2 of Part III from a judgment of the Court in a representative proceeding may themselves be brought as representative proceedings:

(a) an appeal by the representative party on behalf of group members and in respect of the judgment to the extent that it relates to issues common to the claims of group members;

(b) an appeal by a sub-group representative party on behalf of sub-group members in respect of the judgment to the extent that it relates to issues common to the claims of sub-group members.

(2) The parties to an appeal referred to in paragraph (1) (a) are the representative party, as the representative of the group members, and the respondent.

(3) The parties to an appeal referred to in paragraph (1) (b) are the sub-group representative party, as the representative of the sub-group members, and the respondent.

(4) On an appeal by the respondent in a representative proceeding, other than an appeal referred to in subsection (5), the parties to the appeal are:

(a) in the case of an appeal in respect of the judgment generally, the respondent and the representative party as the representative of the group members; and

(b) in the case of an appeal in respect of the judgment to the extent that it relates to issues common to the claims of sub-group members, the respondent and the sub-group representative party as the representative of the sub-group members.

(5) The parties to an appeal in respect of the determination of an issue that relates only to a claim of an individual group member are that group member and the respondent.

(6) If the representative party or the sub-group representative party does not bring an appeal within the time provided for instituting appeals, another member of the group or sub-group may, within a further 21 days, bring an appeal as representing the group members or sub-group members, as the case may be.

(7) Where an appeal is brought from a judgment of the court in a representative proceeding, the Court may direct that notice of the appeal be given to such person or persons, and in such manner, as the Court thinks appropriate.

(8) Section 33J does not apply to an appeal proceeding.

(9) The notice instituting an appeal in relation to issues that are common to the claims of group members or sub-group members must describe or otherwise identify the group members or sub-group members, as the case may be, but need not specify the names or number of those members.

SECT 33ZD

Appeals to the High Court; extended operation of sections 33ZC and 33ZF

(1) Sections 33ZC and 33ZF apply in relation to appeals to the High Court from judgments of the Court in representative proceedings in the same way as they apply to appeals to the Court from such judgments.

(2) Nothing in subsection (1) limits the operation of section 33 whether in relation to appeals from judgments of the court in representative proceedings or otherwise.

Division 6: Miscellaneous

FEDERAL COURT OF AUSTRALIA ACT 1976

SECT 33ZE

Suspension of limitation periods

(1) Upon the commencement of a representative proceeding, the running of any limitation period that applies to the claim of a group member to which the proceeding relates is suspended.

(2) The limitation period does not begin to run again unless either the member opts out of the proceeding under section 33J or the proceeding, and any appeals arising from the proceeding, are determined without finally disposing of the group member's claim.

SECT 33ZF

General power of Court to make orders

(1) In any proceeding (including an appeal) conducted under this part, the Court may, of its own motion or on application by a party or a group member, make any order the Court thinks appropriate or necessary to ensure that justice is done in the proceeding.

(2) Subsection (1) does not limit the operation of section 22.

SECT 33ZG

Saving of rights, powers etc.

Except as otherwise provided by this Part, nothing in this Part affects:

(a) the commencement or continuance of any action of a representative character commenced otherwise than under this Part; or

(b) the Court's powers under provisions other than this Part, for example, its powers in relation to a proceeding in which no reasonable cause of action is disclosed or that is oppressive, vexatious, frivolous or an abuse of the process of the Court; or

(c) the operation of any law relating to:

(i) vexatious litigants (however described); or

(ii) proceedings of a representative character; or

(iii) joinder of parties; or

(iv) consolidation of proceedings; or

(v) security for costs.

SECT 33ZH

Special provision relating to claims under Part VI of the "Trade Practices Act 1974"

(1) For the purposes of subsection 87(1) of the "Trade Practices Act 1974", a group member in a representative proceeding is to be taken to be a party to the proceeding.

(2) An application under subsection 87(1A) of the "Trade Practices Act 1974" by a representative party in a representative proceeding is to be taken to be an application by the representative party and all the group members.

SECT 33ZJ

Reimbursement of representative party's costs

(1) Where the Court has made an award of damages in a representative proceeding, the representative party or a sub-group representative party, or a person who has been such a party, may apply to the Court for an order under this section.

(2) If, on an application under this section, the Court is satisfied that the costs reasonably incurred in relation to the representative proceeding by the person making the application are

likely to exceed the costs recoverable by the person from the respondent, the Court may order that an amount equal to the whole or a part of the excess be paid to that person out of the damages awarded.

(3) On an application under this section, the Court may also make any other order it thinks just.

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ANNEXURE E

Uniform Law Conference of Canada

CLASS PROCEEDINGS ACT

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PART I

Definitions

1.- In this Act:

"certification order" means an order certifying a proceeding as a class proceeding;

"class proceeding" means a proceeding certified as a class proceeding under Part 2;

"common issues" means

(a) common but not necessarily identical issues of fact, or

(b) common but not necessarily identical issues of law that arise from common but not necessarily identical facts;

"court", except in sections 36 (4) and 37, means the [superior court of the jurisdiction];

"defendant" includes a respondent;

"plaintiff' includes a petitioner.

PART II: Certification

Plaintiff's class proceeding

2. (1) One member of a class of persons who are resident in [the enacting jurisdiction] may commence a proceeding in the court on behalf of the members of that class.

(2) The person who commences a proceeding under subsection (1) must make an application to a judge of the court for an order certifying the proceeding as a class proceeding and, subject to subsection (4), appointing the person as representative plaintiff.

(3) An application under subsection (2) must be made

(a) within 90 days after the later of

(i) the date on which the last appearance or statement of defence was delivered, and

(ii) the date on which the time prescribed by the [rules of court] for delivery of the last appearance or statement of defence expires without its being delivered, or

(b) with leave of the court at any other time.

(4) The court may certify a person who is not a member of the class as the representative plaintiff for the class proceeding only if it is necessary to do so in order to avoid a substantial injustice to the class.

Defendant's class proceeding

3. A defendant to two or more proceedings may, at any stage of one of the proceedings, make an application to a judge of the court for an order certifying the proceedings as a class proceeding and appointing a representative plaintiff

Class certification

4. The court must certify a proceeding as a class proceeding on an application under section 2 or 3 if

(a) the pleadings disclose a cause of action,

(b) there is an identifiable class of 2 or more persons,

(c) the claims of the class members raise a common issue, whether or not the common issue predominates over issues affecting only individual members,

(d) a class proceeding would be the preferable procedure for the resolution of the common issues, and

(e) there is a representative plaintiff who

(i) would fairly and adequately represent the interests of the class,

(ii) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the class and of notifying class members of the proceeding, and

(iii) does not have, on the common issues, an interest that is in conflict with the interests of other class members.

Certification application

5. (1) The court may adjourn the application for certification to permit the parties to amend their materials or pleadings or to permit further evidence.

(2) An order certifying a proceeding as a class proceeding is not a determination of the merits of the proceeding.

Subclass certification

6. (1) Despite section 4, if a class includes a subclass whose members have claims that raise common issues not shared by all the class members so that, in the opinion of the court the protection of the interests of the subclass members requires that they be separately represented, the court may, in addition to the representative plaintiff for the class, appoint a representative plaintiff for each subclass who

(a) would fairly and adequately represent the interests of the subclass,

(b) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the subclass and of notifying subclass members of the proceeding, and

(c) does not have, on the common issues for the subclass, an interest that is in conflict with the interests of other subclass members.

(2) A class that comprises persons resident in [the enacting jurisdiction] and persons not resident in [the enacting jurisdiction] must be divided into resident and non-resident subclasses.

Certain matters not bar to certification

7. The court must not refuse to certify a proceeding as a class proceeding by reason only of one or more of the following:

(a) the relief claimed includes a claim for damages that would require individual assessment after determination of the common issues;

(b) the relief claimed relates to separate contracts involving different class members;

(c) different remedies are sought for different class members ;

(d) the number of class members or the identity of each class member is not ascertained or may not be ascertainable;

(e) the class includes a subclass whose members have claims that raise common issues not shared by all class members.

Contents of certification order

8. (1) A certification order must

(a) describe the class in respect of which the order was made by setting out the class's identifying characteristics,

(b) appoint the representative plaintiff for the class,

(c) state the nature of the claims asserted on behalf of the class,

(d) state the relief sought by the class,

(e) set out the common issues for the class,

(f) state the manner in which and the time within which a class member may opt out of the proceeding,

(g) state the manner in which, and the time within which a person who is not a resident of [the enacting jurisdiction] may opt in to the proceeding , and

(h) include any other provisions the court considers appropriate.

(2) If a class includes a subclass whose members have claims that raise common issues not shared by all the class members so that in the opinion of the court, the protection of the interests of the subclass members requires that they be separately represented, the certification order must include the same information in relation to the subclass that, under subsection (1), is required in relation to the class.

(3) The court may at any time amend a certification order on the application of a party or class member or on its own motion.

Refusal to certify

9. If the court refuses to certify a proceeding as a class proceeding the court may permit the proceeding to continue as one or more proceedings between different parties and, for that purpose, the court may

(a) order the addition, deletion or substitution of parties,

(b) order the amendment of the pleadings, and

(c) make any other order that it considers appropriate.

If conditions for certification not satisfied

10. (1) Without limiting subsection 8(3), at any time after a certification order is made under this Part, the court may amend the certification order, decertify the proceeding or make any other order it considers appropriate if it appears to the court that the conditions mentioned in section 4 or subsection 6(1) are not satisfied with respect to a class proceeding.

(2) If the court makes a decertification order under subsection (1), the court may permit the proceeding to continue as one or more proceedings between different parties and may make any order referred to in section 9 (a) to (c) in relation to each of those proceedings.

PART III: Conduct of Class Proceedings

Role of court

Stages of class proceedings

11. (1) Unless the court otherwise orders under section 12, in a class proceeding,

(a) common issues for a class must be determined together,

(b) common issues for a subclass must be determined together, and

(c) individual issues that require the participation of individual class members must be determined individually in accordance with sections 27 and 28.

(2) The court may give judgment in respect of the common issues and separate judgments in respect of any other issue.

Court may determine conduct of proceeding

12. The court may at any time make any order it considers appropriate respecting the conduct of a class proceeding to ensure its fair and expeditious determination and for that purpose, may impose on one or more of the parties the terms it considers appropriate.

Court may stay any other proceeding

13. The court may at any time stay or sever any proceeding related to the class proceeding on the terms the court considers appropriate.

Applications

14. (1) The judge who makes a certification order is to hear all applications in the class proceeding before the trial of the common issues.

(2) If a judge who has heard applications under subsection (1) becomes unavailable for any reason to hear an application in the class proceeding the chief justice of the court may assign another judge of the court to hear the application.

(3) A judge who hears applications under subsection (1) or (2) may but need not preside at the trial of the common issues.

Participation of Class Members

15. (1) In order to ensure the fair and adequate representation of the interests of the class or any subclass or for any other appropriate reason, the court may, at any time in a class

proceeding, permit one or more class members to participate in the proceeding if this would be useful to the class.

(2) Participation under subsection (1) must be in the manner and on the terms, including terms as to costs, that the court considers appropriate.

Opting out and opting in

16. (1) A member of a class involved in a class proceeding may opt out of the proceeding in the manner and within the time specified in the certification order.

(2) Subject to subsection (4), a person who is not a resident of [the enacting jurisdiction] may, in the manner and within the time specified in the certification order made in respect of a class proceeding, opt in to that class proceeding if the person would be, but for not being a resident of [the enacting jurisdiction], a member of the class involved in the class proceeding.

(3) A person referred to in subsection (2) who opts in to a class proceeding is from that time a member of the class involved in the class proceeding for every purpose of this Act.

(4) A person may not opt in to a class proceeding under subsection (2) unless the subclass of which the person is to become a member has or will have, at the time the person becomes a member, a representative plaintiff who satisfies the requirements of section 6 (1)(a), (b) and (c).

(5) If a subclass is created as a result of persons opting in to a class proceeding under subsection (2), the representative plaintiff for that subclass must ensure that the certification order for the class proceeding is amended, if necessary, to comply with section 8(2).

Discovery

17. (l) Parties to a class proceeding have the same rights of discovery under the [rules of court] against one another as they would have in any other proceeding.

(2) After discovery of the representative plaintiff or, in a proceeding referred to in section 6, one or more of the representative plaintiffs, a defendant may, with leave of the court, discover other class members.

(3) In deciding whether to grant a defendant leave to discover other class members, the court must consider

(a) the stage of the class proceeding and the issues to be determined at that stage,

(b) the presence of subclasses,

(c) whether the discovery is necessary in view of the defences of the party seeking leave,

(d) the approximate monetary value of individual claims, if any,

(e) whether discovery would result in oppression or in undue annoyance, burden or expense for the class members sought to be discovered, and

(f) any other matter the court considers relevant.

(4) A class member is subject to the same sanctions under the [rules of court] as a party for failure to submit to discovery.

Examination of class members before an application

18. (1) A party may not require a class member, other than a representative plaintiff, to be examined as a witness before the hearing of any application, except with leave of the court.

(2) Subsection 17(3) applies to a decision whether to grant leave under subsection (1) of this section.

Notices

Notice of certification

19. (1) Notice that a proceeding has been certified as a class proceeding must be given by the representative plaintiff to the class members in accordance with this section.

(2) The court may dispense with notice if, having regard to the factors set out in subsection (3), the court considers it appropriate to do so.

(3) The court must make an order setting out when and by what means notice is to be given under this section and in doing so must have regard to

(a) the cost of giving notice,

(b) the nature of the relief sought,

(c) the size of the individual claims of the class members,

(d) the number of class members,

(e) the presence of subclasses,

(f) the places of residence of class members, and

(g) any other relevant matter.

(4) The court may order that notice be given by

(a) personal delivery,

(b) mail,

(c) posting, advertising, publishing or leafleting,

(d) individually notifying a sample group within the class, or

(e) any other means or combination of means that the court considers appropriate.

(5) The court may order that notice be given to different class members by different means.

(6) Unless the court orders otherwise, notice under this section must

(a) describe the proceeding, including the names and addresses of the representative plaintiffs and the relief sought,

(b) state the manner in which and the time within which a class member may opt out of the proceeding,

(c) state the manner in which and the time within which a person who is not a resident of [the enacting jurisdiction] may opt in to the proceeding,

(d) describe any counterclaim or third party proceeding being asserted in the proceeding, including the relief sought,

(e) summarize any agreements respecting fees and disbursements

(i) between the representative plaintiff and the representative plaintiffs solicitors, and

(ii) if the recipient of the notice is a member of a subclass, between the representative plaintiff for that subclass and that representative plaintiff's solicitors,

(f) describe the possible financial consequences of the proceedings to class members and subclass members,

(g) state that the judgment on the common issues for the class, whether favorable or not, will bind all class members who do not opt out of the proceeding,

(h) state that the judgment on the common issues for a subclass, whether favorable or not, will bind all subclass members who do not opt out of the proceeding,

(i) describe the rights, if any, of class members to participate in the proceeding,

(j) give an address to which class members may direct inquiries about the proceeding; and

(k) give any other information the court considers appropriate.

(7) With leave of the court notice under this section may include a solicitation of contributions from class members to assist in paying solicitors' fees and disbursements.

Notice of determination of common issues

20. (1) Where the court determines common issues in favour of a class and considers that the participation of individual class members is required to determine individual issues, the representative party shall give notice to those members in accordance with this section.

(2) Subsections 19(3) to (5) apply to notice given under this section.

(3) Notice under this section must

(a) state that common issues have been determined,

(b) identify the common issues that have been determined and explain the determinations made,

(c) state that members of the class or subclass may be entitled to individual relief,

(d) describe the steps that must be taken to establish an individual claim,

(e) state that failure on the part of a member of the class or subclass to take those steps will result in the member not being entitled to assert an individual claim except with leave of the court,

(f) give an address to which members of the class or subclass may direct inquiries about the proceeding, and

(g) give any other information that the court considers appropriate.

Notice to protect interests of affected persons

21. (1) At any time in a class proceeding, the court may order any party to give notice to the persons that the court considers necessary to protect the interests of any class member or party or to ensure the fair conduct of the proceeding.

(2) Subsections 19(3) to (5) apply to notice given under this section.

Approval of notice by the court

22. A notice under this Division must be approved by the court before it is given.

Giving of notice by another party

23. The court may order a party to give the notice required to be given by another party under this Act.

Costs of notice

24. (1) The court may make any order it considers appropriate as to the costs of any notice under this Division, including an order apportioning costs among parties.

(2) In making an order under subsection (1), the court may have regard to the different interests of a subclass.

PART IV: Orders, Awards and Related Procedures

Order on Common Issues and Individual Issues

Contents of order on common issues

25. An order made in respect of a judgment on common issues of a class or subclass must

(a) set out the common issues,

(b) name or describe the class or subclass members to the extent possible,

(c) state the nature of the claims asserted on behalf of the class or subclass, and

(d) specify the relief granted.

Judgment on common issues is binding

26. (1) A judgment on common issues of a class or subclass binds every member of the class or subclass, as the case may be, who has not opted out of the class proceeding, but only to the extent that the judgment determines common issues that

(a) are set out in the certification order,

(b) relate to claims described in the certification order, and

(c) relate to relief sought by the class or subclass as stated in the certification order.

(2) A judgment on common issues of a class or subclass does not bind a party to the class proceeding in any subsequent proceeding between the party and a person who opted out of the class proceedings.

Subsection (2) ensures that a class member who opts out cannot later benefit from the class action judgment.

Determination of individual issues

27. (1) If the court determines common issues in favour of a class or subclass and determines that there are issues, other than those that may be determined under section 32, that are applicable only to certain individual members of the class or subclass, the court may

(a) determine those individual issues in inner hearings presided over by the judge who determined the common issues or by another judge of the court,

(b) appoint one or more persons including, without limitation, one or more independent experts, to conduct an inquiry into those individual issues under the [rules of court] and report back to the court, or

(c) with the consent of the parties, direct that those individual issues be determined in any other manner.

(2) The court may give any necessary directions relating to the procedures that must be followed in conducting hearings, inquiries and determinations under subsection (1).

(3) In giving directions under subsection (2), the court must choose the least expensive and most expeditious method of determining the individual issues that is consistent with justice to members of the class or subclass and the parties and, in doing so, the court may

(a) dispense with any procedural step that it considers unnecessary, and

(b) authorize any special procedural steps, including steps relating to discovery, and any special rules, including rules relating to admission of evidence and means of proof that it considers appropriate.

(4) The court must set a reasonable time within which individual members of the class or subclass may make claims under this section in respect of the individual issues.

(5) A member of the class or subclass who fails to make a claim within the time set under subsection (4) may not later make a claim under this section in respect of the issues applicable only to that member except with leave of the court.

(6) The court may grant leave under subsection (5) if it is satisfied that

(a) there are apparent grounds for relief,

(b) the delay was not caused by any fault of the person seeking the relief; and

(c) the defendant would not suffer substantial prejudice if leave were granted.

(7) Unless otherwise ordered by the court making a direction under subsection (1)(c), a determination of issues made in accordance with subsection (1)(c) is deemed to be an order of the court.

Individual assessment of liability

28. Without limiting section 27, if after determining common issues in favour of a class or subclass, the court determines that the defendant's liability to individual class members cannot reasonably be determined without proof by those individual class members, section 27 applies to the determination of the defendant's liability to those class members.

Aggregate Awards

Aggregate awards of monetary relief

29. (1) The court may make an order for an aggregate monetary award in respect of all or any part of a defendant's liability to class members and may give judgment accordingly if

(a) monetary relief is claimed on behalf of some or all class members,

(b) no questions of fact or law other than those relating to the assessment of monetary relief remain to be determined in order to establish the amount of the defendant's monetary liability, and

(c) the aggregate or a part of the defendant's liability to some or all class members can reasonably be determined without proof by individual class members.

(2) Before making an order under subsection (1), the court must provide the defendant with an opportunity to make submissions to the court in respect of any matter touching on the proposed order including, without limitation,

(a) submissions that contest the merits or amount of an award under that subsection, and

(b) submissions that individual proof of monetary relief is required due to the individual nature of the relief.

Statistical evidence may be used

30. (1) For the purposes of determining issues relating to the amount or distribution of an aggregate monetary award under this Act the court may admit as evidence statistical information that would not otherwise be admissible as evidence, including information derived from sampling, if the information was compiled in accordance with principles that are generally accepted by experts in the field of statistics.

(2) A record of statistical information purporting to be prepared by or published under the authority of an enactment of the Parliament of Canada or the legislature of any province may be admitted as evidence without proof of its authenticity.

(3) Statistical information must not be admitted as evidence under this section unless the party seeking to introduce the information

(a) has given to the party against whom the statistical evidence is to be used a copy of the information at least 60 days before that information is to be introduced as evidence,

(b) has complied with subsections (4) and (5); and

(c) introduces the evidence by an expert who is available for cross-examination on that evidence.

(4) Notice under this section must specify the source of any statistical information sought to be introduced that

(a) was prepared or published under the authority of an enactment of the Parliament of Canada or the legislature of any province,

(b) was derived from market quotations, tabulations, lists, directories or other compilations generally used and relied on by members of the public, or

(c) was derived from reference material generally used and relied on by members of an occupational group.

(5) Except with respect to information referred to in subsection (4), notice under this section must

(a) specify the name and qualifications of each person who supervised the preparation of the statistical information sought to be introduced, and

(b) describe any documents prepared or used in the course of preparing the statistical information sought to be introduced.

(6) Unless this section provides otherwise, the law and practice with respect to evidence tendered by an expert in a proceeding applies to a class proceeding.

(7) Except with respect to information referred to in subsection (4), a party against whom statistical information is sought to be introduced under this section may require the party seeking to introduce it to produce for inspection any document that was prepared or used in the course of preparing the information, unless the document discloses the identity of persons responding to a survey who have not consented in writing to the disclosure.

Average or proportional share of aggregate awards

31. (1) If the court makes an order under section 29, the court may further order that all or a part of the aggregate monetary award be applied so that some or all individual class or subclass members share in the award on an average or proportional basis if

(a) it would be impractical or inefficient to

(i) identify the class or subclass members entitled to share in the award, or

(ii) determine the exact shares that should be allocated to individual class or subclass member, and

(b) failure to make an order under this subsection would deny recovery to a substantial number of class or subclass members.

(2) If an order is made under subsection (1), any member of the class or subclass in respect of which the order was made may, within the time specified in the order, apply to the court to be excluded from the proposed distribution and to be given the opportunity to prove that member's claim on an individual basis.

(3) In deciding whether to exclude a class or subclass member from an average distribution, the court must consider

(a) the extent to which the class or subclass member's individual claim varies from the average for the class or subclass,

(b) the number of class or subclass members seeking to be excluded from an average distribution, and

(c) whether excluding the class or subclass members referred to in paragraph (b) would unreasonably deplete the amount to be distributed on an average basis.

(4) An amount recovered by a class or subclass member who proves that member's claim on an individual basis must be deducted from the amount to be distributed on an average basis before the distribution.

Individual share of aggregate award

32. (1) When the court orders that all or a part of an aggregate monetary award under section 29(1) be divided among individual class or subclass members on an individual basis, the court must determine whether individual claims need to be made to give effect to the order.

(2) If the court determines under subsection (1) that individual claims need to be made, the court must specify the procedures for determining the claims.

(3) In specifying the procedures under subsection (2), the court must minimize the burden on class or subclass members and, for that purpose, the court may authorize

(a) the use of standard proof of claim forms,

(b) the submission of affidavit or other documentary evidence, and

(c) the auditing of claims on a sampling or other basis.

(4) When specifying the procedures under subsection (2), the court must set a reasonable time within which individual class or subclass members may make claims under this section.

(5) A class or subclass member who fails to make a claim within the time set under subsection (4) may not later make a claim under this section except with leave of the court.

(6) Subsection 27(6) applies to a decision whether to grant leave under subsection (5) of this section.

(7) The court may amend a judgment given under subsection 29(1) to give effect to a claim made with leave under subsection (5) of this section if the court considers it appropriate to do so.

Distribution

33. (1) The court may direct any means of distribution of amounts awarded under this Division that it considers appropriate.

(2) In giving directions under subsection (1), the court may order that

(a) the defendant distribute directly to the class or subclass members the amount of monetary relief to which each class or subclass member is entitled by any means authorized by the court, including abatement and credit,

(b) the defendant pay into court or some other appropriate depository the total amount of the defendant's liability to the class or subclass members until further order of the court; or

(c) any person other than the defendant distribute directly to each of the class or subclass members, by any means authorized by the court, the amount of monetary relief to which that class or subclass member is entitled.

(3) In deciding whether to make an order under clause (2)(a), the court

(a) must consider whether distribution by the defendant is the most practical way of distributing the award, and

(b) may take into account whether the amount of monetary relief to which each class or subclass member is entitled can be determined from the records of the defendant.

(4) The court must supervise the execution of judgments and the distribution of awards under this Division and may stay the whole or any part of an execution or distribution for a reasonable period on the terms it considers appropriate.

(5) The court may order that an award made under this Division be paid

(a) in a lump sum, promptly or within a time set by rite court or

(b) in instalments, on the terms the court considers appropriate.

(6) The court may

(a) order that the costs of distributing an award under this Division, including the costs of any notice associated with the distribution and the fees payable to a person administering the distribution, be paid out of the proceeds of the judgment, and

(b) make any further or other order it considers appropriate.

Undistributed award

34. (1) The court may order that all or any part of an award under this Division that has not been distributed within a time set by the court be applied in any manner that may reasonably be expected to benefit class or subclass members, even though the order does not provide for monetary relief to individual class or subclass members.

(2) In deciding whether to make an order under subsection (1), the court must consider

(a) whether the distribution would result in unreasonable benefits to persons who are not members of the class or subclass, and

(b) any other matter the court considers relevant.

(3) The court may make an order under subsection (1) whether or not all the class or subclass members can be identified or all their shares can be exactly determined.

(4) The court may make an order under subsection (1) even if the order would benefit

(a) persons who are not class or subclass members, or

(b) persons who may otherwise receive monetary relief as a result of the class proceeding.

(5) If any part of an award that, under subsection 32(1), is to be divided among individual class or subclass members remains unclaimed or otherwise undistributed after a time set by the court the court may order that part of the award

(a) be applied against the cost of the class proceeding,

(b) be forfeited to the Government, or

(c) be returned to the party against whom the award was made.

Termination of Proceedings and Appeals

Settlement, discontinuance, abandonment and dismissal

35. (1) A class proceeding may be settled, discontinued or abandoned only

(a) with the approval of the court, and

(b) on the terms the court considers appropriate.

(2) A settlement may be concluded in relation to the common issues affecting a subclass only

(a) with the approval of the court, and

(b) on the terms the court considers appropriate.

(3) A settlement under this section is not binding unless approved by the court.

(4) A settlement of a class proceeding or of common issues affecting a subclass that is approved by the court binds every member of the class or subclass who has not opted out of the class proceeding, but only to the extent provided by the court.

(5) In dismissing a class proceeding or in approving a settlement, discontinuance or abandonment the court must consider whether notice should be given under section 20 and whether the notice should include

(a) an account of the conduct of the proceeding,

(b) a statement of the result of the proceeding, and

(c) a description of any plan for distributing any settlement funds.

Appeals

36. (1) Any party may appeal without leave to the [appellate court of the enacting jurisdiction] from

(a) a judgment on common issues, or

(b) an order under Division 2 of this Part other than an order that determines individual claims made by class or subclass members.

(2) With leave of a justice of the [appellate court of the enacting jurisdiction], a class or subclass member, a representative plaintiff or a defendant may appeal to that court any order

(a) determining an individual claim made by a class or subclass member, or

(b) dismissing an individual claim for monetary relief made by a class or subclass member.

(3) With leave of a justice of the [appellate court of the enacting jurisdiction], any party may appeal to the [appellate court of the enacting jurisdiction] from

(a) an order certifying or refusing to certify a proceeding as a class proceeding,

(b) an order decertifying a proceeding.

(4) If a representative plaintiff does not appeal or seek leave to appeal as permitted by subsection (1) or (3) within the time limit for bringing an appeal set under [the relevant section of the enactment establishing the appellate court of the enacting jurisdiction] or if a representative plaintiff abandons an appeal under subsection (1) or (3), any member of the class or subclass for which the representative plaintiff had been appointed may apply to a justice of the [appellate court of the enacting jurisdiction] for leave to act as the representative plaintiff for the purposes of subsection (1) or (3).

(5) An application by a class or subclass member for leave to act as the representative plaintiff under subsection (4) must be made within 30 days after the expiry of the appeal period available to the representative plaintiff or by such other date as the justice may order.

PART V: Costs, Fees and Disbursements

Costs

37. (1) Class members, other than the representative plaintiff are not liable for costs except with respect to the determination of their own individual claims.

(2) In determining by whom and to what extent costs should be paid, a court may consider whether the class proceeding was a test case, raised a novel point of law or addressed an issue of significant public interest.

(3) A court that orders costs may order that those costs be assessed in any manner that the court considers appropriate.

[Alternatively]
[37. (1) Subject to this section, neither the [superior or the appellate court of the jurisdiction] may award costs to any party to an application for certification under subsection 2(2) or section 3, to any party to a class proceeding or to any party to an appeal arising from a class proceeding at any stage of the application, proceeding or appeal.

(2) A court referred to in subsection (1) may only award costs to a party in respect of an application for certification or in respect of all or any part of a class proceeding or an appeal from a class proceeding

(a) at any time that the court considers that there has been vexatious, frivolous or abusive conduct on the part of any party,

(b) at any time that the court considers that an improper or unnecessary application or other step has been made or taken for the purpose of delay or increasing costs or for any other improper purpose, or

(c) at any time that the court considers that there are exceptional circumstances that make it unjust to deprive the successful party of costs.

(3) A court that orders costs under subsection (2) may order that those costs be assessed in any manner that the court considers appropriate.

(4) Class members, other than the person appointed as representative plaintiff for the class, are not liable for costs except with respect to the determination of their own individual claims.

Agreements respecting fees and disbursements

38. (1) An agreement respecting fees and disbursements between a solicitor and a representative plaintiff must be in writing and must

(a) state the terms under which fees and disbursements are to be paid,

(b) give an estimate of the expected fee, whether or not that fee is contingent on success in the class proceeding, and

(c) state the method by which payment is to be made, whether by lump sum or otherwise.

(2) An agreement respecting fees and disbursements between a solicitor and a representative plaintiff is not enforceable unless approved by the court, on the application of the solicitor.

(3) An application under subsection (2) may,

(a) unless the court otherwise orders, be brought without notice to the defendants, or

(b) if notice to the defendants is required, be brought on the terms respecting disclosure of the whole or any part of the agreement respecting fees and disbursements that the court may order.

(4) Interest payable on fees under an agreement approved under subsection (2) must be calculated in the manner set out in the agreement or, if not so set out,

(a) at the interest rate, as that term is defined in [the court order interest Act of the enacting jurisdiction], or

(b) at any other rate the court considers appropriate.

(5) Interest payable on disbursements under an agreement approved under subsection (2) must be calculated in the manner set out in the agreement or, if not so set out

(a) at the interest rate, as that term is defined in [the court order interest Act of the enacting jurisdiction], or

(b) at any other rate the court considers appropriate, on the balance of disbursements incurred as totalled at the end of each 6 month period following the date of the agreement.

(6) Amounts owing under an enforceable agreement are a first charge on any settlement funds or monetary award.

(7) If an agreement is not approved by the court, the court may

(a) determine the amount owing to the solicitor in respect of fees and disbursements,

(b) direct an inquiry, assessment or accounting under the [rules of court] to determine the amount owing, or

(c) direct that the amount owing be determined in any other manner.

PART VI: General

Limitation periods

39. (1) Subject to subsection (3), any limitation period applicable to a cause of action asserted in a proceeding

(a) is suspended in favour of a person if another proceeding was commenced and it is reasonable for the person to assume that he or she was a class member for the purposes of that other proceeding, and

(b) resumes running against the person when clauses (2)(a) to (g) applies to the person as though he or she was the member referred to in subsection (2).

(2) Subject to subsection (3), any limitation period applicable to a cause of action asserted in a proceeding that is certified as a class proceeding under this Act is suspended in favour of a class member on the commencement of the proceeding and resumes running against the class member when

(a) the member opts out of the class proceeding,

(b) a ruling by the court has the effect of excluding the class member from the class proceeding or from being considered to have ever been a class member,

(c) an amendment is made to the certification order that has the effect of excluding the member from the class proceeding,

(d) a decertification order is made under section 10,

(e) the class proceeding is dismissed without an adjudication on the merits,

(f) the class proceeding is discontinued or abandoned with the approval of the court, or

(g) the class proceeding is settled with the approval of the court unless the settlement provides otherwise.

(3) If there is a right of appeal in respect of an event described in subsection (2)(a) to (g), the limitation period resumes running as soon as the time for appeal has expired without an appeal being commenced or as soon as any appeal has been finally disposed of.

Rules of Court

40. The [rules of court] apply to class proceedings to the extent that those rules are not in conflict with this Act.

Application of Act

41. This Act does not apply to

(a) a proceeding that may be brought in a representative capacity under another Act,

(b) a proceeding required by law to be brought in a representative capacity, and

(c) a representative proceeding commenced before this Act comes into force.

http://www.law.ualberta.ca/alri/ulc/acts/eclass.htm

ANNEXURE F

MANITOBA PROPOSED CLASS PROCEEDINGS ACT

APPENDIX A
PROPOSED CLASS PROCEEDINGS ACT

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PART I

Definitions

1. In this Act:

"certification order" means an order certifying a proceeding as a class proceeding;

"class proceeding" means a proceeding certified as a class proceeding under Part 2;

"common issues" means

(a) common but not necessarily identical issues of fact, or

(b) common but not necessarily identical issues of law that arise from common but not necessarily identical facts;

"court", except in section 37, means the Court of Queen's Bench;

"defendant" includes a respondent;

"plaintiff" includes an applicant.

PART II: Certification

Plaintiff's class proceeding

2. (1) One member of a class of persons who are resident in Manitoba may commence a proceeding in the court on behalf of the members of that class.

(2) The person who commences a proceeding under subsection (1) must make an application to a judge of the court for an order certifying the proceeding as a class proceeding and, subject to subsection (4), appointing the person as representative plaintiff.

(3) An application under subsection (2) must be made

(a) within 90 days after the close of pleadings, or

(b) with leave of the court at any other time.

(4) The court may certify a person who is not a member of the class as the representative plaintiff for the class proceeding.

Defendant's class proceeding

3. A defendant to two or more proceedings may, at any stage of one of the proceedings, make an application to a judge of the court for an order certifying the proceedings as a class proceeding and appointing a representative plaintiff.

Class certification

4. (1) The court must certify a proceeding as a class proceeding on an application under section 2 or 3 if

(a) the pleadings disclose a cause of action

(b) there is an identifiable class of 2 or more persons,

(c) the claims of the class members raise a common issue, whether or not the common issue predominates over issues affecting only individual members,

(d) a class proceeding would be the preferable procedure for the fair and efficient resolution of the common issues, and

(e) there is a representative plaintiff who

(i) would fairly and adequately represent the interests of the class,

(ii) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the class and of notifying class members of the proceeding, and

(iii) does not have, on the common issues, an interest that is in conflict with the interests of other class members.

(2) In determining whether a class proceeding would be the preferable procedure for the fair and efficient resolution of the common issues, the court must consider all relevant matters including the following:

(a) whether questions of fact or law common to the members of the class predominate over any questions affecting only individual members;

(b) whether a significant number of the members of the class have a valid interest in individually controlling the prosecution of separate actions;

(c) whether the class proceeding would involve claims that are or have been the subject of any other proceedings;

(d) whether other means of resolving the claims are less practical or less efficient;

(e) whether the administration of the class proceeding would create greater difficulties than those likely to be experienced if relief were sought by other means.

Certification application

5. (1) The court may adjourn the application for certification to permit the parties to amend their materials or pleadings or to permit further evidence.

(2) An order certifying a proceeding as a class proceeding is not a determination of the merits of the proceeding.

Subclass certification

6. (1) Despite section 4, if a class includes a subclass whose members have claims that raise common issues not shared by all the class members so that, in the opinion of the court, the protection of the interests of the subclass members requires that they be separately represented, the court may, in addition to the representative plaintiff for the class, appoint a representative plaintiff for each subclass who

(a) would fairly and adequately represent the interests of the subclass,

(b) has produced a plan for the proceeding that sets out a workable method of advancing the proceeding on behalf of the subclass and of notifying subclass members of the proceeding, and

(c) does not have, on the common issues for the subclass, an interest that is in conflict with the interests of other subclass members.

(2) A class that comprises persons resident in Manitoba and persons not resident in Manitoba may be divided into resident and non-resident subclasses.

Certain matters not bar to certification

7. The court must not refuse to certify a proceeding as a class proceeding by reason only of one or more of the following:

(a) the relief claimed includes a claim for damages that would require individual assessment after determination of the common issues;

(b) the relief claimed relates to separate contracts involving different class members;

(c) different remedies are sought for different class members;

(d) the number of class members or the identity of each class member is not ascertained or may not be ascertainable;

(e) the class includes a subclass whose members have claims that raise common issues not shared by all class members.

Contents of certification order

8. (1) A Certification Order must

(a) describe the class in respect of which the order was made by setting out the class's identifying characteristics,

(b) appoint the representative plaintiff for the class,

(c) state the nature of the claims asserted on behalf of the class,

(d) state the relief sought by the class,

(e) set out the common issues for the class,

(f) state the manner in which and the time within which a class member may opt out of the proceeding,

(g) state the manner in which and the time within which a person who is not a resident of Manitoba may opt in to the proceeding, and

(h) include any other provisions the court considers appropriate.

(2) If a class includes a subclass whose members have claims that raise common issues not shared by all the class members so that in the opinion of the court the protection of the interests of the subclass members requires that they be separately represented, the certification order must include the same information in relation to the subclass that, under subsection (1), is required in relation to the class.

(3) The court may at any time amend a certification order on the application of a party or class member or an its own motion.

(4) Without limiting the generality of subsection (3), where it appears to the court that a representative plaintiff is not acting in the best interests of the class, the court may substitute another class member or any other person as the representative plaintiff.

Refusal to certify

9. If the court refuses to certify a proceeding as a class proceeding, the court may permit the proceeding to continue as one or more proceedings between different parties and for that purpose, the court may

(a) order the addition, deletion or substitution of parties,

(b) order the amendment of the pleadings, and

(c) make any other order that it considers appropriate.

If conditions for certification not satisfied

10. (1) Without limiting subsection 8(3), at any time after a certification order is made under this Part, the court may amend the certification order, decertify the proceeding or make any other order it considers appropriate if it appears to the court that the conditions mentioned in section 4 or subsection 6(1) are not satisfied with respect to a class proceeding.

(2) If the court makes a decertification order under subsection (1), the court may permit the proceeding to continue as one or more proceedings between different parties and may make any order referred to in section 9 (a) to (c) in relation to each of those proceedings.

PART III: Conduct of Class Proceedings

Role of Court

Stages of class proceedings

11. (1) Unless the court otherwise orders under section 12, in a class proceeding

(a) common issues for a class must be determined together,

(b) common issues for a subclass must be determined together, and

(c) individual issues that require the participation of individual class members must be determined individually in accordance with sections 27 and 28.

(2) The court may give judgment in respect of the common issues and separate judgment in respect of any other issue.

Court may determine conduct of proceeding

12. The court may at any time make any order it considers appropriate respecting the conduct of a class proceeding to ensure its fair and expeditious determination and, for that purpose, may impose on one or more of the parties the terms it considers appropriate.

Court may stay any other proceeding

13. The court may at any time stay or sever any proceeding related to the class proceeding on the terms the court considers appropriate.

Motions

14. (1) The judge who makes a certification order is to hear all motions in the class proceeding before the trial of the common issues.

(2) If a judge who has heard motions under subsection (1) becomes unavailable for any reason to hear a motion in the class proceeding, the chief justice of the court may assign another judge of the court to hear the motion.

(3) Where the parties agree, a judge who hears motions under subsection (1) or (2) may preside at the trial of the common issues.

Participation of Class Members

Participation of class members

15. (1) In order to ensure the fair and adequate representation of the interests of the class or any subclass or for any other appropriate reason, the court may, at any time in a class proceeding, permit one or more class members to participate in the proceeding if this would be useful to the class.

(2) Participation under subsection (1) must be in the manner and on the terms, including terms as to costs, that the court considers appropriate.

Opting out and opting in

16. (1) A member of a class involved in a class proceeding may opt out of the proceeding in the manner and within the time specified in the certification order.

(2) Subject to subsection (4), a person who is not a resident of Manitoba may, in the manner and within the time specified in the certification order made in respect of a class proceeding, opt in to that class proceeding if the person would be, but for not being a resident of Manitoba, a member of the class involved in the class proceeding.

(3) A person referred to in subsection (2) who opts in to a class proceeding is from that time a member of the class involved in the class proceeding for every purpose of this Act.

(4) A person may not opt in to a class proceeding under subsection (2) unless the subclass of which the person is to become a member has or will have, at the time the person becomes a member, a representative plaintiff who satisfies the requirements of section 6 (1) (a), (b) and (c).

(5) If a subclass is created as a result of persons opting in to a class proceeding under subsection (2), the representative plaintiff for that subclass must ensure that the certification order for the class proceeding is amended, if necessary, to comply with section 8(2).

Discovery

17. (1) Parties to a class proceeding have the same rights of discovery under the Queen's Bench Rules against one another and against non-class members as they would have in any other proceeding.

(2) After discovery of the representative plaintiff or, in a proceeding referred to in section 6, one or more of the representative plaintiffs, a defendant may, with leave of the court, discover other class members.

(3) In deciding whether to grant a defendant leave to discover other class members, the court must consider

(a) the stage of the class proceeding and the issues to be determined at that stage,

(b) the presence of subclasses,

(c) whether the discovery is necessary in view of the defences of the party seeking leave,

(d) the approximate monetary value of individual claims, if any,

(e) whether discovery would result in oppression or in undue annoyance, burden or expense for the class members sought to be discovered, and

(f) any other matter the court considers relevant.

(4) A class member is subject to the same sanctions under the Queen's Bench Rules as a party for failure to submit to discovery.

Examination of class members before an application

18. (1) A party may not require a class member, other than a representative plaintiff, to be examined as a witness before the hearing of any application, except with leave of the court.

(2) Subsection 17(3) applies to a decision whether to grant leave under subsection (1) of this section.

Notices

Notice of certification

19. 1) Notice that a proceeding has been certified as a class proceeding must be given by the representative plaintiff to the class members in accordance with this section.

(2) The court may dispense with notice if, having regard to the factors set out in subsection (3), the court considers it appropriate to do so.

(3) The court must make an order setting out when and by what means notice is to be given under this section and in doing so must have regard to

(a) the cost of giving notice,

(b) the nature of the relief sought,

(c) the size of the individual claims of the class members,

(d) the number of class members,

(e) the presence of subclasses,

(f) the places of residence of class members, and

(g) any other relevant matter.

(4) The court may order that notice be given by

(a) personal delivery,

(b) mail,

(c) posting, advertising, publishing or leafleting,

(d) individually notifying a sample group within the class,

(e) creating and maintaining an Internet site, or

(f) any other means or combination of means that the court considers appropriate.

(5) The court may order that notice be given to different class members by different means.

(6) Unless the court orders otherwise, notice under this section must

(a) describe the proceeding, including the names and addresses of the representative plaintiffs and the relief sought,

(b) state the manner in which and the time within which a class member may opt out of the proceeding,

(c) state the manner in which and the time within which a person who is not a resident of Manitoba may opt in to the proceeding,

(d) describe any counterclaim or third party proceeding being asserted in the proceeding, including the relief sought,

(e) summarize any agreements respecting fees and disbursements

(i) between the representative plaintiff and the representative plaintiff's solicitors, and

(ii) if the recipient of the notice is a member of a subclass, between the representative plaintiff for that subclass and that representative plaintiff's solicitors,

(f) describe the possible financial consequences of the proceedings to class members and subclass members,

(g) state that the judgment on the common issues for the class, whether favorable or not will bind all class members who do not opt out of the proceeding,

(h) state that the judgment on the common issues for a subclass, whether favorable or not will bind all subclass members who do not opt out of the proceeding,

(i) describe the rights, if any, of class members to participate in the proceeding,

(j) give an address to which class members may direct inquiries about the proceeding, and

(k) give any other information the court considers appropriate.

(7) With leave of the court, notice under this section may include a solicitation of contributions from class members to assist in paying solicitors' fees and disbursements.

Notice of determination of common issues

20. (1) Where the court determines common issues in favour of a class and considers that the participation of individual class members is required to determine individual issues, the representative party shall give notice to those members in accordance with this section.

(2) Subsections 19(3) to (5) apply to notice given under this section.

(3) Notice under this section must

(a) state that common issues have been determined,

(b) identify the common issues that have been determined and explain the determinations made,

(c) state that members of the class or subclass may be entitled to individual relief,

(d) describe the steps that must be taken to establish an individual claim,

(e) state that failure on the part of a member of the class or subclass to take those steps will result in the member not being entitled to assert an individual claim except with leave of the court,

(f) give an address to which members of the class or subclass may direct inquiries about the proceeding, and

(g) give any other information that the court considers appropriate.

Notice to protect interests of affected persons

21. (1) At any time in a class proceeding, the court may order any party to give notice to the persons that the court considers necessary to protect the interests of any class member or party or to ensure the fair conduct of the proceeding.

(2) Subsections 19(3) to (5) apply to notice given under this section.

Approval of notice by the court

22. A notice under this Division must be approved by the court before it is given.

Giving of notice by another party

23. The court may order a party to give the notice required to be given by another party under this Act.

Costs of notice

24. (1) The court may make any order it considers appropriate as to the costs of any notice under this Division including an order apportioning costs among parties.

(2) In making an order under subsection (1), the court may have regard to the different interests of a subclass.

PART IV: Orders, Awards and Related Procedures

Order on Common Issues and Individual Issues

Contents of order on common issues

25. An order made in respect of a judgment on common issues of a class or subclass must

(a) set out the common issues,

(b) name or describe the class or subclass members to the extent possible,

(c) state the nature of the claims asserted on behalf of the class or subclass, and

(d) specify the relief granted.

Judgment on common issues is binding

26. (1) A judgment on common issues of a class or subclass binds every member of the class or subclass, as the case may be, who has not opted out of the class proceeding, but only to the extent that the judgment determines common issues that

(a) are set out in the certification order,

(b) relate to claims described in the certification order, and

(c) relate to relief sought by the class or subclass as stated in the certification order.

(2) A judgment on common issues of a class or subclass does not bind a party to the class proceeding in any subsequent proceeding between the party and a person who opted out of the class proceedings.

Determination of individual issues

27. (1) If the court determines common issues in favour of a class or subclass and determines that there are issues, other than those that may be determined under section 32, that are applicable only to certain individual members of the class or subclass, the court may

(a) determine those individual issues in further hearings presided over by the judge who determined the common issues or by another judge of the court,

(b) appoint one or more persons including, without limitation, one or more independent experts, to conduct an inquiry into those individual issues under the Queen's Bench Rules and report back to the court, or

(c) with the consent of the parties, direct that those individual issues be determined in any other manner.

(2) The court may give any necessary directions relating to the procedures that must be followed in conducting hearings, inquiries and determination under subsection (1).

(3) In giving directions under subsection (2), the court must choose the least expensive and most expeditious method of determining the individual issues that is consistent with justice to members of the class or subclass and the parties and, in doing so, the court may

(a) dispense with any procedural step that it considers unnecessary, and

(b) authorize any special procedural steps, including steps relating to discovery, and any special rules, including rules relating to admission of evidence and means of proof, that it considers appropriate.

(4) The court must set a reasonable time within which individual members of the class or subclass may make claims under this section in respect of the individual issues.

(5) A member of the class or subclass who fails to make a claim within the time set under subsection (4) may not later make a claim under this section in inspect of the issues applicable only to that member except with leave of the court.

(6) The court may grant leave under subsection (5) if it is satisfied that

(a) there are apparent grounds for relief,

(b) the delay was not caused by any fault of the person seeking the relief, and

(c) the defendant would not suffer substantial prejudice if leave were granted.

(7) Unless otherwise ordered by the court making a direction under subsection (1)(c), a determination of issues made in accordance with subsection (1)(c) is deemed to be an order of the court.

Individual assessment of liability

28. Without limiting section 27, if, after determining common issues in favour of a class or subclass, the court determines that the defendant's liability to individual class members cannot

reasonably be determined without proof by those individual class members, section 27 applies to the determination of the defendant 's liability to those class members.

Aggregate Awards

Aggregate awards of monetary relief

29. (1) The court may make an order for an aggregate monetary award in respect of all or any part of a defendant's liability to class members and may give judgment accordingly if

(a) monetary relief is claimed on behalf of some or all class members,

(b) no questions of fact or law other than those relating to the assessment of monetary relief remain to be determined in order to establish the amount of the defendant's monetary liability, and

(c) the aggregate or a part of the defendant's liability to some or all class members can reasonably be determined without proof by individual class members.

(2) Before making an order under subsection (1), the court must provide the defendant with an opportunity to make submission to the court in respect of any matter touching on the proposed order including, without limitation,

(a) submissions that contest the merits or amount of an award under that subsection, and

(b) submissions that individual proof of monetary relief is required due to the individual nature of the relief.

Statistical evidence may be used

30. (1) For the purposes of determining issues relating to the amount or distribution of an aggregate monetary award under this Act, the court may admit as evidence statistical information that would not otherwise be admissible as evidence, including information derived from sampling, if the information was complied in accordance with principles that are generally accepted by experts in the field of statistics.

(2) A record of statistical information purporting to be prepared by or published under the authority of an enactment of the Parliament of Canada or the legislature of any province may be admitted as evidence without proof of its authenticity.

(3) Statistical information must not be admitted as evidence under this section unless the party seeking to introduce the information

(a) has given to the party against whom the statistical evidence is to be used a copy of the information at least 60 days before that information is to be introduced as evidence,

(b) has complied with subsections (4) and (5), and

(c) introduces the evidence by an expert who is available for cross-examination on that evidence.

(4) Notice under this section must specify the source of any statistical information sought to be introduced that

(a) was prepared or published under the authority of an enactment of the Parliament of Canada or the legislature of any province,

(b) was derived from market quotations, tabulations, lists, directories or other compilations generally used and relied on by members of the public, or

(c) was derived from reference material generally used and relied on by members of an occupational group.

(5) Except with respect to information referred to in subsection (4), notice under this section must

(a) specify the name and qualifications of each person who supervised the preparation of the statistical information sought to be introduced, and

(b) describe any documents prepared or used in the course of preparing the statistical information sought to be introduced.

(6) Unless this section provides otherwise, the law and practice with respect to evidence tendered by an expert in a proceeding applies to a class proceeding.

(7) Except with respect to information referred to in subsection (4), a party against whom statistical information is sought to be introduced under this section may require the party seeking to introduce it to produce for inspection any document that was prepared or used in the course of preparing the information unless the document discloses the identity of persons responding to a survey who have not consented in writing to the disclosure.

Average or proportional share of aggregate awards

31. (1) If the court makes an order under section 29, the court may further order that all or a part of the aggregate monetary award be applied so that some or all individual class or subclass members share in the award on an average or proportional basis if

(a) it would be impractical or inefficient to

(i) identity the class or subclass members entitled to share in the award, or

(ii) determine the exact shares that should be allocated to individual class or subclass members, and

(b) failure to make an order under this subsection would deny recovery to a substantial number of class or subclass members.

(2) If an order is made under subsection (1), any member of the class or subclass in inspect of which the order was made may, within the time specified in the order, apply to the court to be excluded from the proposed distribution and to be given the opportunity to prove that member's claim on an individual basis.

(3) In deciding whether to exclude a class or subclass member from an average distribution, the court must consider

(a) the extent to which the class or subclass member's individual claim varies from the average for the class or subclass,

(b) the number of class or subclass members seeking to be excluded from an average distribution, and

(c) whether excluding the class or subclass members referred to in paragraph (b) would unreasonably deplete the amount to be distributed on an average basis.

(4) An amount recovered by a class or subclass member who proves that member's claim on an individual basis must be deducted from the amount to be distributed on an average basis before the distribution.

Individual share of aggregate award

32. (1) When the court orders that all or a part of an aggregate monetary award under section 29(1) be divided among individual class or subclass members on an individual basis, the court must determine whether individual claims need to be made to give effect to the order.

(2) If the court determines under subsection (1) that individual claims need to be made, the Court must specify the procedures for determining the claims.

(3) In specifying the procedures under subsection (2), the court must minimise the burden on class or subclass members and for that purpose, the court may authorize

(a) the use of standard proof of claim forms,

(b) the submission of affidavit or other documentary evidence, and

(c) the auditing of claims on a sampling or other basis.

(4) When specifying the procedures under subsection (2), the court must set a reasonable time within which individual class or subclass members may make claims under this section.

(5) A class or subclass member who fails to make a claim within the time set under subsection (4) may not later make a claim under this section except with leave of the court.

(6) Subsection 27(6) applies to a decision whether to grant leave under subsection (5) of this section.

(7) The court may amend a judgment given under subsection 29(1) to give effect to a claim made with leave under subsection (5) of this section if the court considers it appropriate to do so.

Distribution

33. (1) The court may direct any means of distribution of amounts awarded under this Division that it considers appropriate.

(2) In giving directions under subsection (1), the court may order that

(a) the defendant distribute directly to the class or subclass members the amount of monetary relief to which each class or subclass member is entitled by any means authorized by the court, including abatement and credit,

(b) the defendant pay into court or some other appropriate depository the total amount of the defendant's liability to the class or subclass members until further order of the court, or

(c) any person other than the defendant distribute directly to each of the class or subclass members, by any means authorized by the court, the amount of monetary relief to which that class or subclass member is entitled.

(3) In deciding whether to make an order under clause (2)(a), the court

(a) must consider whether distribution by the defendant is the most practical way of distributing the award, and

(b) may take into account whether the amount of monetary relief to which each class or subclass member is entitled can be determined from the records of the defendant.

(4) The court must supervise the execution of judgments and the distribution of awards under this Division and may stay the whole or any part of an execution or distribution for a reasonable period on the terms it considers appropriate.

(5) The court may order that an award made under this Division be paid

(a) in a lump sum, promptly or within a time set by the court, or

(b) in instalments, on the terms the court considers appropriate.

(6) The court may

(a) order that the costs of distributing an award under this Division, including the costs of any notice associated with the distribution and the fees payable to a person administering the distribution be paid out of the proceeds of the judgment, and

(b) make any further or other order it considers appropriate.

Undistributed award

34. (1) The court may order that all or any part of an award under this Division that has not been distributed within a time set by the court be applied in any manner that may reasonably be expected to benefit class or subclass members, even though the order does not provide for monetary relief to individual class or subclass members.

(2) In deciding whether to make an order under subsection (1), the court must consider

(a) whether the distribution would result in unreasonable benefits to persons who are not members of the class or subclass, and

(b) any other matter the court considers relevant.

(3) The court may make an order under subsection (1) whether or not all the class or subclass members can be identified or all their shares can be exactly determined.

(4) The court may make an order under subsection (1) even if the order would benefit

(a) persons who are not class or subclass members, or

(b) persons who may otherwise receive monetary relief as a result of the class proceeding.

(5) If any part of an award that, under subsection 32(1), is to be divided among individual class or subclass members remains unclaimed or otherwise undistributed after a time set by the court the court may order that part of the award

(a) be applied against the cost of the Class proceeding,

(b) be forfeited to the Government, or

(c) be returned to the party against whom the award was made.

Termination of Proceedings and Appeals

Settlement, discontinuance, abandonment and dismissal

35. (1) A class proceeding may be settled, discontinued or abandoned only

(a) with the approval of the court, and

(b) on the terms the court considers appropriate.

(2) A settlement may be concluded in relation to the common issues affecting a subclass only

(a) with the approval of the court, and

(b) on the terms the court considers appropriate.

(3) A settlement under this section is not binding unless approved by the court.

(4) A settlement of a class proceeding or of common issues affecting a subclass that is approved by the court binds every member of the class or subclass who has not opted out of the class proceeding, but only to the extent provided by the court.

(5) In dismissing a class proceeding or in approving a settlement discontinuance or abandonment, the court must consider whether notice should be given under section 20 and whether the notice should include

(a) an account of the conduct of the proceeding,

(b) a statement of the result of the proceeding, and

(c) a description of any plan for distributing any settlement funds.

(6) Before approving a settlement under subsections (1) or (2), the court must be satisfied that the agreement is fair, reasonable, and in the best interests of those affected by it. In making that determination, the court must consider, inter alia:

(a) the settlement terms and conditions,

(b) the nature and likely duration and cost of the proceeding,

(c) the amount offered in relation to the likelihood of success in the proceeding,

(d) the expressed opinions of class members other than the representative party,

(e) recommendations of neutral parties, if any, and

(f) whether satisfactory arrangements have been made for the distribution of money to be paid to the class members.

Appeals

36. (1) Any party may appeal without leave to the Court of Appeal from

(a) a judgment on common issues, or

(b) an order under Division 2 of this Part, other than an order that determines individual claims made by class or subclass members.

(2) With leave of a justice of the Court of Appeal, a class or subclass member, a representative plaintiff or a defendant may appeal to that court any order

(a) determining an individual claim made by a class or subclass member, or

(b) dismissing an individual claim for monetary relief made by a class or subclass member.

(3) With leave of a justice of the Court of Appeal, any party may appeal to the Court of Appeal from

(a) an order certifying or refusing to certify a proceeding as a class proceeding,

(b) an order decertifying a proceeding.

(4) If a representative plaintiff does not appeal or seek leave to appeal as permitted by subsection (1) or (3) within the time limit for bringing an appeal set under the Court of Appeal Rules or if a representative plaintiff abandons an appeal under subsection (1) or (3), any member of the class or subclass for which the representative plaintiff had been appointed may apply to a justice of the Court of Appeal for leave to act as the representative plaintiff for the purposes of subsection (1) or (3).

(5) An application by a class or subclass member for leave to act as the representative plaintiff under subsection (4) must be made within 30 days after the expiry of the appeal period available to the representative plaintiff or by such other date as the justice may order.

PART V: Costs, Fees and Disbursements

Costs

37. (1) Subject to this section, neither the Court of Queen's Bench nor the Court of Appeal may award costs to any party to an application for certification under subsection 2(2) or section 3, to any party to a class proceeding or to any party to an appeal arising from a class proceeding at any stage of the application, proceeding or appeal.

(2) A court referred to in subsection (1) may only award costs to a party in respect of an application for certification or in respect of all or any part of a class proceeding or an appeal from a class proceeding

(a) at any time that the court considers that there has been vexatious, frivolous or abusive conduct on the part of any party,

(b) at any time that the court considers that an improper or unnecessary application or other step has been made or taken for the purpose of delay or increasing costs or for any other improper purpose, or

(c) at any time that the court considers that there are exceptional circumstances that make it unjust to deprive the successful party of costs.

(3) A court that orders costs under subsection (2) may order that those costs be assessed in any manner that the court considers appropriate.

(4) Class members, other than the person appointed as representative plaintiff for the class, are not liable for costs except with respect to the determination of their own individual claims.

Agreements respecting fees and disbursements

38. (1) An agreement respecting fees and disbursements between a solicitor and a representative plaintiff must be in writing and must

(a) state the terms under which fees and disbursements are to be paid,

(b) give an estimate of the expected fee, whether or not that fee is contingent on success in the class proceeding, and

(c) state the method by which payment is to be made, whether by lump sum or otherwise.

(2) An agreement respecting fees and disbursements between a solicitor and a representative plaintiff is not enforceable unless approved by the court on the application of the solicitor.

(3) An application under subsection (2) may,

(a) unless the court otherwise orders, be brought without notice to the defendants, or

(b) if notice to the defendants is required, be brought on the terms respecting disclosure of the whole or any part of the agreement respecting fees and disbursements that the court may order.

(4) An application under subsection (2) must be brought prior to certification of the proceeding as a class proceeding.

(5) Interest payable on fees under an agreement approved under subsection (2) must be calculated in the manner set out in the agreement or, if not so set out,

(a) at the prejudgment interest rate, as that term is defined in the Court of Queen's Bench Act, or

(b) at any other rate the court considers appropriate.

(6) Interest payable on disbursements under an agreement approved under subsection (2) must be calculated in the manner set out in the agreement or, if not so set out,

(a) at the prejudgment interest rate, as that term is defined in the Court of Queen's Bench Act, or

(b) at any other rate the court considers appropriate, on the balance of disbursements incurred as totalled at the end of each 6 month period following the date of the agreement.

(7) Amounts owing under an enforceable agreement are a first charge on any settlement funds or monetary award.

(8) If an agreement is not approved by the court or if the court is persuaded at any point in the proceeding that an agreement has ceased to be fair and reasonable in all the circumstance, the court may

(a) determine the amount owing to the solicitor in respect of fees and disbursements,

(b) direct an inquiry, assessment or accounting under the Queen's Bench Rules to determine the amount owing, or

(c) direct that the amount owing be determined in any other manner.

(9) An application under subsection 58(4) of tile Law Society Act must be made to

(a) the judge who presided at the trial of the common issues, or

(b) the judge who approved the settlement agreement as the case may be.

PART VI: General

Limitation periods

39. (1) Subject to subsection (3), any limitation period applicable to a cause of action asserted in a proceeding

(a) is suspended in favour of a person if another proceeding was commenced and it is reasonable for the person to assume that he or she was a class member for the purposes of that other proceeding, and

(b) resumes running against the person when clauses (2)(a) to (g) applies to the person as though he or she was the member referred to in subsection (2).

(2) Subject to subsection (3), any limitation period applicable to a cause of action asserted in a proceeding under this Act is suspended in favour of a class member on the commencement of the proceeding and resumes running against the class member when

(a) the member opts out of the class proceeding,

(b) a ruling by the court has the effect of excluding the class member from the class proceeding or from being considered to have ever been a class member,

(c) an amendment is made to the certification order that has the effect of excluding the member from the class proceeding,

(d) a decertification order is made under section 10,

(e) the class proceeding is dismissed without an adjudication on the merits,

(f) the class proceeding is discontinued or abandoned with the approval of the court, or

(g) the class proceeding is settled with the approval of the court, unless the settlement provides otherwise.

(3) If there is a right of appeal in respect of an event described in subsection (2)(a) to (g), the limitation period resumes running as soon as the time for appeal has expired without an appeal being commenced or as soon as any appeal has been finally disposed of.

Rules of Court

40. The Queen's Bench Rules, other than Rules 20A and 78, apply to class proceedings, to the extent that those rules are not in conflict with this Act.

Application of Act

41. This Act does not apply to

(a) a proceeding that may be brought in a representative capacity under another Act,

(b) a proceeding required by law to be brought in a representative capacity, and

(c) a representative proceeding commenced before this Act comes into force.

ANNEXURE G

NORTH DAKOTA SUPREME COURT RULES N.D.R.CIV.P.

RULE 23. CLASS ACTIONS RULE

(a) Commencement of a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all in a class action if:

(1) the class is so numerous or so constituted that joinder of all members, whether or not otherwise required or permitted, is impracticable; and

(2) there is a question of law or fact common to the class.

(b) Certification of Class Action.

(1) Unless deferred by the court, as soon as practicable after the commencement of a class action the court shall hold a hearing and determine whether or not the action is to be maintained as a class action and by order certify or refuse to certify it as a class action.

(2) The court may certify an action as a class action if it finds that (A) the requirements of subdivision (a) have been satisfied, (B) a class action should be permitted for the fair and efficient adjudication of the controversy, and (C) the representative parties fairly and adequately will protect the interests of the class.

(3) If appropriate, the court may (A) certify an action as a class action with respect to a particular claim or issue, (B) certify an action as a class action to obtain one or more forms of relief equitable, declaratory, or monetary, or (C) divide a class into subclasses and treat each subclass as a class.

(c) Criteria Considered.

(1) In determining whether the class action should be permitted for the fair and efficient adjudication of the controversy, as appropriately limited under subdivision (b)(3), the court shall consider, and give appropriate weight to, the following and other relevant factors :

(A) whether a joint or common interest exists among members of the class;

(B) whether the prosecution of separate actions by or against individual members of the class would create a risk of inconsistent or varying adjudications with respect to individual members of the class that would establish incompatible standards of conduct for a party opposing the class;

(C) whether adjudications with respect to individual members of the class as a practical matter would be dispositive of the interests of other members not parties to the adjudication or substantially impair or impede their ability to protect their interests;

(D) whether a party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making final injunctive relief or corresponding declaratory relief appropriate with respect to the class as a whole;

(E) whether common questions of law or fact predominate over any questions affecting only individual members;

(F) whether other means of adjudicating the claims and defences are impracticable or inefficient;

(G) whether a class action offers the most appropriate means of adjudicating the claims and defences;

(H) whether members not representative parties have a substantial interest in individually controlling the prosecution or defence of separate actions;

(I) whether the class action involves a claim that is or has been the subject of a class action, a government action, or other proceeding;

(J) whether it is desirable to bring the class action in another forum;

(K) whether management of the class action poses unusual difficulties ;

(L) whether any conflict of laws issues involved pose unusual difficulties; and

(M) whether the claims of individual class members are insufficient in the amounts or interests involved, in view of the complexities of the issues and the expenses of the litigation, to afford significant relief to the members of the class.

(2) In determining under subdivision (b)(2) that the representative parties fairly and adequately will protect the interests of the class the court must find that:

(A) the attorney for the representative parties will adequately represent the interests of the class;

(B) the representative parties do not have a conflict of interest in the maintenance of the class action; and

(C) the representative parties have or can acquire adequate financial resources, considering subdivision (q), to assure that the interests of the class will not be harmed.

(d) Order on Certification.

(1) The order of certification shall describe the class and state: (A) the relief sought, (B) whether the action is maintained with respect to particular claims or issues, and (C) whether subclasses have been created.

(2) The order certifying or refusing to certify a class action shall state the reasons for the court's ruling and its findings on the factors listed in subdivision (c)(1).

(3) An order certifying or refusing to certify an action as a class action is appealable.

(4) Refusal of certification does not terminate the action, but does preclude it from being maintained as a class action.

(e) Amendment of Certification Order.

(1) The court may amend the certification order at any time before entry of judgment on the merits. The amendment may (A) establish subclasses, (B) eliminate from the class any class member who was included in the class as certified, (C) provide for an adjudication limited to

certain claims or issues, (D) change the relief sought, or (E) make any other appropriate change in the order.

(2) If notice of certification has been given pursuant to subdivision (g), the court may order notice of the amendment of the certification order to be given in terms and to any members of the class the court directs.

(3) The reasons for the court's ruling shall be set forth in the amendment of the certification order.

(4) An order amending the certification order is appealable. An order denying the motion of a member of a defendant class, not a representative party, to amend the certification order is appealable if the court certifies it for immediate appeal.

(f) Jurisdiction Over Multi-State Classes (Reserved)

(g) Notice of Action.

(1) Following certification, the court by order, after hearing, shall direct the giving of notice to the class.

(2) The notice, based on the certification order and any amendment of the order, must include:

(A) a general description of the action, including the relief sought and the names and addresses of the representative parties;

(B) a statement of the right of a member of the class under subdivision (h) to be excluded from the action by filing an election to be excluded, in the manner specified, by a certain date;

(C) a description of possible financial consequences for the class;

(D) a general description of any counterclaim being asserted by or against the class, including the relief sought;

(E) a statement that the judgment, whether favorable or not, will bind all members of the class who are not excluded from the action;

(F) a statement that any member of the class may enter an appearance either personally or through counsel;

(G) an address to which inquiries may be directed; and

(H) other information the court deems appropriate;

(3) the order must prescribe the manner of notification to be used and specify the members of the class to be notified. In determining the manner and form of the notice to be given, the court shall consider the interests of the class, the relief requested, the cost of notifying members of the class, and the possible prejudice to members who do not receive notice.

(4) Each member of the class, not a representative party, whose potential monetary recovery or liability is estimated to exceed $100 must be given personal notice, mailed notice, or notice via third-party commercial carrier if the person's identity and whereabouts can be ascertained by the exercise of reasonable diligence.

(5) For members of the class not given notice under paragraph (4), the court shall provide, as a minimum, a means of notice reasonably calculated to apprise the members of the class of the pendency of the action. Techniques calculated to assure effective communication of information concerning commencement of the action must be used. The techniques may include personal notice, mailed notice, or notice via third-party commercial carrier, newspaper, television, radio, posting in public or other places, and distribution through trade, union, public interest, or other appropriate groups.

(6) The plaintiff shall advance the expense of notice under this subdivision if there is no counterclaim asserted. If a counterclaim is asserted the expense of notice must be allocated as the court orders in the interest of justice.

(7) The court may order that steps be taken to minimize the expense of notice.

(h) Exclusion.

(1) A member of a plaintiff class may elect to be excluded from the action unless (A) he is a representative party, (B) the certification order contains an affirmative finding under subparagraph (A), (B), or (C) of subdivision (c)(1), or (C) a counterclaim under subdivision (k) is pending against the member or his class or subclass.

(2) Any member of a plaintiff class entitled to be excluded under paragraph (1) who files an election to be excluded, in the manner and in the time specified in the notice, is excluded from and not bound by the judgment in the class action.

(3) the elections shall be made a part of the record in the action.

(4) A member of a defendant class may not elect to be excluded.

(i) Conduct of Action.

(1) The court on motion of a party or its own motion may make or amend any appropriate order dealing with the conduct of the action including, but not limited to, the following:

(A) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument;

(B) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given as the court directs, of (i) any step in the action, (ii) the proposed extent of the judgment, or (iii) the opportunity of members to signify whether they consider the representation fair and adequate, to enter an appearance and present claims or defences, or otherwise to participate in the action;

(C) imposing conditions on the representative parties or on intervenors;

(D) inviting the attorney general to participate with respect to the question of adequacy of class representation;

(E) making any other order to assure that the class action proceeds only with adequate class representation; and

(F) making any order to assure that the class action proceeds only with competent representation by the attorney for the class.

(2) A class member not a representative party may appear and be represented by separate counsel.

(j) Discovery by or Against Class Members.

(1) Discovery under applicable discovery rules may be used only on order of the court against a member of the class who is not a representative party or who has not appeared. In deciding whether discovery should be allowed the court shall consider, among other relevant factors, the timing of the request, the subject matter to be covered, whether representatives of the class are seeking discovery on the subject to be covered, and whether the discovery will result in annoyance, oppression, or undue burden or expense for the members of the class.

(2) Discovery by or against representative parties or those appearing is governed by the rules dealing with discovery by or against a party to a civil action.

(k) Counterclaims.

(1) A defendant in an action brought by a class may plead as a counterclaim any claim the court certifies as a class action against the plaintiff class. On leave of court, the defendant may plead as a counterclaim a claim against a member of the class or a claim the court certifies as a class action against a subclass.

(2) Any counterclaim in an action brought by a plaintiff class must be asserted before notice is given under subdivision (g).

(3) If a judgment for money is recovered against a party on behalf of a class, the court rendering judgment may stay distribution of any award or execution of any portion of a judgment allocated to a member of the class against whom the losing party has pending an action in or out of state for a judgment for money, and continue the stay so long as the losing party in the class action pursues the pending action with reasonable diligence.

(4) A defendant class may plead as a counterclaim any claim on behalf of the class that the court certifies as a class action against the plaintiff The court may certify as a class action a counterclaim against the plaintiff on behalf of a subclass or permit a counterclaim by a member of the class. The court shall order that notice of the counterclaim by the class, subclass, or member of the class be given to the members of the class as the court directs, in the interest of justice.

(5) A member of a class or subclass asserting a counterclaim shall be treated as a member of a plaintiff class for the purpose of exclusion under subdivision (h).

(6) The court's refusal to allow, or the defendant's failure to plead, a claim as a counterclaim in a class action does not bar the defendant from asserting the claim in a subsequent action.

(l) Dismissal or Compromise.

(1) Unless certification has been refused under subdivision (b), a class action, without the approval of the court after hearing, may not be (A) dismissed voluntarily, (B) dismissed involuntarily without an adjudication on the merits, or (C) compromised.

(2) If the court has certified the action under subdivision (b), notice of hearing on the proposed dismissal or compromise shall be given to all members of the class in a manner the court directs. If the court has not ruled on certification, notice of hearing on the proposed dismissal or compromise may be ordered by the court which shall specify the persons to be notified and the manner in which notice is to be given.

(3) Notice given under paragraph (2) shall include a full disclosure of the reasons for the dismissal or compromise including, but not limited to, (A) any payments made or to be made in connection with the dismissal or compromise, (B) the anticipated effect of the dismissal or compromise on the class members, (C) any agreement made in connection with the dismissal or compromise, (D) a description and evaluation of alternatives considered by the representative parties and (E) an explanation of any other circumstances giving rise to the proposal. The notice also shall include a description of the procedure available for modification of the dismissal or compromise.

(4) On the hearing on the dismissal or compromise, the court may (A) as to the representative parties or a class certified under subdivision (b), permit dismissal with or without prejudice or approve the compromise, (B) as to a class not certified, permit dismissal without prejudice, (C) deny the dismissal, (D) disapprove the compromise, or (E) take other appropriate action for the protection of the class and in the interest of justice.

(5) The cost of notice given under paragraph (2) shall be paid by the party seeking dismissal, or as agreed in case of a compromise, unless the court after hearing orders otherwise.

(m) Effect of Judgment on Class.

In a class action certified under subdivision (b) in which notice has been given under subdivision (g) or (l), a judgment as to the claim or particular claim or issue certified is binding, according to its terms, on any member of the class who has not filed an election of exclusion under subdivision (h). The judgment shall name or describe the members of the class who are bound by its terms.

(n) Costs.

(1) Only the representative parties and those members of the class who have appeared individually are liable for costs assessed against a plaintiff class.

(2) The court shall apportion the liability for costs assessed against a defendant class.

(3) Expenses of notice advanced under subdivision (g) are taxable as costs in favour of the prevailing party.

(o) Relief Afforded.

(1) The court may award any form of relief consistent with the certification order to which the party in whose favour it is rendered is entitled, including equitable, declaratory, monetary, or other relief to individual class or the class in a lump sum or instalments.

(2) Damages fixed by a minimum measure of recovery provided by any statute may not be recovered in a class action.

(3) If a class is awarded a judgment for money, the distribution shall be determined as follows:

(A) the parties shall list as expeditiously as possible all members of the class whose identity can be determined without expending a disproportionate share of the recovery;

(B) the reasonable expense of identification and distribution shall be paid, with the court's approval, from the funds to be distributed;

(C) the court may order steps taken to minimize the expense of identification;

(D) the court shall supervise, and may grant or stay the whole or any portion of, the execution of the judgment and the collection and distribution of funds to the members of the class as their interests warrant;

(E) the court shall determine what amount of the funds available for the payment of the judgment cannot be distributed to members of the class individually because they could not be identified or located or because they did not claim or prove the right to money apportioned to them. The court after hearing shall distribute that amount in whole or in part, to one or more states as unclaimed property or to the defendant.

(F) in determining the amount, if any, to be distributed to a state or to the defendant, the court shall consider the following criteria: (i) any unjust enrichment of the defendant (ii) the wilfulness or lack of wilfulness on the part of the defendant; (iii) the impact on the defendant of the relief granted; (iv) the pendency of other claims against the defendant; (v) any criminal sanction imposed on the defendant; and (vi) the loss suffered by the plaintiff class.

(G) in order to remedy or alleviate any harm done, the court may impose conditions on the defendant respecting the use of the money distributed to him.

(H) any amount to be distributed to a state shall be distributed as unclaimed property to any state in which are located the last known addresses of the members of the class to whom distribution could not be made. If the last known addresses cannot be ascertained with reasonable diligence, the court may determine by other means what portion of the unidentified or unlocated members of the class were residents of a state. A state shall receive that portion of the distribution that its residents would have received had they been identified and located. Before entering an order distributing any part of the amount to a state the court shall give written notice of its intention to make distribution to the attorney general of the state of the residence of any person given notice under subdivision (g) or (l) and shall afford the attorney general an opportunity to move for an order requiring payment to the state.

(p) Attorney's Fees.

(1) Attorney's fees for representing a class are subject to control of the court.

(2) If under an applicable provision of law a defendant or defendant class is entitled to attorney's fees from a plaintiff class, only representative parties and those members of the class who have appeared individually are liable for those fees. If a plaintiff is entitled to attorney's fees from a defendant class, the court may apportion the fees among the members of the class.

(3) If a prevailing class recovers a judgment for money or other award that can be divided for the purpose, the court may order reasonable attorney's fees and litigation expenses of the class to be paid from the recovery.

(4) If the prevailing class is entitled to declaratory or equitable relief the court may order the adverse party to pay to the class its reasonable attorney's fees and litigation expenses if permitted by law in similar cases not involving a class or the court finds that the judgment has vindicated an important public interest. However, if any monetary award is also recovered, the court may allow reasonable attorney's fees and litigation expenses only to the extent that a reasonable proportion of that award is insufficient to defray the fees and expenses.

(5) In determining the amount of attorney's fees for a prevailing class the court shall consider the following factors:

(A) the time and effort expended by the attorney in the litigation, including the nature, extent, and quality of the services rendered;

(B) results achieved and benefits conferred upon the class;

(C) the magnitude, complexity, and uniqueness of the litigation;

(D) the contingent nature of success;

(E) in cases awarding attorney's fees and litigation expenses under paragraph (4) because of the vindication on an important public interest, the economic impact on the party against whom the award is made; and

(F) appropriate criteria included in the North Dakota Code of Professional Responsibility.

(q) Arrangements for Attorney's Fees and Expenses.

(1) Before a hearing under subdivision (b)(1) or at any other time the court directs, the representative parties and the attorney for the representative parties shall file with the court jointly or separately :

(A) a statement showing any amount paid or promised them by any person for the services rendered or to be rendered in connection with the action or for the costs and expenses of the litigation and the source of all of the amounts;

(B) a copy of any written agreement, or a summary of any oral agreement, between the representative parties and their attorney concerning financial arrangements or fee; and

(C) a copy of any written agreement, or a summary of any oral agreement, by the representative parties or the attorney to share these amounts with any person other than a member, regular associate, or an attorney regularly of counsel with his law firm. This statement shall be supplemented promptly if additional arrangements are made.

(2) Upon a determination that the costs and litigation expenses of the action cannot reasonably and fairly be defrayed by the representative parties or by other available sources, the court by order may authorize and control the solicitation and expenditure of voluntary contributions for this purpose from members of the class, advances by the attorneys or others, or both, subject to reimbursement from any recovery obtained for the class. The court may order any available funds so contributed or advanced to be applied to the payment of any costs taxed in favour of a party opposing the class.

(r) Statute of Limitations.

The statute of limitations is tolled for all class members upon the commencement of an action asserting a class action. The statute of limitations resumes running against a member of a class:

(A) upon filing an election of exclusion;

(B) upon entry of a certification order, or of an amendment thereof, eliminating him from the class;

(C) except as to representative parties, upon entry of an order under subdivision (b) refusing to certify the action as a class action; and

(D) upon dismissal of the action without an adjudication on the merits.

(s) Uniformity of Application and Construction.

This Rule shall be construed and applied to effectuate its general purpose to make uniform the law with respect to the subject of this Rule among states enacting it.

(t) Short Title.

This Rule may be cited as the "Model Class Actions Rule."

http://www.court.state.nd.us/Court/Rules/CIVIL/RULE23.htm

ANNEXURE H

LOUISIANA

CHAPTER 5. CLASS AND DERIVATIVE ACTIONS

SECTION 1. CLASS ACTIONS

Art. 591. Prerequisites; maintainable class actions

A. One or more members of a class may sue or be sued as representative parties on behalf of all only if:

(1) The class is so numerous that joinder of all members is impracticable.

(2) There are questions of law or fact common to the class.

(3) The claims or defences of the representative parties are typical of the claims or defences of the class.

(4) The representative parties will fairly and adequately protect the interests of the class.

(5) The class is or may be defined objectively in terms of ascertainable criteria, such that the court may determine the constituency of the class for purposes of the conclusiveness of any judgment that may be rendered in the case.

B. An action may be maintained as a class action only if all of the prerequisites of Paragraph A of this Article are satisfied, and in addition:

(1) The prosecution of separate actions by or against individual members of the class would create a risk of:

(a) Inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class; or

(b) Adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) The party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) The court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to these findings include:

(a) The interest of the members of the class in individually controlling the prosecution or defence of separate actions;

(b) The extent and nature of any litigation concerning the controversy already commenced by or against members of the class;

(c) The desirability or undesirability of concentrating the litigation in the particular forum;

(d) The difficulties likely to be encountered in the management of a class action;

(e) The practical ability of individual class members to pursue their claims without class certification;

(f) The extent to which the relief plausibly demanded on behalf of or against the class, including the vindication of such public policies or legal rights as may be implicated, justifies the costs and burdens of class litigation; or

(4) The parties to a settlement request certification under Subparagraph B(3) for purposes of settlement, even though the requirements of Subparagraph B(3) might not otherwise be met.

C. Certification shall not be for the purpose of adjudicating claims or defences dependent for their resolution on proof individual to a member of the class. However, following certification, the court shall retain jurisdiction over claims or defences dependent for their resolution on proof individual to a member of the class.

Acts 1997, No. 839,§ 1, eff. July 1, 1997.

Art. 592. Certification procedure; notice; judgment; orders

A. (1) Within ninety days after service on all adverse parties of the initial pleading demanding relief on behalf of or against a class, the proponent of the class shall file a motion to certify the action as a class action. The delay for filing the motion may be extended by stipulation of the parties or on motion for good cause shown.

(2) If the proponent fails to file a motion for certification within the delay allowed by subparagraph A(1), any adverse party may file a notice of the failure to move for certification. On the filing of such a notice and after hearing thereon, the demand for class relief may be stricken. If the demand for class relief is stricken, the action may continue between the named parties alone. A demand for class relief stricken under this Subparagraph may be reinstated upon a showing of good cause by the proponent.

(3) (a) No motion to certify an action as a class action shall be granted prior to a hearing on the motion. Such hearing shall be held as soon as practicable, but in no event before:

(i) All named adverse parties have been served with the pleading containing the demand for class relief or have made an appearance or, with respect to unserved defendants who have not appeared, the proponent of the class has made due and diligent effort to perfect service of such pleading; and

(ii) The parties have had a reasonable opportunity to obtain discovery on class certification issues, on such terms and conditions as the court deems necessary.

(b) If the court finds that the action should be maintained as a class action, it shall certify the action accordingly. If the court finds that the action should not be maintained as a class action, the action may continue between the named parties.

(c) In the process of class certification, or at any time thereafter before a decision on the merits of the common issues, the court may alter, amend, or recall its initial ruling on certification and may enlarge, restrict, or otherwise redefine the constituency of the class or the issues to be maintained in the class action.

(d) No order contemplated in this Subparagraph shall be rendered alter a judgment or partial judgment on the merits of common issues has been rendered against the party opposing the class and over such party's objection.

B. (1) In any class action maintained under Article 591(B)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. This notice, however given, shall be given as soon as practicable after certification, but in any event early enough that a delay provided for the class members to exercise an option to be excluded from the class will have expired before commencement of the trial on the merits of the common issues.

(2) The notice required by Subparagraph B(1) shall include:

(a) A general description of the action, including the relief sought, and the names and addresses of the representative parties or, where appropriate, the identity and location of the source from which the names and addresses of the representative parties can be obtained.

(b) A statement of the fight of the person to be excluded from the action by submitting an election form, including the manner and time for exercising the election.

(c) A statement that the judgment, whether favorable or not, will include all members who do not request exclusion.

(d) A statement that any member who does not request exclusion may, if the member desires, enter an appearance through counsel at that member's expense.

(e) A statement advising the class member that the member may be required to take further action as the court deems necessary, such as submitting a proof of claim in order to participate in any recovery had by the class.

(f) A general description of any counterclaim brought against the class.

(g) The address of counsel to whom inquiries may be directed.

(h) Any other information that the court deems appropriate.

(3) Unless the parties agree otherwise, the proponents of the class shall bear the expense of the notification required by this Paragraph. The court may require the party opposing the class to co-operate in securing the names and addresses of the persons within the class defined by the court for the purpose of providing individual notice, but any additional costs reasonably incurred by the party opposing the class in complying with this order shall be paid by the proponent of the class. The court may tax all or part of the expenses incurred for notification as costs.

C. The judgment in an action maintained as a class action under Article 591(B)(1) or (B)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under Article 591(B)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in Paragraph B was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

D. When appropriate an action may be brought or maintained as a class action with respect to particular issues, or a class may be divided into subclasses and each subclass treated as a class, and the provisions of Article 591 and this Article shall then be construed and applied accordingly.

E. In the conduct of actions to which Article 591 and this Article apply, the court may make any of the following appropriate orders:

(1) Determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument.

(2) Requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to members of the class of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defences, or otherwise to come into the action.

(3) Imposing conditions on the representative parties or on intervenors.

(4) Requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly.

(5) Dealing with similar procedural matters, including but not limited to case management orders providing for consolidation, duties of counsel, the extent and the scheduling of and the delays for pre-certification and post-certification discovery, and other matters which affect the general order of proceedings; however, the court may not order the class-wide trial of issues dependent for their resolution on proof individual to a member of the class, including but not limited to the causation of the member's injuries, the amount of the member's special or general damages, the individual knowledge or reliance of the member, or the applicability to the member of individual claims or defences.

(6) Any of the orders provided in this Paragraph may be combined with an order pursuant to Article 1551, and may be altered or amended as may be desirable from time to time.

Acts 1997, No. 839,§ 1, eff. July 1, 1997.

Art. 593. Venue

A. An action brought on behalf of a class shall be brought in a parish of proper venue as to the defendant.

B. An action brought against a class shall be brought in a parish of proper venue as to any member of the class named as a defendant.

Acts 1989, No. 117,§ 1; Acts 1997, No. 839,§ 1, eff. July 1, 1997.

Art. 594. Dismissal or compromise

A. (1) An action previously certified as a class action shall not be dismissed or compromised without the approval of the court exercising jurisdiction over the action.

(2) Notice of the proposed dismissal of an action previously certified as a class action shall be provided to all members of the class, together with the terms of any proposed compromise that the named parties have entered into. Notice shall be given in such manner as the court directs.

B. After notice of the proposed compromise has been provided to the members of the class, the court shall order a hearing to determine whether the proposed compromise is fair, reasonable, and adequate for the class. At such hearing, all parties to the action, including members of the class, shall be permitted an opportunity to be heard.

C. The court shall retain the authority to review and approve any amount paid as attorney fees pursuant to the compromise of a class action, notwithstanding any agreement to the contrary.

D. Any agreement entered by the parties to a class action that provides for the payment of attorney fees is subject to judicial approval.

E. If the terms of the proposed compromise provide for the adjudged creation of a settlement fund to be disbursed to and among members of the class in accordance with the terms thereof, the court having jurisdiction over the class action is empowered to approve the compromise settlement of the class action as a whole and issue a final judgment accordingly, following a finding that the compromise is fair, reasonable, and adequate for the class, and to order the distribution of the settlement fund accordingly, without the necessity of prior qualification of representatives of minors, interdicts, successions, or other incompetents or absentees, or prior approval of the terms of the settlement or the distribution thereof by another court; provided, that in such cases the court having jurisdiction over the class action shall include in the orders of settlement and distribution of the settlement fund appropriate provisions

to ensure that all funds adjudicated to or for the benefit of such incompetents, successions, or absentees are placed in appropriate safekeeping pending the completion of appointment, qualification and administrative procedures otherwise applicable in this Code to the interests and property of incompetents, successions, and absentees.

Acts 1993, No. 39,§ 1, eff. May 18, 1993; Acts 1997, No. 839,§ 1, eff. July 1, 1997.

Art. 595. Award of expenses of litigation; security for costs

A. The court may allow the representative parties their reasonable expenses of litigation, including attorney's fees, when as a result of the class action a fund is made available, or a recovery or compromise is had which is beneficial, to the class.

B. The court, on contradictory motion at any stage of the proceeding in the trial court prior to judgment, may require the plaintiff in a class action to furnish security for the court costs which a defendant may be compelled to pay. This security for costs may be increased or decreased by the court, on contradictory motion of any interested party, on a showing that the security furnished has become inadequate or excessive.

Art. 596. Prescription; suspension

Liberative prescription on the claims arising out of the transactions or occurrences described in a petition brought on behalf of a class is suspended on the filing of the petition as to all members of the class as defined or described therein. Prescription which has been suspended as provided herein, begins to run again:

(1) As to any person electing to be excluded from the class, from the submission of that person's election form;

(2) As to any person excluded from the class pursuant to Article 592, thirty days after mailing or other delivery or publication of a notice to such person that the class has been restricted or otherwise redefined so as to exclude him; or

(3) As to all members, thirty days after mailing or other delivery or publication of a notice to the class that the action has been dismissed, that the demand for class relief has been stricken pursuant to Article 592, or that the court has

denied a motion to certify the class or has vacated a previous order certifying the class.

Acts 1997, No. 839,§ 1, eff. July 1, 1997.

Art. 597. Effect of judgment

A definitive judgment on the merits rendered in a class action concludes all members of the class, whether joined in the action or not, if the members who were joined as parties fairly insured adequate representation of all members of the class.

http://www.legis.state.la.us/tsrs/ccp/ccp_597.htm

CHAPTER 17 – THE PROTECTION OF MINORITY SHAREHOLDERS

17.1 'The undertaking of industrial and commercial enterprises on the vast scale with which we are familiar today would be impossible if the law did not provide the means by which large sums of capital may be raised from a multitude of investors, the application of that capital confined within broad limits to a small group of managers and directors, and the investors guarded against personal liability to the creditors of the enterprise if it fails. The law has provided the means for the achievement of these objects in the form of the limited company'.(1)

In South Africa, as elsewhere, the Companies Act seeks to achieve a balance between the protection afforded to entrepreneurs when carrying on business in the form of the limited company and the protection of the public against the unbridled soliciting of investments and the reckless carrying on of the business without incurring personal liability. To this end a number of provisions have been enacted relating, for example, to the issue of shares and debentures, the appointment and the powers and duties of directors and auditors, the books of account and financial statements, the general meetings of shareholders and the winding up by the Court.

17.2 As stated in the First Report, the typical minority shareholder has no influence over the appointment of directors or auditors of the company. He is normally not allowed access to the books and records of the company and is solely dependent on such 'snapshots' of the company's affairs as might be reflected in its financial statements.

17.3 In the United States institutional investors — mutual and pension funds — hold about 60% of the equity of large US corporations. Individuals hold the other 40%.(2)

17.4 "Managers of large corporations sometimes do not act in the best interests of their employers, the share owners. This problem has troubled economists and business people for centuries and although progress has been made, the agency costs of this conflict of interests remain substantial. Especially when no shareholder owns more than, say, 5% of the firms, no one has enough incentive to monitor management, because the private benefit is small — the 'free rider' problem.(3)

17.5 To alleviate some of the problems experienced by minority shareholders, the legislation in some jurisdictions provided measures which are additional to those usually found in companies laws and which are designed to both protect and to empower those shareholders who have very little say in the affairs of the company.

Some of these measures, namely

— the publication by listed public companies of quarterly financial statements reviewed by the external auditor

— access to the records of the company

— the codification of the fiduciary duties of directors;

— dissenter and derivative actions; and

— class actions;

have been discussed and recommended in Chapters 9, 11, 14, 15 and 16 respectively.

Other measures include

— legal backing for accounting standards;

— the annual publication of statements by directors on the affairs of the company;

— the imposition of civil liability on directors;

— stricter duties of external auditors to report irregularities;

— improved avenues of communication between external auditors and shareholders.

17.6 ***Legal Backing for Accounting Standards.***

17.6.1 In its First Report the Commission referred to the lack of legal backing for accounting standards (or accounting practice or accounting principles) as follows:

"Section 286(3) of the Companies Act provides that the annual financial statements of a company must, 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, insofar as they are applicable, and comply with any other requirements of the Act.

Unfortunately a statutory enforced statement of generally accepted accounting practice does not exist in South Africa.[4]

17.6.2 The existence of the problem is recognized by the auditing profession.

17.6.3 In 1973 the South African Accounting Practices Board was established to consider, prepare, issue and publish statements of generally accepted accounting practice (GAAP) prepared by the (then) National Council of Chartered Accountants (SA) (now SAICA).

The Accounting Practices Board has no statutory standing but the South African Public Accountants and Auditors Board has issued a circular supporting the statements of GAAP issued by the Accounting Practices Board.[5]

17.6.4 In the statement AC 100 issued by SAICA, the following is stated:

"In 1977 the APB obtained Senior Counsel's opinion on the following questions:

- Does compliance with a statement of GAAP, issued by the APB, constitute compliance with the requirements of Section 286(3) of the Companies Act?

- Does non-compliance with these statements constitute a contravention of the requirements of Section 286(3)of the Companies Act?

The following is a summary of Senior Counsel's opinion:

- With reference to the first question posed, Senior Counsel is of the opinion that, having regard to the procedure adopted by the APB in considering and approving statements of GAAP and to the composition of the APB, that to the extent that a company in drawing up its financial statements complies with, and an auditor in carrying out his duties follows, a statement of the APB, they 'can safely assume that they have complied with the provisions of the Companies Act in respect of "generally accepted accounting practice'.

- In discussing the second question, Senior Counsel expressed the opinion that 'the question whether any particular practice complies with the statutory requirement remains a matter of fact and of professional opinion to be decided upon the merits of each particular case' and the existence of an APB statement therefore constituted evidence of what generally accepted accounting practice was, but need 'not necessarily be decisive'. It therefore 'does not necessarily follow that non-compliance with these statements will constitute contravention' of the requirements of the Companies Act.

- Counsel reached the conclusion that, while compliance with APB statements removes any fear of non-compliance with the requirements of the Companies Act to conform with generally accepted accounting practice, non-compliance 'could' or 'may' constitute a contravention of the Act in that regard, but would not necessarily do so.

- Counsel, however, also pointed out that statements issued by the APB were likely to win growing acceptance from the profession and the business community. Consequently a practice which 'today may be regarded as within the limits of the permissible, although it is not in accordance with the statement of the Board, may well within a few years or less be regarded as falling outside those limits'.

17.6.5 Legal backing for accounting standards is recognized in many jurisdictions and is widely supported by professional organizations.

17.6.6 Some examples of legal backing for accounting standards are

Australia

"(9) 'AASB' means the Australian Accounting Standard Board.

'accounting standard' means:

(a) an instrument in force under section 334; or

(b) a provision of such an instrument as it so has effect.

(296) Compliance with accounting standards and regulations (Corporations Law) (Amended by Act No. 61 of 1998)

(1) The financial report for a financial year must comply with the accounting standards. However, a small proprietary company's report does not have to comply with particular accounting standards if:

(a) the report is prepared in response to a shareholder direction under section 293; and

(b) the direction specifies that the report does not have to comply with those accounting standards.

(334) Accounting standards (Corporations Law) (Amended by Act No. 61 of 1998

(1) The AASB may make accounting standards for the purposes of this Law. The standards must be in writing and must not be inconsistent with this law or the Regulations".

India

"(211) (3C) For the purposes of this section, the expression 'accounting standards' means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under subsection (1) of section 210A:

Provided that the standard of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed the Central government under this subsection".

Pakistan

"234 (3) Subject to the provisions of this Ordinance, in the case of a listed company:

(i) such International Accounting Standards and other standards shall be followed in regard to the accounts and preparation of the balance sheet and profit and loss account as are notified for the purpose in the official Gazette by the Authority".

17.6.7 Although some experts have little faith in the efficacy of legal backing for accounting standards, it should at least close one avenue of escape used by dishonest or inept auditors, namely the inexactitude of the concept of 'generally accepted'.

17.6.8 It is recommended that legal backing for accounting standards be introduced by means of the following definition in the Companies Act:

'generally accepted accounting practice' means the accounting statements issued from time to time by the South African Institute of Chartered Accountants, approved by a fully represenative Accounting Practices Board[(6)] and published by the Minister in the *Gazette*'.

17.7 ***Annual Report on the Affairs of the Company***

17.7.1 In some of the jurisdictions in the Pacific Rim, corporation laws require directors to cause a report on the activities of companies to be attached to the annual balance sheets.

17.7.2 As an example, the **Companies Act** of **Malaysia** (section 169) requires the report to include information regarding

"(6) (a) .....

(b) the principal activities of the company in the course of the financial year and any significant change in the nature of those activities during that period;

(c) the net amount of the profit or loss of the company for the financial year after provision for income tax;

(d) the amounts and particulars of any material transfers to or from reserves or provisions;

(e) where, during the financial year, the company has issued any shares or debentures, the purposes of the issue, the classes of shares or debentures issued, the number of shares of each class and the amount of debentures of each class, and the terms of issue of the shares and debentures of each class;

…….

(i) whether the directors (before the profit and loss account and balance sheet were made out) took reasonable steps to ascertain what action had been taken in relation to the writing off of bad debts and the making of provision for doubtful debts, and satisfied themselves that all known bad debts had been written off and that adequate provision had been made for doubtful debts;

(j) whether at the date of the report the directors are aware of any circumstances which would render the amount written off for bad debts or the amount of the provision for doubtful debts inadequate to any substantial extent and, if so, giving particulars of the circumstances;

(k) whether the directors (before the profit and loss account and balance sheet were made out) have taken reasonable steps to ensure that any current assets which were unlikely to be realized in the ordinary course of business including their value as shown in the accounting records of the company have been written down to an amount which they might be expected so to realize;

(l) whether at the date of the report the directors are aware of any circumstances:

(i) which would render the values attributed to current assets in the accounts misleading;

(ii) which have arisen which render adherence to the existing method of valuation of assets or liabilities of the company misleading or inappropriate; and, if so, giving particulars of the circumstances;

(m) .....

(n) .....

(o) whether at the date of the report the directors are aware of any circumstances not otherwise dealt with in the report or accounts which would render any amount stated in the accounts misleading and, if so, giving particulars of the circumstances;

(p) whether the results of the company's operations during the financial year were, in the opinion of the directors, substantially affected by any item, transaction or event of a material and unusual nature and, if so, giving particulars of that item, transaction or event and the amount or the effect thereof, if known or reasonably ascertainable; and

(q) whether there has arisen in the interval between the end of the financial year and the date of the report any item, transaction or event of a material and unusual nature likely, in the opinion of the directors, to affect substantially the results of the company's operations for the financial year in which the report is made and, if so, giving particulars of the item, transaction or event.

(7) In subsection (6) of this section, the expression 'any item, transaction or event of a material and unusual nature' includes but is not limited to:

(a) any change in accounting policies adopted since the last report;

(b) any material change in the method of valuation of the whole or any part of the trading stock;

(c) any material item appearing in the accounts or consolidated accounts for the first time or not usually included in the accounts or consolidated accounts; and

(d) any absence from the accounts or consolidated accounts of any material item usually included in the accounts or consolidated accounts."

The penalty for the making of false or misleading statements or reports is imprisonment for 10 years or a fine of 250 000 Ringgit, (approximately R 375 000) or both.

The penalty sections 364 and 364A read as follows:

"s364 ……..

(2) Every person who in any return, report, certificate, balance sheet or other document required by or for the purposes of this Act makes or authorises the making of a statement false or misleading in any material particular knowing it to be false or misleading or intentionally omits or authorises the omission or accession of any matter or thing thereby making the document misleading in a material respect shall be guilty of an offence against this Act.

Penalty: Imprisonment for ten years or 250 000 ringgit or both.

(3) For the purposes of subsection (2) where a person at a meeting votes in favour of the making of a statement referred to in that subsection knowing it to be false, he shall be deemed to have authorised the making of that statement.

s364A. False reports (Companies Act)

(1) An officer of a corporation who, with intent to deceive, makes or furnishes or knowingly and wilfully authorises or permits the making or furnishing of, any false or misleading statement or report to:

(a) a director, auditor, member, debenture holder or trustee for debenture holders of the corporation;

(b) in the case of a corporation that is a subsidiary, an auditor of the holding company;

(c) a prescribed Stock Exchange whether within or without Malaysia or an officer thereof; or

(d) the Securities Commission established under the Securities Commission Act 1992

relating to the affairs of the corporation shall be guilty of an offence against this Act.

Penalty: Imprisonment for ten years or 250 000 ringgit or both.

(2) In subsection (1) 'officer' includes a person who at any time has been an officer of the corporation."

17.7.3 It is recommended that directors of South African public companies be required to cause an audited report on the activities of the company to be attached to the annual balance sheet, with contents similar to that required by section 169 of the Companies Act of Malaysia, and stating their opinion, with the grounds therefor, as to the prospects of the business of the company and of its subsidiaries and of any subsidiary or business undertaking to be acquired.

17.8 *The Civil Liability of Directors*

17.8.1 Codification of the fiduciary duties of directors is recommended (see Chapter 14) and should be complemented by a civil liability imposed by statute for the negligent, reckless or intentional disregard thereof.

17.8.2 Examples of civil and criminal liability imposed on directors in some other jurisdictions and referred to in the First Report are

Argentina

"Administrators and representatives of a company must perform their duties with loyalty and with the diligence of good businessmen. Those persons who fail to meet these obligations shall be jointly, severally and unlimitedly liable for damages and losses that result from their action or omission."

(Article 59 of the Companies Act)

"Damage caused to a company by fraud or negligence of the members or of anyone who controls it, shall incur such parties in the joint obligation to pay compensation without their claiming compensation from the profits that their act afforded to other businesses.

A partner or controller who uses funds or goods of the company for his own use or negotiates on his own account or for that of third parties, is obligated to bring the resulting profits to the company; the losses being to his exclusive account."

(Article 54 of the Companies Act)

Belgium

"Directors are responsible pursuant to the common law for the execution of the mandate which they have received and for their acts within their management.

They are jointly and severally liable both to the corporation or towards third parties for all damages resulting from a violation of the provisions of this title or of the corporate charter. They shall be released from this liability, with respect to violations in which they have not participated, only if no fault can be attributed to them and if they have denounced these violations to the first general meeting taking place after they have learned of the violation."

(Act 62 of the Commercial Companies Law)

Brazil

"In exercising his duties, a company officer shall employ the care and diligence which an active and honest man customarily employs in the administration of his own affairs."

(Article 153 of the Corporation Law)

"An officer shall not be personally liable for commitments undertaken on behalf of the company and by virtue of normal administrative acts; he shall, however, answer in civil courts for losses caused when he acts:-

(1) with negligence or fraud, within his attributions of powers;

(2) in violation of law or corporate by-laws."

(Article 158 of the Corporation Law)

Canada

"(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall —

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

(2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.

(3) Subject to subsection 146(5), no provision in a contract, the articles, by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves him from liability for a breach thereof."

Chile

"The culpability of the directors who are jointly and severally liable for damages to the company, shareholders or third parties, shall be presumed in the following cases:

(1) If the company does not keep books or registers;

(2) If provisional dividends are distributed when there are accumulated losses, with respect to the directors who concurred in the respective decision;

(3) If the company hides its assets, acknowledges supposed debts or similar disposals.

The culpability of a director or directors shall also be presumed where they unduly benefit, directly or through another individual or legal person from a company transaction which, at the same time, causes damage to the company."

"The board of directors must furnish sufficient, faithful and timely information to the shareholders and to the public, as the law and, as the case may be, the Superintendent determines with respect to the legal, economic and financial situation of the Company.

If the violation of this obligation causes damage to the company, the shareholders or to third parties, the directors in violation shall be jointly and severally liable for the damages caused. The preceding provision shall apply notwithstanding the administrative sanctions which the Superintendent may apply and the other penalties which the law establishes, as the case may be."

(Articles 45 and 46 of the Corporation Law)

Italy

"Liability in respect of the company. The directors must perform the duties imposed on them by law and by the company contract as trustees (Article 1710) and are jointly (Article 1292) responsible toward the company for losses deriving from non-performance of such duties, unless these are the particular province of the executive committee or of one of several administrators.

In every case the directors are jointly responsible (Article 1292) if they have not exercised supervision of the general progress of management, or if being aware of prejudicial acts, they have not done their utmost to prevent their performance or to eliminate or mitigate the harmful results.

Liability for acts and omissions of the administrators does not extend to those among them who being blameless registered without delay their dissent in the attendance book and minutes of the board, and who have immediately notified the presiding authority of the auditing collegium."

(Article 2392 of the Civil Code)

"Liability to company creditors. The directors are responsible to company creditors to fulfil their duties with respect to the safeguarding of the company assets.

The creditors may file suit when the company assets prove insufficient to meet their credits."

(Article 2394 of the Civil Code)

Japan

"In any of the following cases, directors who have done the act mentioned therein shall be jointly and severally liable for payment or in damages to the corporation as to the amount which has been illegally distributed in the case of Item 1, the amount unpaid in the case of item 2, and the amount of damage caused to the corporation in the cases of items 3 through 5.

1. **Where a proposal for distributing profits in contravention of the provisions of Article 290, paragraph 1, has been submitted to a general meeting, or if they have distributed money in violation of Article 293-5, paragraph 3.**

2. **Where money has been lent to other directors.**

3. **Where a transaction has been effected in contravention of the provisions of Article 264, paragraph 1.**

4. **Where a transaction mentioned in the preceding Article has been effected.**

5. **Where an act in contravention of laws or ordinances or of the Articles of Incorporation has been done.**

Where any act mentioned in the preceding paragraph has been done in accordance with a resolution of the board of directors, the directors who have assented to the resolution shall be deemed liable for the act.

The directors who participated in the resolution of the preceding paragraph and who have not expressed their dissent in the minutes shall be presumed to have assented to such resolutions."

(Article 266 of the Company Law)

Malaysia

"As to the duty and liability of officers (Companies Act)

(1) A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.

……..

(5) This section is in addition to and not in derogation of any other written law or rule of law relating to the duty or liability of directors or officers of a company."

(Section 132 of the of the Companies Act)

"If in the course of the winding up of a company or in any proceedings against a company it appears that an officer of the company who was knowingly a party to the contracting of a debt had, at the time the debt was contracted, no reasonable or probable ground of expectation, after taking into consideration the other liabilities, if any, of the company at the time, of the company being able to pay the debt, the officer shall be guilty of an offence against this Act."

(Section 303(3) of the Companies Act)

"If in the course of the winding up of a company or in any proceedings against a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court on application of the liquidator or any creditor or contributory of the company may if it thinks proper so to do declare that any person who was knowingly a party to the carrying on of the business in that manner shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court directs."

(Section 304(1) of the Companies Act)

"(5) Where any business of a company is carried on with the intent or for the purpose mentioned in subsection (1) every person who was knowingly a party to the carrying on of the business with that intent or purpose shall be guilty of an offence against this Act.

Penalty: Imprisonment for three years or 10 000 ringgit.

(6) This section shall have effect notwithstanding that the person concerned is criminally liable apart from this section in respect of the matters on the ground of which the declaration is made."

(Section 304 (5) and (6) of the Companies Act)

Mauritius

"Standard of Care and Civil Liability of Officers (1) Every officer of a company shall exercise:

(a) the powers and discharge the duties of his office honestly, in good faith and in the best interests of the company; and

(b) the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

(2) Where a director of a public company also holds office as an executive he shall exercise the degree of care, diligence and skill which a reasonably prudent and competent executive in his position would exercise.

(3) Without limiting any liability of a director under section 102(2), where an officer commits any breach of his duties under the Sub-Part:

(a) the officer and every person who knowingly participated in the breach shall be liable to compensate the company for any loss it suffers as a result of the breach;

(b) the officer shall account to the company for any profit made by him as a result of such breach; and

(c) any contract or other transaction entered into between the officer and the company in breach of those duties may be rescinded by the company."

(Section 112 of the Companies Act)

The Netherlands

"1. In case of bankruptcy of a corporation, each managing officer is jointly and severally liable towards the estate for the amount of the liabilities insofar as these cannot be satisfied through liquidation of the other assets if the management has performed its tasks in an obviously improper manner and it is likely that this is an important cause of the bankruptcy.

2. In case the management has not performed its obligations in articles 10 or 394, it shall be supposed that it has performed its tasks improperly and that such improperly performed tasks are an important cause of the bankruptcy. The same applies in case the company is a fully liable partner (general partner) of a general partnership or limited company and the obligations in article 6 of the Code of Commerce are not performed. An unimportant omission shall not be taken into consideration.

3. Not liable is the director who proves that the improper performance of his duties through management was not attributable to him and that he was not negligent in taking measures to prevent the consequences thereof."

(Section 138 of Civil Code)

Singapore

"SECTION 401. False or misleading statement (Companies Act)

(1) Every corporation which advertises, circulates or published any statement of the amount of its capital which is misleading or in which the amount of nominal or authorised capital is stated without the words 'nominal' or 'authorised', or in which the amount of capital or authorised or subscribed capital is stated but the amount of paid-up capital or the amount of any charge on uncalled capital is not stated as prominently as the amount of authorised or subscribed capital is stated, and every officer of the corporation who knowingly authorises, directs or consents to, such advertising, circulation or publication shall be guilty of an offence.

(2) Every person who in any return, report, certificate, balance sheet or other document required by or for the purposes of this Act wilfully makes or authorises the making of a statement false or misleading in any material particular knowing it to be false or misleading or wilfully omits or authorises the accession of any matter or thing without which the document is misleading in a material respect shall be guilty of an offence and shall be liable on conviction to a fine not exceeding $10 000 or to imprisonment for a term not exceeding 2 years or to both.

(3) For the purposes of subsection (2), where a person at a meeting votes in favour of the making of a statement referred to in that subsection he shall be deemed to have authorised the making of that statement.

SECTION 402. False reports (Companies Act)

(1) An officer of a corporation who, with intent to deceive, makes or furnishes, or knowingly and wilfully authorises or permits the making or furnishing of, any false or misleading statement or report to:

(a) a director, auditor, member, debenture holder or trustee for debenture holders of the corporation;

(b) in the case of a corporation that is a subsidiary, an auditor of the holding company; or

(c) a stock exchange in Singapore or elsewhere or an officer thereof or the Securities Industry Council,;

relating to the affairs of the corporation, shall be guilty of an offence and shall be liable on conviction to a fine not exceeding $10 000 or to imprisonment for a term not exceeding 2 years or to both.

(2) In subsection (1), 'officer' includes a person who at any time has been an officer of the corporation."

Spain

"1. The administrators shall be liable to the company, to the shareholders and to the company creditors for the damage they cause by acts contrary to the Law or the by-laws, or for those carried out without the diligence with which they should fulfil their duties.

2. All the members of the organ of administration that carries out a damaging act or resolution shall be jointly and severally liable, unless they prove that, not having intervened in its adoption and execution, they did not know of its existence or, knowing of it, they did all that they were able to avoid the damage, or else, they were expressly opposed to it.

3. In no case shall the circumstance that the damaging act or resolution had been adopted, authorised or ratified by the general meeting exempt them from liability."

(Article 133 of the Companies Act)

Sweden

"A founder, a director or a managing director who in performing his duty deliberately or negligently causes damages to the company shall compensate it for the damage caused. The same rule shall apply when a shareholder or others have suffered damage through a violation of this Act or the articles of association."

(Chapter XV Section 1 of the Stock Corporations Companies Act)

Switzerland

"The members of the board of directors and all persons who occupy a managerial position or liquidators are liable for damages to the company, as well as to each stockholder or company creditor by their wilful or negligent failure to perform their duties.

Those who legally delegate the exercise of their duties or powers to another organ of the company shall likewise be liable for damages caused by the latter, unless they prove to have taken every care possible under the circumstance in matters of choices, instruction and inspection."

(Article 754 of the Code of Obligations)

"All persons who are occupied with the verification of the annual statements and of the group statements, with the formation of the company, as well as with the increase or reduction of capital stock shall be liable to the company, as well as to each shareholder or business creditor, for the damage which they cause them by their wilful or negligent failure to perform their duties."

(Article 755 of the Code of Obligations)

17.8.3 It is recommended that where a director or officer of a company commits any breach of his duties whether intentionally or negligently, the director or officer should be liable

(a) to compensate the company for any loss it suffers as a result of the breach;

(b) to compensate any shareholder for any damages suffered as a result of the breach.

17.9 ***Stricter Duties of External Auditors to Report Irregularities***

17.9.1 Problems relating to ineffectual South African legislation regarding the duties of auditors to report irregularities were stated as follows in the First Report.[7]

> **"16.1 As pointed out, section 20(5) of the Public Accountants' and Auditors Act, No. 80 of 1991, requires the auditor of an undertaking to take certain steps**
>
> ***'if he is satisfied' or 'has reason to believe'***
>
> **that in the conduct of the affairs of the undertaking**
>
> ***'a material irregularity'*** **has taken place or is taking place which** ***'has caused'*** **or** ***'is likely to cause'*** **financial loss to the undertaking or any of its members or creditors.**
>
> **These provisions are lacking in clarity, are difficult to police, and the steps which the auditor has to take are time-consuming.**
>
> **The phrases** ***'material irregularity', 'is satisfied', 'likely to cause loss, 'has been satisfied', 'adequate steps',*** **mean that in a given situation a particular auditor is**

required to form an opinion which might differ from the opinion of another auditor, given the same facts.

Thus one auditor might be satisfied that a 'material' irregularity has taken place which is likely to cause financial loss, while another auditor might not share his view.

One auditor might be satisfied that adequate steps have been taken for the prevention of loss likely to be caused and another might not agree.

If, say, serious theft or fraud is discovered, the auditor is first obliged to despatch a report in writing to the person in charge of the undertaking. If he does not receive a satisfactory reply within 30 days thereafter, then only is the matter reported to the Board which may then, in its discretion, report it to other authorities or interested persons.

The inevitable delay means that all the assets of a company could disappear before the relevant authority is eventually notified by the Board.(7)

16.2 An auditor should probably be required to report all irregularities to all interested parties whether the irregularities are, in his opinion, material or immaterial.

The materiality of a particular irregularity or the frequent occurrence of what normally would be regarded as immaterial irregularities, should be known to the particular supervisor, or shareholders or creditors of the entity concerned.

If all irregularities are required to be reported it would remove the element of subjectivity created by the undefined concept of 'materiality'.

16.3 In the Scandinavian countries companies are required to minute matters pointed out by the auditors to directors and managers.

Denmark

For the use of the board of directors the auditor shall maintain an audit book in which he shall state the audit functions that have been performed and such irregularities concerning the company's bookkeeping and accountancy that might

have been ascertained. The audit book shall be produced at any meeting of the board of directors and any entry into the book shall be signed by all members of the board.

(Section 92 of the Companies Act)

Norway

Matters which the auditor has pointed out to the board of directors or manager shall be entered in a record book or otherwise set forth in writing. The board shall keep the record book and documents in safe custody.

(Section 10 - 10 of the Law on Joint Stock Companies)

Sweden

Remarks directed by the auditors to the board of directors or the managing director shall be recorded in minutes or in a separate document which shall be given to the board of directors and preserved by the board in a safe manner.

(Section 11 of the Stock Corporations Companies Act)

6.10 To persuade auditors to report irregularities, some countries introduced severe penalties for failing to so report.

Examples thereof are the following:

France

Commissioners of accounts (auditors) have to

— **inform shareholders at their meeting of the irregularities and inaccuracies discovered by them in the course of the performance of their duties; and**

— **disclose to the Public Prosecutor the punishable offences of which they have knowledge.**
(Article 233 of the Companies Law)

— **Any auditor who knowingly gives or confirms false information relating to a company or who does not disclose the offences to the public prosecutor is punishable by imprisonment for a period from 1 to 5 years or by a fine of 2 000 francs to 100 000 francs or to both the imprisonment and the fine.**
(Article 457 of the Companies Law)

Iran

The auditor must report

— **'any violation of default in company's affairs on the part of directors or the managing director' to the first general meeting; and**

— **any offence he discovers to 'the competent judicial authorities as well as to the first general meeting'.**

(Article 151 of the Commercial Code)

— **An auditor who deliberately furnishes a general meeting with false information concerning the state of the company or who certifies such false information in his report is 'liable to corrective imprisonment of three months to two years'.**

(Article 267 of the Commercial Code)

Malaysia

An auditor who is satisfied that

— **there has been a breach or non-observance of any of the provisions of the Companies Act; and**

— **the circumstances are such that in his opinion the matter has not been or will not be adequately dealt with by comment in his report on the accounts or by bringing the matter to the notice of the directors of the company,**

he must forthwith report the matter to the Registrar of Companies;

the penalty for non-compliance is imprisonment for two years or a fine of 30 000 ringgit, or both. (Section 174 (8) of the Companies Act)".

17.9.2 The duty of auditors to report irregularities is sometimes seen by them as a breach of a fundamental duty not to disclose confidential information.

17.9.3 SAICA stated its views as follows (29.1.1999):

"Whistle blowing

Section F, paragraph 40 of SAICA's submission to the Commission of Inquiry states that the concept of reporting irregularities could be enhanced if legislation facilitating whistle blowing could be introduced. Having recently re-examined this matter, we would like to add the following comments.

Introducing legislation to protect whistle blowing auditors can have a far-reaching effect. The whistle blowing auditor is bound by a common law duty not to disclose confidential information acquired during the performance of professional services. This duty is encapsulated as a fundamental principle in the Code of Professional Conduct of the Public Accountants' and Auditors' Board.

The auditor finds himself in an untenable position. If he comes across information indicating irregularities and misconduct on the part of the client or employer, or even on the part of a fellow auditor, the public expects him to be a watchdog and report it to an appropriate third party. However, if he does report the alleged misconduct, such act may constitute a breach of the duty of confidentiality.

In South African law, there is no definite legislative protection for auditors to blow the whistle. Although various status such as the Constitution, the Draft Open democracy Bill, the Labour Relations Act, the Banks Act and the Public Accountants and Auditors Act deal with this issue, either directly or indirectly, there is no definitive protection for a whistle blower.

In terms of the common law, however, there are exceptions to the duty of confidentiality. These are:

a. When disclosure is authorised

b. When disclosure is required by law

c. When there is a a professional duty or right to disclose:

— to comply with technical standards and other requirements;

— to protect the professional interests of a member in legal proceedings;

— to comply with the quality review of the Institute;

— to respond to an inquiry or investigation by the Investigation or Disciplinary Committee.

These exceptions, found in SAICA's Code of Professional Conduct, are also reflected in the matter of Densam (Pty) Ltd vs Cywilnat (Pty) Ltd, 1991(1) SA100, which dealt with the banker/customer relationship, and the situation where 'public interest' permits one to breach the duty of confidentiality.

Uncertainty surrounds the concepts of 'professional duty' and' public interest', and it appears that no definitive judgement on this matter has been delivered. This uncertainty will be a deterrent to blow the whistle and therefore reiterate our original submission that it is in the broader interest of society to protect whistle blowing auditors via separate legislation.

Having carefully considered the options, SAICA has come to the conclusion that whistle blowing legislation is required in South Africa and it proposes that the Commission's Report should make such a recommendation".

17.9.4 **Dr Brenda Porter,** the Director of Accounting Research at Cranfield University, Bedford, UK, has submitted her paper 'Auditors' Responsibilities with respect to Fraud in Anglo-American Countries – A Controversial Issue' to the Commission. It is reproduced in full.[8]

17.9.5 The auditing profession does not distinguish between professional services rendered when approached to do so on a voluntary basis, and professional services rendered when the appointment is mandatory in terms of a statute which seeks to protect the minority shareholders, other investors, regulators and the public.

While there might be a common law duty, similar to that of ordinary employees, not to disclose confidential information when voluntarily employed, such a duty should not exist when auditors are appointed in terms of a statute which seeks to protect the uninformed.

17.9.6 In addition, the auditing profession seems to believe that the external auditor of a company has a duty of confidentiality towards the directors or other managers or the majority shareholders of the company. The profession seems to have difficulty in accepting that the client consists of all the shareholders whether part of the majority or part of the minority, and that no separate duty of confidentiality exists towards the directors, managers or majority shareholders.

17.9.7 After further deliberation, SAICA has come to the conclusion that

— the delay in reporting material irregularities which is caused by the provisions of section 20(5) is no longer acceptable;

— irregularities which have been reported in terms of section 20(5), as well as irregularities not reported because sufficient steps had been taken to prevent or recover loss should, in the interest of transparency and keeping stakeholders informed, be reported on in the annual financial statements of the entity concerned.

17.9.8 However, SAICA is still of the view that

— to prevent a proliferation of reports on trifling matters only material irregularities should be reported;

— immediate reporting of irregularities should not be mandatory, but be left to the discretion of the auditor.

The submission is reproduced in full.[9]

17.9.9 During November 1998 a National Accountancy Consultative Forum was held under the auspices of the then Deputy Minister of Finance, Ms Gill Marcus, to enable all interested parties to make representations regarding the contents of a new accounting profession bill.

17.9.10 Thereafter a proposed Bill was drafted by the Forum's Coordinating Committee. The latest version of that bill, the 'Draft Accountancy Profession Bill, 2001' contains the following provisions dealing with the obligation of auditors to report irregularities.

(16) "(5) (a) For the purposes of this subsection—

'reportable irregularity' means any unlawful act or omission committed by any person in the conduct of the management or control of an entity, which —

(i) has caused or is likely to cause financial loss to the entity or to any partner, member, shareholder or creditor of the entity; or

(ii) is fraudulent or amounts to theft; or

(iii) represents a material breach of any fiduciary duty owed by such person to any partner, member, shareholder, or creditor of the entity, or under any law applying to the entity or the conduct or management thereof;

'statutory regulator', in relation to an entity regulated by any law, means the regulator established in respect of the entity by or under such law.

(b) (i) A registered auditor who acts as auditor of an entity and who is satisfied [or] has reason to believe that a reportable irregularity has taken place or is taking place in respect of such entity, must without delay dispatch a report in writing to the person in charge of that entity and all members of the board of directors or other controlling body thereof, giving particulars of the irregularity, and at the same time drawing the attention of such persons to the provisions of this subsection, and requesting all such persons individually and collectively to acknowledge receipt of such report in writing.

(ii) If, in the opinion of the registered auditor, the risk of financial loss to the entity, or to any of its partners, members, shareholders or creditors, would be materially increased by any delay, the auditor must simultaneously with the dispatch of a report in terms of subparagraph (i) furnish the statutory regulator of the entity concerned or, where no such regulator exists, the RBA, with copies of the report and such other information and particulars as the auditor deems fit.

(c) Unless the registered auditor has, within 30 days after the date of dispatching the report referred to in paragraph (b)(i) and after renewed investigation, been satisfied that no reportable irregularity has taken place or is taking place, or that the relevant irregularity has ceased and that adequate steps have been taken for the recovery of any loss (if any), the auditor must after expiry of the said period of 30 days without delay —

(i) if a copy of the report has been furnished to a statutory regulator or the RBA under paragraph (b)(ii), furnish that regulator or the RBA with any acknowledgements of receipt received from the relevant person in charge of the entity and other members of the relevant board or body mentioned in paragraph (b)(i), other replies so received and any other information and particulars as the auditor may deem fit; or

(ii) if such copy of a report has not been so furnished, furnish the statutory regulator of the relevant entity or, where no such regulator exists, the RBA, with copies of the report and of any acknowledgements of receipt received from the person in charge and other members of the relevant board or body mentioned in paragraph (b)(i), any other replies so received and any other information and particulars as the auditor may deem fit.

(d) The RBA and the statutory regulator may disclose any information furnished to it in terms of this subsection to any state official vested with a statutory interest in the entity, or any partner, member, shareholder or creditor of the entity involved, or any juristic person of whom the entity is a member or who is vested with authority over the entity or who has the power to take disciplinary steps in respect of the entity, or to the committee of any stock exchange on which shares of the entity are listed or, if the RBA or such regulator believes it to be in the best interest of the public, to any other person, institution or body.

(e) For the purpose of determining whether any reportable irregularity has taken place or is taking place, a registered auditor may carry out such investigations as the auditor may deem fit.

(f) Nothing in this subsection confers upon any person any right of action against a registered auditor which, but for the provisions of this subsection, such person would not have had".

17.9.11 As can be seen, the proposed bill basically follows the views of SAICA

— as to the type of irregularity which should be reported;

— when it should be reported;

— that no reporting to the regulator should follow if the irregularity has ceased or if adequate steps had been taken to recover any loss.

17.9.12 However, SAICA believes that all such reportable irregularities, whether cured or not, should be disclosed in the annual financial statements.

This view was not shared by the Coordinating Committee of the Consultative Form; why, is not clear.

17.9.13 The view expressed by SAICA, that if all irregularities are reported it could result in a proliferation of reports on trifling matters, is obviously correct.

Unfortunately, this would be the lesser of two evils. Experience in South Africa and elsewhere leads to the conclusion that auditors should not have a discretion whether or not to report irregularities, nor should they be allowed to decide whether an irregularity is material nor not. All professions have members who are incompetent or dishonest and the public should be protected against these as far as possible.

17.9.14 The problems relating to the 'materiality' of irregularities are exacerbated by the fact that irregularities, whether material or not, are seldom reported by auditors.

17.9.15 The First Report stated

> **"These problems are compounded by the fact that material irregularities are seldom reported by auditors. This can be seen from the 1995 and 1996 reports of the Board.**
>
> **Bearing in mind that 2 058 companies were liquidated during 1994 and 1 719 during 1995, that Attorneys-General and the Office for Serious Economic Offences cannot cope with the number of reported frauds and that the Commercial Crime Unit of the police cannot cope with the numerous contraventions of the Companies Act, the contents of the reports of the Board disclose a pathetic situation in regard to the reporting of material irregularities by auditors.**
>
> **The 1995 Report reads as follows:**
>
> **"Report of alleged material irregularities for the year ended 31 December 1995**
>
> **Notwithstanding the Board's re-issued Circular No B3/91 which stipulated the manner in which these matters should be reported, a number of reports are still being received by the Board which do not comply with the Board's requests — particularly where matters will be reported to the Attorney-General. Altogether 57 reports were received.**
>
> **18 Reports received were onward reported by the Director : Legal to certain officials including the various Attorneys-General, the Commercial Branch of the South African Police, the Registrar of Companies, Registrar of Insurance, Commissioner of Inland Revenue, and SA Reserve Bank.**
>
> **These fell into the following categories:**

* Trading under insolvent circumstances	3
* Various contraventions of the Companies Act 61/1973	5
* Contravention of the Insurance Act 27/1943	1
* Contravention of the VAT Act 89/1991	2
* Contravention of the Banks Act 94/1990	1
* Contravention of the Exchange Control Regulations	1
* Whereabouts of directors unknown	1
* Fraud/theft	1
* Contravention of the Income Tax Act 58/1962	2

The remaining 39 reports received were not onward reported, but were retained on file for perusal by members or creditors.

During the year the Board was informed of one prosecution by the Attorney-General and two decisions not to prosecute. (These include matters referred to the Attorney-General in previous years).

In the case prosecuted, the director was charged with contravening section 218(2) of the Companies Act. He was acquitted."

The 1996 report reads as follows:

"Report of alleged material irregularities for the year ended 31 December 1996

Notwithstanding the Board's reissued Circular Nr B3/1991 which stipulated the manner in which these matters should be reported, a number of reports are still being received by the Board which do not comply with our requests — particularly in the case of matters which are to be onward reported to the Attorney-General. Altogether 120 reports were received.

Of the reports received, 21 were onward reported by the Director : Legal to the following authorities:

Various attorneys-general

The Commercial Branch of the South African Police Services

The Registrar of Companies

The Registrar of Insurance

The Commissioner for Inland Revenue

The South African Reserve Bank

One or more of the law societies

The Estate Agents Board

The Auditor-General

The Registrar of Medical Schemes

These fell into the following categories:

Trading under insolvent circumstances	**7**
Various contraventions of the Companies Act, Act 61 of 1973	**4**
Contravention of the VAT Act, Act 89 of 1991	**1**
Contravention of the Exchange Control Regulations	**2**
Fraud and/or theft	**5**
Contravention of the Income Tax Act, Act 58 of 1962	**1**
Contravention of the Share Blocks Control Act, Act 59 of 1980	**1**

The remaining 105 reports received were not onward reported, but were retained on file for perusal by members or creditors.

During the year the Board was informed of one prosecution by the Attorney-General and four decisions not to prosecute. (These include matters referred to the Attorney-General in previous years.) Obviously not all cases are referred to the attorneys-general.

In the case prosecuted, various directors were charged with contravening section 286(4)(a) of the Companies Act."

17.9.16 The failure of auditors to report irregularities is not restricted to South Africa.

17.9.17 A perceived massive failure to report serious irregularities in **Ireland** has recently led to the appointment of a Review Group to consider *inter alia*

"— Whether self-regulation in the auditing profession is working effectively and consistently;

— Whether any new or revised structures and arrangements are necessary to improve public confidence, and if so, what forms should they take".

The Review Group concluded that self-regulation is not working effectively and consistently and recommended the introduction of a Public Oversight Body for the auditing profession in Ireland.(10)

17.9.18 The Commission is of the view that, as in **France**, an auditor, appointed in terms of a statute, should be required to report all transgressions of the law to all interested parties, whether the transgressions are, in the opinion of the auditor, material or immaterial.

This would remove the element of subjectivity so often used as an excuse not to report, and would allow the minority shareholders or the regulators or other interested parties to decide themselves whether the transgression is material or whether the frequent occurrence thereof is material and whether remedial action should be taken.

17.9.19 It is recommended that external auditors should be obliged to

(a) report forthwith all irregularities which come to their attention in respect of the entity which they audit to the regulatory authorities;

(b) at the expense of the entity report all such irregularities to the shareholders

(i) at the following annual general meeting;, or if considered to be serious

(ii) at a general meeting convened for that purpose by the auditor or by any other means which the auditor deems appropriate.

17.10 ***Improved Avenues of Communication between External Auditors and Shareholders***

17.10.1 Section 281(c) of the South African Companies Act entitles the external auditor of a company to attend general meetings and to be heard at such meetings on any part of the business of the meeting which concerns him as an auditor.

With the exception of the report on the annual financial statements, the right to attend and to be heard at general meetings is virtually the only other possible avenue of communication between auditors and shareholders.

17.10.2 The lack of other avenues of communication is not restricted to South Africa and will be found in many other jurisdictions which followed the lead of the United Kingdom.

17.10.3 In these jurisdictions comparative research into the duties of auditors seldom extend beyond the boundaries of which is referred to as the 'Anglo-Saxon' jurisdictions.

17.10.4 The easily accessible prescribed duties of auditors in other jurisdictions such as in South and Central America, Europe, Asia and the Pacific Rim are ignored.

17.10.5 Examples of the duties of auditors and of the avenues of communication between auditors and shareholders in some such jurisdictions and referred to in the First Report, are as follows:

Argentina

Auditors

— must be invited to attend all meetings of the board of directors, of the executive committee of the board and of shareholders of a company, and may speak at such meetings;

— must provide shareholders who represent not less than 2% of the capital of a company, with information on matters within the competence of the auditors whenever such shareholders request it;

— may summon meetings of shareholders whenever they deem it necessary or whenever the directors fail to do so;

— may insert matters on the agendas of meetings.

(Article 294 of the Commercial Companies Act)

Bahama Islands

Auditors

— may similarly be required to attend meetings and answer questions relating to his duties.

(Section 139 of the Companies Act)

Canada

(1) The auditor of a corporation is entitled to receive notice of every meeting of shareholders and at the expense of the corporation, to attend and be heard thereat on matters relating to the duties of an auditor.

(2) If a director or shareholder of a corporation, whether or not the shareholder is entitled to vote at the meeting, has given written notice not less than ten days before a meeting of shareholders to the auditor or a former auditor of the corporation, the auditor or former auditor shall attend the meeting at the expense of the corporation and answer questions relating to his duties as auditor.

(Section 168 of Canada Business Corporations Act)

El Salvador

Auditors

— may submit matters they believe pertinent to the administration of the company for inclusion in the agenda of the general meeting of shareholders;

— may convene ordinary and extraordinary general meetings of shareholders in the case of omission to do so by the directors and in any other case they judge to be convenient.

(Article 291 of the Commercial Code)

France

Commissioners of accounts (auditors) have to

— inform shareholders at their meetings of the irregularities and inaccuracies discovered by them in the course of the performance of their duties.

(Article 233 of the Companies Law)

Honduras

Auditors

— may submit matters they believe pertinent to the administration of the company for inclusion in the agenda of the general meeting of shareholders;

— may convene ordinary and extraordinary general meetings of shareholders in the case of omission to do so by the directors and in any other case they judge to be convenient.

(Article 233 of of the Commercial Code)

Iran

The auditor must report

— 'any violation of default in company's affairs on the part of directors or the managing director' to the first general meeting.

(Article 151 of the Commercial Code)

Mexico

Auditors

* may include matters which they deem pertinent in the agendas for meetings of the board of directors or of stockholders;

* may convene ordinary or extraordinary meetings of stockholders when the directors fail to do so, or whenever the auditors may deem it advisable to do so;

* may attend all meetings of the board of directors and express their views at such meetings;

* may attend general meetings of stockholders and express their views at such meetings;

* may, in general, exercise at any time an unlimited supervision over the business of the company.

(Article 166 of the Companies Law.

Nepal

Auditors

— have to be present at the general meeting of the company if asked to attend and have to answer questions relating to the accounts and records audited by them.

(Section 107 of the Companies Act)

Norway

Auditors

* are obliged to furnish information on matters concerning the company that have come to their knowledge in the performance of their assignment if so requested by the general assembly or any member thereof.

(Chapter 10 section 12 of the Companies Act)

Paraguay

Auditors

* must furnish information on matters within their competence to shareholders who represent at least 10% of the paid up capital and who require such information;

* may convene an extraordinary general meeting when they deem it necessary and may convene an ordinary general meeting when the board of directors has omitted to do so;

* may have matters which they consider appropriate included in the agendas of meetings.

(Section 1124 of the Civil Code)

St Vincent and Grenadines

* A director or a shareholder of a company may give the auditor written notice to attend a meeting of the shareholders whereupon the auditor must attend the meeting at the expense of the company and answer questions relating to his duties as an auditor.

(Section 169 of the Companies Act)

17.10.6 The protection of minority shareholders will be significantly enhanced if auditors are required to play a more active role in the affairs of the company and are also required to inform shareholders of matters which might affect them.

17.10.7 It is recommended that the Companies Act be amended in respect of public companies to provide for the following:

(1) The auditor of a company be entitled to receive notice of every meeting of the board of directors, of the executive committee of the board and of the shareholders, and be entitled to attend and speak at such meetings.

(2) If a director or shareholder of a company, whether or not the shareholder is entitled to vote at the meeting, has given written notice not less than ten days before a meeting of shareholders to the auditor or a former auditor of the company, the auditor or former auditor shall attend the meeting at the expense of the company and answer questions relating to his duties as auditor.

(3) The auditor of a company be entitled to include matters which the auditor deems appropriate in the agendas of meetings of the board of directors, the executive committee of the board or the shareholders.

(4) The auditor of a company be entitled at the expense of the company to convene meetings of shareholders when the directors fail to do so or whenever the auditor may deem it advisable to do so.

(5) The auditor be entitled at the expense of the company to disseminate to shareholders by any means any information which the auditor deems to be appropriate.

.....

NOTES

1. **Pennington's Company Law, 3** ed, p. 1.

2. **Latham, Mark** : 'The Internet will Drive Corporate Monitoring' – Oct. 22 1999. www.corpmon. com.

3. **Ibid**

4. **Republic of South Africa : First Report of the Commission of Inquiry into the Affairs of the Masterbond Group of Companies,** 1997 – p. 179.

5. **Henochsberg on the Companies Act,** 4th Ed. Vol. 2, p. 456. (Butterworths, Durban, 1985).

6. **Gloeck, Professor Dieter :** 'Legal Backing of Accounting Standards within the broader accountability framework', (School of Accounting, University of Pretoria, 1998).

7. **Section 20(5) of the Public Accountants' and Auditors' Act, No. 80 of 1991** reads as follows:

> *"(5)(a) If any person acting in the capacity of auditor to any undertaking is satisfied or has reason to believe that in the conduct of the affairs of such undertaking a material irregularity has taken place or is taking place which has caused or is likely to cause financial loss to the undertaking or to any of its members or creditors, he shall forthwith despatch a report in writing to the person in charge of that undertaking giving particulars of the irregularity, at the same time drawing the attention of such person in charge to the provisions of paragraphs (b) and (c) and requesting him to acknowledge receipt of such report in writing.*
>
> *(b) Unless within 30 days after an auditor has despatched such a report, he has been satisfied that no such irregularity has taken place or is taking place or that adequate steps have been taken for the recovery of any such loss so caused or for the prevention of any such loss*

likely to be so caused, he shall forthwith furnish the board with copies of the report and of any acknowledgement of receipt thereof and reply thereto and such other particulars as he may deem fit.

(c) The board may disclose any information supplied to it in terms of paragraph (b) to any attorney-general or the Registrar of Banks or any officer in the public service or any member or creditor of the undertaking concerned or any juristic person of whom the undertaking is a member or who has control over the undertaking or who has the power to take disciplinary steps against the undertaking, or to the committee of any stock exchange on which shares of the undertaking are listed, or, if the board believes it to be in the best interests of the public, to any other person, institution or body.

(d) For the purpose of determining whether any irregularity contemplated in this subsection has taken place or is taking place, an auditor may carry out such investigation as he may deem fit.

(7) An auditor shall, in performing any duty referred to in subsections (5) and (6), have regard to all the information which comes to his knowledge in his capacity of auditor to any undertaking and all the information which comes to his knowledge from any other source."

8. "AUDITORS' RESPONSIBILITIES WITH RESPECT TO FRAUD IN ANGLO-AMERICAN COUNTRIES- A CONTROVERSIAL ISSUE

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Please Note: The attached paper was prepared in September 1996 for Sherer, M., and Turley, S (1997) Current Issues in Auditing (3rd Ed). The AICPA issued Statement on Auditing Standards no. 82: Consideration of fraud in a Financial Statement Audit in February 1997. A short document outlining the main changes introduced in SAS no. 82 and the significance thereof is in the course of preparation.

INTRODUCTION

In recent years corporate fraud has cost British businesses many millions of pounds: between 1989 and 1994 reported fraud amounted to £2.2 billion (KPMG, 1995) and it is estimated that reported fraud represents less than 10 percent of total frauds (Financial Times, 1993, p-g). It is evident that corporate fraud is a serious problem. Such fraud, especially that committed by senior executives and directors, usually comes to light when companies fail unexpectedly. When such failures occur, invariably the question asked is, "Where were the auditors?"

The role of external auditors in detecting and reporting corporate fraud is a highly controversial issue. Not only do opinions vary, widely amongst auditors, it is also the issue which makes the greatest contribution to the audit expectation-performance gap - the gap between what society expects of auditors and what it perceives it receives from them (Porter, 1993). Whilst numerous surveys have shown that politicians, the courts, financial journalists and the public expect auditors to detect and report fraud, the auditing profession has, in general, downplayed its responsibility in this regard: instead it has emphasised that detection of fraud is management's responsibility and that audits are not designed, and cannot be relied upon, for this purpose (Porter, 1991). The position may be illustrated by the following quotations:

- It is obvious that a company's auditor should spot a few million dollars being paid for work that doesn't exist, or coming from phoney customers. Obvious but wrong. Contrary to popular belief and common sense, the job of an auditor is not to identify these kinds of transactions (Crowe, 1989, p.16).

- Surely auditors who can measure the value of profits or assets down to the last pound note ought to be able to notice when a few million go missing, or certainly when £215m went walkabout at Ferranti? Not so say the auditors, this is to misunderstand their role ... (Riley, 1990, p.1).

In this chapter we examine the issue of auditors' responsibility to detect and report fraud. After defining what is meant by fraud, we trace the historical development of auditors' legal and professional duties with respect to corporate fraud and discuss reasons for the changes which are evident. We then compare the position in the United Kingdom (UK) with that pertaining in other Anglo-American countries, more particularly, the United States (US), Canada, Australia and New Zealand (NZ). Before concluding the chapter we explore some of the factors which contribute to the

controversial nature of auditors' responsibilities to detect and report fraud and ensure that it will remain a difficult issue to resolve.

DEFINITION OF FRAUD[1]

For the purposes of this chapter, 'fraud' is defined to mean each of the following:

— the use of deception, such as manipulation, falsification, or alteration of accounting records or other documents, in order to obtain an unjust or illegal financial advantage;

— intentional misstatements in, or omissions of amounts or disclosures from, accounting records or financial statements;

— intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure;

— misappropriation of assets or theft.

[1]. This definition is derived from definitions of fraud and/or irregularities provided in Statement of Auditing Standards (SAS) 110: Fraud and Error (APB, 1995); Statement on Auditing Standards (SAS) no.53: *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, 1988); the Canadian Institute of Chartered Accountants' (CICA) Handbook Section 5135 (CICA, 1991); and Auditing Standard (Aus) 210: *Irregularities, Including Fraud Other Illegal Acts and Errors* (AARF, 1995).

HISTORICAL DEVELOPMENT OF AUDITORS' DUTIES TO DETECT AND REPORT CORPORATE FRAUD

The historical development of auditors' duties to detect and report fraud may be discussed conveniently with reference to four phases, namely:

(i) the pre-1920s phase, when detecting fraud was recognised as a primary audit objective;

(ii) the 1920s to 1960s phase, during which the importance of fraud detection as an audit objective declined until it became 'a responsibility not assumed';

(iii) the 1960s to 1980s phase, when auditors' duty to detect fraud was partially reinstated;

(iv) the post-1980s period, during which auditors' duties to detect and, more particularly, report fraud have become more firmly established and expanded.

i) Pre-1920s phase

Prior to the 1920s, fraud detection was accepted as a primary audit objective. This is clearly evidenced by the auditing texts of the time: for example, Dicksee (1898) stated that the objective of an audit was made up of three parts, the detection of fraud, the detection of technical errors, and the detection of errors in principle; similarly, Montgomery (1912) referred to the prevention and detection of fraud and error as the 'chief objects' of an audit. Nevertheless, notwithstanding the importance accorded to fraud detection as an audit objective, the courts were concerned to ensure that auditors' responsibilities were kept within reasonable bounds. For example in the case of *In re London and General Bank (No. 2)* [1895] 2 Ch. 673, Lindley, LJ stated that it was the auditor's duty to report to shareholders any dishonest acts which had occurred and which affected the propriety of the information contained in the balance sheet. However, he also said that the auditor could not be expected to find every fraud committed within the company. That would be asking too much; the auditor was not an insurer or guarantor. What was expected of the auditor was reasonable skill and care in the circumstances. Similarly, in *In re Kingston Cotton Mill Co. Ltd (No.2)* [1896] 2 Ch.279, Lopes, LJ, expanding on Lindley, LJ's remarks, stated: "'An auditor is not bound to be a detective or ... to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog not a bloodhound. [However], if there is anything to excite suspicion he should probe it to the bottom".

These two landmark cases established that auditors are required to conduct their audits with reasonable skill and care appropriate to the circumstances. In the absence of suspicious circumstances they are not required to nose out every fraud but, if their suspicions are aroused, they are required to investigate the matter thoroughly. This remains the legal position in the UK as well as in countries such as Australia and NZ.

ii) 1920s to 1960s phase

During the period from the 1920s to the 1960s, the auditing profession acknowledged progressively less responsibility for detecting fraud. By the end of the period, it was, in general, denying all but an incidental responsibility in this regard: instead it maintained that the prevention and detection of fraud were the responsibility of company managements and that the primary purpose of an audit was to lend credibility to financial statements.

This change in audit objectives is generally explained in terms of auditors responding to changes in the socio-economic environment. During the 1920s to 1960s period, companies grew in size and complexity and various tasks, including the collection and processing of accounting and other information, were delegated to employees. In order to control the activities of employees and, more particularly, to prevent or detect errors and irregularities (i.e. fraud) in the accounting and other records, company managements established systems of internal control. At the same time, as companies grew in size so did the volume of their transactions and it soon became infeasible, with the limits of reasonable time and cost constraints for auditors to check every entry in the accounting records. As a consequence, auditing procedures changed from meticulous checking of every transaction to evaluating the company's internal controls and testing a sample of transactions.

Additionally, following the First World War and, later, the depression of the 1930s, a new class of small investors emerged. Unlike the shareholders of earlier years, who were few in number but closely bound to the companies they partially owned, the new class of investors were little interested in the fortunes of 'their' company *per se*. They were primarily concerned with the returns their investment generated and, if they perceived better returns could be earned elsewhere, they readily switched their allegiance to another company. This changed attitude of investors stimulated a change in focus with respect to financial statements. It is generally agreed that, instead of being seen as documents which reflected the stewardship of company managers entrusted with the financial resources of shareholders, they came to be regarded as a basis for investment decisions. As a result, attention focused on the fairness with which financial statements portrayed the financial position and performance of the reporting entity (see, for example, Lee, 1986). Reflecting these changes in the socio-economic environment, audit objectives shifted away from detecting fraud and error towards assessing the truth and fairness of the information contained in financial statements.

By the end of the 1920s-1960s period, as noted in Montgomery's (1957) auditing text, fraud detection had become "a responsibility not assumed" by auditors [reported in the Commission on Auditors' Responsibilities (CAR), 1978, p.34]. This is also reflected in the professional promulgations of the time. For example, in 1951, the American Institute of Certified Public Accountants (AICPA) stated in its *Codification of Statements on Auditing Procedure:*

> The ordinary examination incident to the issuance of an opinion respecting financial statements is not designed and cannot be relied upon to disclose defalcations and other similar irregularities, although their discovery frequently results. In a well-organised concern reliance for the detection of such irregularities is placed principally upon the maintenance of an adequate system of accounting records with appropriate internal control. If an auditor were to discover defalcations and similar irregularities he would have to extend his work to a point where its cost would be prohibitive (pp 12-13).

Although the demise in fraud detection as an audit objective may be explained in terms of the auditing profession responding to changes in the socio-economic environment, some commentators have suggested that the profession was rather more instrumental in effecting the change. Brown (1962), for example, has argued that the profession, at least in the US, downplayed auditors' responsibility for detecting fraud as a defensive move, following the huge McKesson and Robbins fraud (1938) which auditors failed to uncover. Further, notwithstanding the profession's denial of responsibility for detecting corporate fraud, surveys in the UK and elsewhere [for example, Lee, 1970, in the UK; Beck, 1974, in Australia; CAR, 1978, in the US; the Commission on the Public's Expectations of Audits (Macdonald Commission), 1988, in Canada; Steen, 1989, in the UK; Porter, 1993, in NZ] have consistently found that the majority of financial statement users, other members of the financial community, the general public, and - possibly surprisingly - auditors, believe otherwise. This seems to lend support for Willingham's (1975) contention that "the detection of fraud ... was the stated objective for over 400 years and was removed as an objective by the [auditing] profession rather than by a change in the demand of clients of accounting firms" (p.19). Humphrey, Turley and Moizer (1993, pp.42-43) have suggested that the profession's desire to minimise auditors' responsibility for detecting fraud is reflective of the conflict inherent in any self-regulated profession. As cases involving massive frauds, which auditors failed to detect, reached the courts, so the profession sought to minimise auditors' responsibility in this regard: it sought to protect its own members' interests rather than pursuing its public duties and obligations.

iii) 1960s to 1980s phase

By the 1960s, the profession's denial of responsibility for detecting fraud was subject to criticism from both inside and outside the profession. Morison (1970), for example, drew attention to the fact that neither the press nor the general public shared the view expressed in accounting literature that an audit is not intended to detect fraud. He noted that they considered that if an audit is not meant to uncover major frauds it must be of very little use. He also observed that it is absurd for auditors to state that financial statements are reliable, "that they are 'all right'", and then to add, "they are all right subject of course to the possibility that undetected fraud may have made them all wrong" (p.414). In similar vein, the investment analyst whose solo efforts were responsible for exposing the notorious *Equity Funding* fraud raised the pertinent question: "If routine auditing procedures cannot detect 64,000 phoney insurance policies (two-thirds of the total number), $25 million in counterfeit bonds, and $100 million in missing assets, what is the purpose of audits?" (reported by Woolf, 1978, p.62).

In the light of the widespread criticism, it became clear that the 'responsibility not assumed' stance of the profession could not be sustained. As a consequence, professional pronouncements were amended to acknowledge that, when conducting an audit, auditors have a responsibility to be aware that fraud may exist and that "material irregularities ... will normally be brought to light by sound audit procedures" [Institute of Chartered Accountants in England and Wales (ICAEW), 1961, p.27]. It should be noted that, requiring auditors to be aware that fraud may exist, seems to recognise a duty for auditors to remain alert to suspicious circumstances. As noted earlier, if such circumstances are encountered, auditors have an obligation to '"probe the matter to the bottom" [*Kingston Cotton Mill* case (supra), per Lopes LJ]. Thus, this requirement, together with the acknowledgement that sound auditing procedures should uncover major frauds, indicates that auditors were, once again, accepting some responsibility to detect fraud. However, for most of the 1960s-1980s period the profession continued to downplay auditors' role in the fraud arena and to emphasise that auditors do not have a duty to search for fraud and that an audit is not designed, and cannot be relied upon, to disclose irregularities (for example, ICAEW, 1961, para 27; AICPA, 1972, section 110.05).

Nevertheless, the profession continued to move in the direction of recognising increased responsibility for detecting fraud. At the end of the period, the *Explanatory Foreword to Auditing Standards* [Auditing Practices Committee

(APC), 1980] still insisted that "responsibility for the prevention and detection of fraud rests with management" (para 8), and that "the auditor's duties do not require him specifically to search for fraud" (para 9) but, it also stated:

> [T]he auditor should recognise the possibility of material irregularities or fraud which could, unless adequately disclosed, distort the results or state of affairs shown by the financial statements. The auditor should, therefore, plan his audit so that he has a reasonable expectation of detecting material misstatements in the financial statements resulting from irregularities or fraud (para 10).

iv) Post-1980s period

Since the early 1980s there has been a continuing shift in the profession's stance with respect to corporate fraud. This has been stimulated by the increasing size and incidence of corporate fraud[2] and the growing criticism of auditors by politicians, the courts, financial journalists and the public for failing to uncover even major frauds in companies and, in general, denying a responsibility to do so. Although fraud detection as an audit objective has not reached the prominence it held in the pre-1920s phase, auditors throughout the Anglo-American world acknowledge some responsibility to detect fraud. Additionally, led by the auditing profession in the UK, auditors throughout the region have begun to accept a duty to report fraud (or suspected fraud) detected during the course of an audit to regulatory authorities. However, the level of responsibility for detecting and reporting fraud acknowledged by the auditing profession in different countries varies quite markedly. In the next section, we examine auditors' duties in the UK with respect to fraud and then compare the UK position with that pertaining in the US, Canada, Australia and NZ.

[2] For example, in 1985 it was reported that, in London alone, corporate fraud had risen from £260 million in 1981 to £776 million in 1984, and that the average size of frauds had increased over the same period from £0.65 million to £1.09 million (ICAEW, 1985c).

AUDITORS' DUTIES IN THE UK TO DETECT AND REPORT CORPORATE FRAUD

The 1980s witnessed intense activity by the auditing profession in the UK in relation to auditors' duties with respect to fraud. The reasons for this probably lie in the high level of public and political concern about the large, and rapidly escalating, size and

incidence of corporate fraud in the UK, especially in the financial services sector. In the mid-1980s, Fletcher and Howard, successive Ministers of Corporate and Consumer Affairs, were very vocal in their criticism of auditors for failing to play a more active role in the fight against fraud (Smith, 1985; Allen 1985). They also made it clear that, if auditors did not voluntarily accept greater responsibility to detect and report corporate fraud, it would be forced on them through legislation. The stance of the politicians was supported by officers of the Fraud Investigation Group who stated that they considered it both practical and desirable, within the limits of cost and auditing procedures, for auditors to accept a general responsibility to detect and report fraud (Smith, 1985).

In response to the political pressure exerted on auditors, the professional bodies established working parties to investigate the issue.[3] These working parties were, in general, supportive of the view that auditors have an important role in curtailing corporate fraud but they were strongly opposed to extending auditors' duties to detect fraud. This is reflected in the following extracts from the working parties' reports:

- We do not believe ... that it would be either realistic or cost effective to expand the existing requirements for the auditor to detect fraud (ICAEW, 1985a, para 2.48).

- The auditor's responsibilities are already heavy and we do not think it is necessary or practicable to extend his existing duties in this respect (ICAEW, 1985b, para 3.11).

- In examining the detection function we believe that it is impractical and inefficient to extend generally and indiscriminately the auditor's role (ICAS, 1985, para 4.1).

The strength of the opposition to extending auditors' duty to detect fraud is reflected in a statement by the chairman of the ACCA'S working party:

> It would be quite impossible for auditors to accept responsibility for detecting fraud - the cost would be astronomical. The Government has no idea how an audit is conducted, what it can achieve and what it is there for ... I don't believe the profession should roll over and play dead and accept an increase in its responsibilities (Nelson, quoted by Barclay, 1985, p.1).

The working parties' reports gave far less prominence to the issue of auditors detecting fraud than to auditors reporting fraud. This is probably a consequence of the Government's apparent general satisfaction with the level of responsibility

acknowledged by auditors for detecting fraud. This is reflected, for example, in the statement by Howard, Minister of Corporate and Consumer Affairs, at the 1985 joint ICAEW/Law Society Conference on Financial Fraud: "I would accept that to impose a general duty of detection on the auditor would be unrealistic; on that issue I believe we are on common ground" (ICAEW, 1985c, p.12).

Given the situation outlined above, it is not surprising that there has been relatively little change in the wording of professional pronouncements since 1980 with respect to detecting fraud. This may be seen by comparing the following extracts from the current Auditing Standard [SAS 110: *Fraud and Error*; Auditing Practices Board (APB), 1995] with those quoted above from the *Explanatory Forward to Auditing Standards* (APC, 1980) :

> It is the responsibility of the directors to take such steps as are reasonably open to them to prevent and detect fraud (para 10).... It is not the auditors' function to prevent fraud and error ... (para 17). Auditors plan, perform and evaluate their audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements arising from error or fraud. However, an audit cannot be expected to detect all errors or instances of fraudulent or dishonest conduct (para 18).

The major change in auditors' duties in the corporate fraud arena in recent years concerns reporting fraud which has been detected during an audit. The profession's working parties were supportive of an extension of such duties. The Davison Committee (ICAEW, 1985a), for example, stated that the ICAEW should encourage auditors to report to regulatory authorities suspected cases of serious fraud by management. In similar vein, the Benson Committee (ICAEW, 1985b) concluded that:

- if fraud or suspected fraud by management or employees comes to light during an audit, the auditor has an obligation to inform the directors (para 3.13);

- if fraud by the directors appears to have arisen, or is about to take place, the auditor must qualify the audit report (para 3.16);

- if the auditor is uneasy about transactions which are taking place and cannot obtain satisfactory information or explanations, the auditor must qualify the audit report to the effect that all the information and explanations which were required have not been received (para 3.17).

In support of its position, the Committee stated:

> We are satisfied that the duties put upon the auditor by statute, case law decisions and professional standards would require him to include a qualification in his audit report if fraud by directors arises. ... We think that such matters cannot fail to affect the truth and fairness of the accounts put before the shareholders or they call into question the integrity of the accounting records and accounts. We think the public would be rightly aggrieved if information of this character, which was within the knowledge of the auditor, was not disclosed by him by qualification of his audit report (para 3.18).

Just as the minimal attention given by the profession's working parties to auditors' duty to detect fraud may be traced to the Government's apparent satisfaction with the *status quo*, their support for an extension to auditors' reporting duties may well have been prompted by threats by politicians such as Fletcher and Howard to impose extended reporting duties on auditors if the profession did not accept them voluntarily. The strength of the Government's desire for auditors to assume greater responsibility for reporting corporate fraud (overriding, in appropriate cases, their duty of confidentiality to their clients) is reflected in Howard's statement at the 1985 joint ICAEW/Law Society Conference on Financial Fraud:

> [T]here is little or no point reporting management fraud ... to the perpetrators themselves. In such circumstances I hope it can be generally accepted that there is a clear duty on the auditor to report the matter to the regulatory authorities .... [T]here will be some cases where ... giving the client advanced warning may amount to nothing less than a tip off. I am quite clear the public interest requires the auditor [in appropriate cases] to report to the regulatory authorities without first informing his client. ... I do not think that recognition of such a duty is in any, way inconsistent either with the best traditions and practices of the auditor's profession or with his duty to his clients. Even auditors are not islands. You have duties to the rest of the community of which you are part, and you owe that community, a more compelling duty which must on occasion take first place. Public expectation must be given full weight in these matters (ICAEW, 1985c, pp.12-13).

That the Government's intention of imposing reporting duties on auditors, if the profession failed to accept them voluntarily, was no idle threat was made clear with enactment of the Financial Services Act 1986. This Act requires all investment businesses in the UK to be duly authorised and to comply with strict rules laid down by the Securities and Investments Board (SIB) or relevant Self-Regulating Organisation (SRO) to which the SIB has delegated regulatory powers. The Act includes a requirement for auditors of authorised investment businesses to report matters of concern arising from their duties as auditors (including detected or suspected fraud) to the appropriate regulatory authority. Similar provisions have been included in the Building Societies Act 1986, Banking Act 1987 and Friendly Societies Act 1992. In each case, legislative protection has been provided for auditors against action by their clients for breach of confidentiality or defamation, providing the information is given to the regulatory authorities in good faith.

In response to the political and public pressure on auditors to assume greater responsibility with respect to corporate fraud, and the recommendations of the working parties and committees established to investigate the issue, two auditing guideline exposure drafts (APC 1985, 1988) were issued, followed by the auditing guideline (APC, 1990). The latter contained provisions similar to those proposed in the 1988 exposure draft but the assertiveness of the draft document was softened somewhat. For example, the exposure draft stated that, "since fraud invariably has an impact on either the accounting records or the financial statements, it is generally accepted that auditors should plan their audits so that they have a reasonable expectation of detecting material misstatements caused by fraud" (Foreword). The subsequent guideline contains, what might be regarded as a weaker assertion in terms of detecting fraud, namely,, that auditors have a responsibility "properly to plan, perform and evaluate [their] audit work so as to have a reasonable expectation of detecting material misstatements in the financial statements, whether they are caused by fraud, other irregularities or errors" (para 9). Further, the guideline provides no acknowledgement that fraud invariably impacts on either the accounting records or the financial statements.

Nevertheless, the guideline signals a major shift in the stance of the auditing profession with respect to reporting fraud. It recognises, for example, that auditors may have a duty to qualify their report to shareholders in cases where fraud (or suspected fraud) causes the auditor to conclude that proper accounting records have not been kept, or satisfactory information and explanations have not been received, with the implication that if fraud is found or suspected the auditor is likely to reach such a conclusion (para 26). This, by itself, is a notable extension to the duties

usually specified for auditors in respect of reporting fraud to parties other than management: they are normally restricted to auditors reporting to shareholders when they are of the opinion that the truth and fairness of the financial statements has been impaired as a result of fraud. However, of even greater significance is the guideline's recognition that, when it is in the public interest to do so, auditors may report fraud or suspected fraud to a 'proper authority' (para 31). The guideline allays auditors' concerns about the effect of breaching their duty of confidentiality by stating: '"Where it is in the public interest to disclose and where information is disclosed to an appropriate body or person, and there is no malice motivating the disclosure, the auditor is protected from the risk of breach of confidence or defamation" (para 34). However, the guideline warns that auditors' qualified privilege applies only in cases where matters of concern are reported to the proper authority and points out that the proper authority depends on the nature of the matter to be reported. Possible authorities cited in the guideline include the Serious Fraud Office, the Police, the International Stock Exchange, the SIB and the various SROS under the Financial Services Act 1986 (para 35).

It is pertinent to observe that, in promulgating the provisions relating to auditors reporting to regulatory authorities, the APC went as far as the law would allow-. As Tweedie (1991), Chairman of the APC at the time, explains:

> The APC has taken legal advice on the present state of the law- The auditor certainly owes a duty of confidentiality to the company. That duty is not broken by disclosure to its management or shareholders ... The duty would, however, be broken by disclosure to third parties. Counsel has advised that in the present state of the law the furthest that it is possible to go in encouraging disclosure by auditors to third parties is to say that there will be some cases in which an auditor, although not bound in point of law to disclose information to a third party, is entitled to do so. ...In certain circumstances information which would otherwise be confidential would cease to be so if the information w-as such that disclosure was justified in the 'public interest' and should consequently be reported to a third party (p.30).

Statements such as that quoted above, and analysis of the auditing guideline and its predecessor exposure draft, suggest that, had the APC been able to do so, it would have gone further and imposed a duty on auditors to report detected (or suspected) fraud to regulatory authorities in certain circumstances. This has, in fact, occurred in the APB's SAS l10 (1995). This (current) standard requires auditors who become

aware of an actual, or suspected, instance of fraud, which they believe should be reported to a proper authority in the public interest, to notify the directors (in writing) of their view, unless the directors themselves are implicated. If the directors do not report the matter to a proper authority, the auditors are required to do so (paras 50 and 51). Similarly, if the directors are implicated in the suspected or actual fraud, the auditors are required to "make a report direct to a proper authority in the public interest without delay and without informing the directors in advance" (para 52).

By converting auditors' voluntary right to report to a proper authority in appropriate circumstances to a duty to do, SAS 110 has strengthened auditors' reporting duties from those in the APC'S auditing guideline (1990). However, SAS 110 has dropped reference to the possibility of auditors needing to qualify their audit reports in cases where detected (or suspected) fraud causes the auditor to conclude that proper accounting records have not been kept, or satisfactory information and explanations have not been received.

[3]. Working Party of the lnstitute of Chartered Accountants in England and Wales (ICAEW), Davison Committee; Working Party of the Institute of Chartered Accountants of Scotland (ICAS); Working Party of the Chartered Association of Certified Accountants (ACCA). The ICAEW also established a committee under the chairmanship of Lord Benson to examine the issue.

AUDITORS' DUTIES IN THE UK COMPARED WITH THOSE IN THE US, CANADA, AUS00TRALIA AND NZ

Comparison of the relevant auditing standards[4] reveals that auditors' duties in the UK with respect to detecting fraud are similar to those of auditors in the US, Canada, Australia and NZ. In each case, auditors are required to plan and perform their audits so as to have a reasonable expectation of detecting material misstatements in financial statements resulting from fraud. Further, in each case, auditors are required to plan and perform their audits with an attitude of professional scepticism. However, whilst in the US and Australia auditors are told they should not assume that management is dishonest nor assume unquestioned honesty, auditors in the UK and NZ are permitted, in the absence of evidence to the contrary, to accept representations as truthful and records and documents as genuine. In Canada, an attitude of professional scepticism is defined to mean that the auditor is alert to, amongst other things, evidence which contradicts the assumption of

management's good faith (CICA sec 5135, para .05). This seems to be akin to the UK and NZ provision noted above.

Although auditors' duty to detect fraud in the various countries is similar, detailed analysis of the professional promulgations reveals that the tone of the US standard indicates more exacting duties for auditors in the US than elsewhere. For example, in the US, SAS no.53 (AICPA, 1988) requires auditors to "exercise (al due care in planning, performing and evaluating the results of audit procedures, and (b) the proper degree of professional scepticism to achieve reasonable assurance that material errors or irregularities will be detected" (para 8). In none of the other countries are auditors explicitly required to gain reasonable assurance of detecting material fraud through both planning, performing and evaluating their audit work and exercising the proper degree of professional scepticism: one or other requirement is emphasised.

Like auditors' duty to detect fraud, their duty to report fraud to management and to shareholders is very similar in each of the countries considered here. In each case, when auditors encounter an actual or suspected fraud, they are required to :

- inform the appropriate level of management (or the audit committee or board of directors); and

- consider the effect of the fraud on the financial statements. In cases w-here auditors consider that the truth and fairness of the financial statements has been impaired as a result of fraud, they are required to qualify their audit reports.

Beyond this, auditors' reporting duties differ significantly between the US, Canada and NZ on the one hand, and Australia and the UK on the other. In the US, Canada and NZ, the auditor's duty of confidentiality to the client is, in general, regarded as paramount and overrides 'public interest' considerations. However, in special circumstances, such as in response to a subpoena or where an audit client is subject to a particular regulatory regime, auditors may also have an obligation to report to a regulatory authority. The latter applies, for example, in NZ where, under the provisions of the Reserve Bank of New Zealand Act 1989, auditors of registered banks are required to report to the Reserve Bank if they have reason to believe that the bank is in serious financial difficulties. Similarly, under the Securities Act 1978 (NZ) auditors are required to report to the trustee of a debenture if they have reason to believe that the interests of the debenture-holders are endangered. Nevertheless, in the US, Canada and NZ auditors' ability or duty to report to third parties is limited

and narrowly prescribed. The situation in Australia and the UK is somewhat different.

In Australia AUS 210: *Irregularities, Including Fraud, Other Illegal Acts and Errors* [Australian Accounting Research Foundation (AARF), 1995] points out that, if the auditor is unable to obtain all the information and explanations (s)he considers necessary (for example, when seeking to confirm or dispel a suspicion that fraud has occurred) the matter should be reported in the audit report (para .31)[5] It also notes that, when there are compelling reasons to do so the auditor may disregard his or her normal duty of confidentiality to the entity and report matters concerning the entity's affairs to a third party, without first obtaining permission from the entity's management to do so (para .32). The standard cites as examples of compelling reasons for auditors to report to a third party:

a) the auditor is legally required to make the disclosure, and

b) the auditor believes, on reasonable grounds, that members of the entity's governing body and/or employees have committed a serious criminal offence, and any prior knowledge of the auditor's intention to report the matter may enable them to evade the course of justice (para.32).

A legal requirement to report [see (a) above] may arise under the Companies Act and Codes, subsection 285(10). This subsection requires auditors to report to the Australian National Companies and Securities Commission (NCSC) if, during the course of an audit of a company, they find the Code has been breached in some regard and the matter will not be dealt with adequately by comment in the audit report or by referring it to the company's directors. In an NCSC Practice Note (1990), issued to assist auditors implement this statutory requirement, fraud is cited as an example of a matter unlikely to be dealt with adequately other than by reporting it directly to the NCSC (para 8).

At first sight, auditors' reporting duties in Australia may appear to resemble those pertaining in the UK. However, analysis of the relevant provisions in AUS 210 (AARF, 1995) and SAS 110 (APB, 1995) reveals that the tenor of the two documents is very different. In contrast to the assertive tone adopted in the UK standard, and the apparent willingness of the APC (and, presumably, its successor body, the APB) to extend auditors' duty to report fraud as far as the law allows (see quote from Tweedie, 1991, above), the Australian standard conveys reluctant

acceptance of duties imposed on auditors by statute, and its tone does not encourage auditors to go beyond the legal minimum. The difference in the tenor of the two standards may be illustrated by comparing their respective paragraphs relating to auditors' duty to report to third parties:

- Confidentiality is an implied term of the auditor's contract. The duty of confidentiality, however, is not absolute. In certain exceptional circumstances auditors are not bound by the duty of confidentiality and have the right or duty to report matters to a proper authority in the public interest (SAS 110, para 53).

- The auditor's duty of confidentiality to the entity would ordinarily preclude reporting any matters concerning the entity's affairs to a third party, without the express permission of the entity's management. This rule would be followed unless there are compelling reasons to the contrary ... (AUS 210, para .32).

[4] SAS 110 (APB, 1995; UK); SAS no. 53 (AICPA, 1988; US); CICA Handbook Sections 5300 and 5135 (CICA, 1988 and 1991, respectively; Canada); AUS 2l0 (AARF, 1995; Australia); Auditing Guideline (AG) 9 [New Zealand Society of Accountants (NZSA), 1986; NZ].

[5] As noted earlier, a similar provision was included in the APC'S auditing guideline (1990, UK) but was omitted from the APB's SAS:110 (1995).

REASONS FOR THE INTERNATIONAL DIFFERENCES

From the above outline of auditors' current duties to detect and report corporate fraud in the UK, US, Canada, Australia and NZ, it is evident that auditors' duties to detect fraud in the various countries are broadly similar. However, auditors' detection duties in the US appear to be rather more exacting than elsewhere. As regards reporting fraud, auditors' duties to report detected or suspected fraud to management and shareholders are similar in all of the countries but there are marked differences with respect to auditors reporting detected fraud to third parties. In the UK, auditors have the right or duty to report to a proper authority whenever it is in the public interest to do so; in Australia, auditors are permitted to disregard their duty of confidentiality to their client and report to a third party when there are compelling reasons to do so; in the US, Canada and NZ, auditors' duty of confidentiality is paramount and can be overridden only in exceptional circumstances, such as a specific legal requirement to report to a regulatory authority.

Given the broad similarity of the socio-economic environments of the various countries, it may be asked why these differences in auditors' duties with respect to fraud have arisen. It is suggested that the answer may be found in the relative importance of corporate fraud as a social and economic issue, the level of public and political concern it has generated and, more especially, the strength of the political pressure which has been brought to bear on the auditing profession. As has been noted, in the UK, corporate fraud reached particularly serious proportions in the mid-1980s and became the focus of public and political attention. Politicians made it clear that they expected auditors to be in the front line of the public's defences in the fight against fraud and to extend their duties in this regard. They also made it clear that, if the profession failed to respond appropriately, legislative action would be taken (Smith, 1985; Allen, 1985). The nature of the reporting duties auditors could expect to be imposed on them was indicated by provisions incorporated in the Financial Services Act 1986, the Building Societies Act 1986, and the Banking Act 1987.

In the US, criticism of the auditing profession was rife in the 1970s and 1980s. Senator Metcalf and Congressman Moss were particularly scathing in their attacks on auditors in the mid- to late-1970s, and Congressman Dingell has been similarly critical since the mid-1980s. However, unlike the UK, where public and political criticism of auditors focused almost entirely, on their failure to play a more active role in combating fraud, in the US, criticism of auditors has embraced all of the 'expectation gap' issues and, in particular, auditors' role in detecting and reporting illegal acts (other than fraud). Interest in the latter issue came to the fore in the US as a consequence of the revelations which led to the passing of the Foreign Corrupt Practices Act 1977. The multiple focus of criticism in the US is reflected in the fact that SAS no. 53 (AICPA, 1988) was promulgated as one of nine 'expectation gap standards' which covered a wide range of issues (Guy and Sullivan, 1988). Additionally, in the US, auditors have not been exposed to the specific political threat of having reporting duties imposed on them through legislation nor has legislation been passed, like that in the UK, which embodies reporting duties for auditors. In the prevailing socio-political environment in the US, auditors have acknowledged a duty to detect fraud which is similar to, if not more exacting than, that of their UK counterparts, but they deny any responsibility to report detected or suspected fraud to third parties, except in very restricted and clearly specified circumstances.

In Australia, Canada and NZ, auditors have not come under the intense critical scrutiny which the profession in the UK and US has experienced. Nevertheless, in Australia, largely as a consequence of some major corporate scandals in the 1980s (including, for example, those at Rothwells Tricontinental and the Australian National Safety Council), a statutory duty to report to the NCSC has been imposed on auditors. This duty is invoked when auditors encounter breaches of the Companies Act and Codes and the matter cannot be dealt with adequately other than by the auditor reporting it directly to the Commission. As noted earlier, fraud is one of the matters specified by the NCSC as likely to require direct reporting by auditors, In this political climate, auditors' duties in Australia to detect and report corporate fraud are similar to, but, in the case of reporting fraud, less exacting than, those of auditors in the UK. In Canada and NZ, where auditors do not have a general statutory duty to report to a regulatory authority like that in Australia, auditors acknowledge a similar level of responsibility for detecting fraud as elsewhere in the Anglo-American world but, in general, they deny a responsibility to report fraud to third parties.

AUDITORS' DUTY TO DETECT AND REPORT FRAUD REMAINS A CONTROVERSIAL ISSUE: WHY?

It was noted in the introduction to this chapter that the issue of auditors' duty to detect and report corporate fraud makes the greatest contribution to the audit expectation-performance gap: it displays the greatest disparity between what society expects of auditors and what it perceives it receives from them. It is also an issue which is frequently and hotly debated in auditing circles - some members of the profession argue for increased responsibility, others for less. The question arises: Why is auditors' responsibility for detecting and reporting fraud prone to differing opinions and expectations? In this section we explore some of the factors which help to explain why this issue is both controversial and difficult to resolve. The factors fall into two main groups:

i) those associated with the nature of the external audit: these tend to support arguments in favour of limiting auditors' responsibilities to detect and report corporate fraud;

ii) those associated with society's expectations: these tend to support arguments favouring extended responsibilities for auditors.

(i) Nature of the external audit

The UK Companies Act 1985 (s.235) requires auditors to report to the company's shareholders stating whether, in their opinion, the company's financial statements give a true and fair view of the company's state of affairs and its profit or loss for the financial year, and have been properly prepared in accordance with the Companies Act 1985. Auditors are also required (by s.237) to carry out such investigations as will enable them to form an opinion as to whether:

- proper accounting records have been kept by the company, and proper returns adequate for their audit have been received from branches not visited by them;
- the financial statements are in agreement with the underlying accounting records;
- the information given in the directors' report is consistent with the financial statements.

In any case where auditors consider that one or more of the above requirements has not been met, and/or if they consider they have not received all of the information and explanations they have required for the purposes of their audit, they are required to state that fact in their audit report.

The Companies Act 1985 does not mention auditors having a duty to detect fraud. Therefore; it may be presumed that any responsibility the auditor may have for detecting corporate fraud relates to his or her duty to form an opinion on the truth and fairness of the financial statements and/or on the adequacy of the accounting records and information and explanations received. This seems to define auditors' fraud detection duties fairly narrowly and deviates significantly from the general duty to detect corporate fraud which surveys have shown is expected of auditors by society. However, it could be argued legitimately that every major fraud committed in a company will, to a greater or lesser extent, affect the truth and fairness of the financial statements and/or involve improperly kept accounting records and/or generate inadequate information and explanations. Further, as noted earlier, it was established in the *London and General Bank* case over a century ago that, when performing their duties, auditors must exercise reasonable skill and care appropriate to the circumstances of the audit. Thus, if an auditor fails to detect a fraud which affects the truth and fairness of the financial statements, or which is facilitated by the company failing to keep proper accounting records, the auditor could potentially be held liable for negligence.

Nevertheless, in the *London and General Bank* case, Lindley LJ held that auditors are not bound to exercise more than reasonable skill and care, even in situations where their suspicions about a possible fraud have been aroused. Lopes LJ, in the *Kingston Cotton Mill* case, was even more specific. He stated:

> Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable.

Thus, although case law has established that, in some circumstances, auditors have a duty to detect fraud, the courts have attempted to keep that duty within reasonable bounds. Nevertheless difficulties arise because opinions differ in society as to the circumstances in which auditors have a duty to detect fraud.

Apart from the absence of a general legal requirement to detect corporate fraud, the auditing profession has pointed to the nature of fraud as a reason for not accepting extended detection duties. One of the characteristic features of a fraud, as distinct from an error, is that its perpetration is usually accompanied by attempts to conceal it. As the APB notes in SAS 110 (para 22), this applies particularly in the case of fraud committed by management:

> Management can be in a strong position to commit a fraud and conceal it from others within the entity and from the auditors. Actions that management may take to commit and conceal fraud include:

- introducing complexity into the corporate structure, commercial arrangements with third parties, transactions or internal systems;
- collusive acts with employees or third parties;
- the override of internal controls set up to prevent or detect fraud;
- influencing accounting policies, financial statement presentation and accounting estimates;
- manipulating evidence available to, or responses to evidence requested by, the auditors, or making representations and responses to audit enquiries that lack integrity or are deliberately untruthful.

The auditing profession has pointed out that, given the nature of fraud and the ability of its perpetrators to conceal it, audit procedures which are designed to enable the auditor form an opinion about the truth and fairness of the financial statements and the other matters specified in the Companies Act 1985, may not be appropriate for discovering fraud. The APB (1994) also notes:

> [T]he type of forensic work necessary to follow up suspicions of fraud is time consuming; demands a high level of skill and experience and is consequently expensive and in the final analysis may not be conclusive. The annual audit of a company's financial statements is not the place to undertake such work ... (para 4.25).

However, it should be noted that this statement by the APB refers, not to the (initial) detection of fraud, but to following up suspicions of fraud which, presumably, have been aroused through audit procedures. As noted earlier, in general, pursuing suspicions of fraud is not an 'optional extra' for auditors: since 1896 it has been established that, if an auditor's suspicions are aroused, (s)he must "probe the matter to the bottom" (Lopes, LJ, *Kingston Cotton Mill* case).

In relation to forensic work, Humphrey, Turley and Moizer (1993, p.56) observe that, in recent years, the auditing profession has made some of its strongest public statements about the limited capacity of the statutory audit to detect fraud at the same time as some of the large international accountancy firms have been promoting their ability to provide specialist fraud audits as additional, chargeable extras to the normal statutory audit. It appears that the techniques and expertise to detect corporate fraud are available within audit firms but, rather than using these to satisfy the public's expectations of auditors establishing the absence (or otherwise) of fraud as part of their 'normal' duties, they are offered to management as an additional service. As Humphrey, Turley and Moizer (1993) have noted, "the auditor's fraud detection obligations [are] increasingly appearing to be framed by accountancy firms as a service to management rather than a check on management" (p.56).

This raises questions regarding the parties for whom the audit is conducted. The Companies Act 1985 provides for a company's auditors to be appointed by, and for the auditors to report to, the company's shareholders. It therefore appears that the legislators consider that the external audit of a company is conducted (at [east primarily) for the benefit of the company's shareholders. However, in practice, the shareholders normally delegate their responsibility for appointing auditors to the

company's directors and the latter are also made responsible for fixing the auditor's remuneration. Given that the appointment and payment of auditors is controlled by company directors, it does not seem unreasonable for auditors to, be more concerned with the directors', rather than the shareholders', perceptions of them providing value for money.

Additionally, the nature of an audit is such that it relies on the co-operation and integrity of the audit-client's directors and management. Apart from management affecting such things as the ease with which the auditor can access accounting records and other documents, and make enquiries of various employees, much audit evidence rests on the willingness of management to provide information and respond fully and honestly to the auditor's enquiries. Without management's co-operation and integrity, an effective audit is extremely difficult, if not impossible. The importance of management's representations to the successful conduct of an audit is reflected in the fact that the Companies Act 1985 (s.389A) makes it a criminal offence for any officer of a company knowingly or recklessly to make a statement (written or oral) to the company's auditors which "is misleading, false or deceptive in a material particular".

The need to maintain a high level of mutual trust and co-operation between the audit-client's personnel and the auditor raises problems for the auditor in respect of reporting fraud. In the case of suspected or detected employee fraud, reporting this to management, the board of directors or the audit committee, may result in auditee personnel regarding the auditor as a 'spy' and 'informer', and withdrawing their trust and co-operation. Similarly, if the auditor reports detected or suspected fraud to a 'proper authority' without first informing the client, (s)he faces the danger of being regarded as "a possible mole or sneak" by the client's directors and management - and possibly by others in the financial and business community who hear of it - and the integrity of the profession may be destroyed (ICAEW, 1985b, para 2.3).

(ii) Society's expectations

Despite the absence of a general legal requirement for auditors to detect and report fraud and the difficulties they face in performing these duties, they are nevertheless expected, by the majority of the financial and business community and the general public, to detect all - or at least all material - corporate fraud. One of the key reasons for this probably lies in the fact that auditors are the only independent professionals who routinely visit companies and have the opportunity, if not a duty, to 'find out what is going on': they alone have a legal right of access to all of the company's

accounts, books and records and the right to seek the information and explanations they require from the company's officers and employees.

This 'detective' role of auditors has been accentuated in recent years as auditors, seemingly, have been cast in the role of quasi-agents of regulatory bodies. The Financial Services Act 1986, Building Societies Act 1986, Banking Act 1987 and Friendly Societies Act 1992, have given the auditors of entities in the financial services sector the duty or the right (depending on the circumstances) to report to the relevant regulator when they consider it appropriate to do so in order to protect the interests of depositors and/or shareholders. It is suggested that, by enacting legislation requiring auditors to report matters of concern encountered during an audit to regulatory authorities, the Government has given a clear message that it expects auditors to play a greater social role in combating corporate fraud and, thus, to extend their duties in this regard.

This accords with the view expressed by Knox (1994), deputy director of the Serious Fraud Office, who regards the detection of fraud by auditors as an element of their '"social responsibility". He notes, "law enforcement is a matter for the whole community, and [given that] the only independent examination of company accounts is by the auditors - it is not surprising that auditors would wish to detect any malpractice" (p.128). Knox also suggests that auditors are likely to want to detect fraud, if it exists in a company, for two further reasons, namely:

- uncovering fraud within a company is likely to be regarded as good service by the company's directors (assuming they themselves are not involved); and

- discovering fraud by an audit-client's directors and/or management will provide a warning for the auditor of the risk of continuing to act for the client. (As noted above, the nature of an audit is such that considerable reliance must be placed on management's representations. If management lacks integrity, these representations are likely to be unreliable and the probability of audit failure is increased.)

An area where the auditing profession is acknowledging increased responsibility in relation to detecting fraud is that of companies' internal controls. Since about the 1920s, the profession has emphasised that prevention and detection of fraud is management's responsibility and is best achieved through an effective system of internal controls. In recent years it has begun to acknowledge that auditors also have a role to play in this regard. More specifically, professional bodies such as the Research Committee of ICAS (1993, p.33) and the APB (1994 para 4.42) have

expressed the view that auditors should be required to examine an auditee's internal controls and consider whether they are appropriate, adequate and effective to minimise the risk of fraud occurring and maximise the likelihood of it being detected. They should also be required to report to the entity's board of directors and, if it has one, its audit committee, any weaknesses detected in the internal controls, and to express an opinion in the entity's annual report on the adequacy of the internal controls for preventing and detecting fraud.

These views of the professional bodies accord with those of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee, 1992). The latter recommended that the directors of listed companies should be required to make a statement (in the company's annual report) on the effectiveness of their system of internal control and that auditors should be required to report on the directors' statement (para 4.32). However, faced with strong opposition from both company directors and auditors (based principally on apparently unresolvable questions as to how the effectiveness of internal controls can be judged), the proposal for directors to report on the effectiveness of their system of internal control has been dropped; additionally, 'system of internal control' has been limited to 'system of internal financial control'. The directors of listed companies are now required to report that they have reviewed the effectiveness of the company's system of internal financial control without expressing an opinion thereon. As McInnes and Stevenson (1996, pp.12-13) have noted, the collapse of Barings Bank highlights the vital role that internal controls play in preventing fraud. They intimate that the public is entitled to expect (i) management to establish systems of internal control that will minimise the risk of undetected fraud from occurring and (ii) auditors to express an opinion on whether such systems have been established and maintained throughout the year. They observe, "the public are not going to get the reassurances they are entitled to as long as boards of directors and auditors are unwilling or (more worryingly) unable to express an opinion on the effectiveness of these systems" (p.13). They suggest, "the unwillingness of auditors to accept responsibility for providing an opinion on the effectiveness of internal control systems is to some extent underpinned by the fear of litigation" (pp.13-14). As noted earlier, some commentators have suggested that it is this fear which has underpinned the profession's unwillingness to acknowledge any responsibility for detecting corporate fraud.

AN INHERENT CONFLICT

It is well established in the literature on professions that a profession exists to satisfy a societal need. It has a specialist body of knowledge which enables it to provide a service to members of society which they are unable to provide for themselves. The nature of the profession's expertise is such that it is generally beyond the ability of those receiving the service to judge its quality. Thus, the profession's governing body is expected, amongst other things, to ensure that its members act in the public interest and satisfy the need in society which underpins the profession's existence. The governing body is also expected, by the profession's members, to protect their interests. This dual responsibility of protecting both the public's and members' interests generates an inherent conflict in any self-regulatory profession.

In the case of auditing, society has a general expectation that auditors will help to fulfil the need to detect corporate fraud. *Prima facie*, the professional body has a responsibility to ensure its members meet this expectation. However, a question arises as to the level of fraud which is reasonable to expect auditors to detect. It is generally accepted that it would not be reasonable to expect auditors to detect, for example, all minor pilfering within companies or very ingeniously concealed fraud. However, opinions differ as to the cut-off point between what is reasonable and unreasonable to expect of auditors.

It is suggested that part of the reason the auditing profession has sought to deny its responsibility for detecting fraud - other than that which gives rise to material misstatements in the financial statements - is because, in its view, the public's expectations of auditors in this regard are not always reasonable. Its view of what is reasonable (or otherwise) has probably been influenced by the rising tide of litigation resulting from unexpected corporate failures which have been accompanied by major frauds the auditors failed to detect: the profession perceives that auditors are being held responsible for *business* failures rather than *audit* failures. However, notwithstanding the profession's denial of responsibility, the public has continued to expect external auditors to detect, at least material, fraud. As Singleton-Green (1990), editor of *Accountancy*, has noted:

> We cannot get away from the fact that the layman expects the auditor to discover all serious frauds .... [I]f auditors did not have a responsibility to find fraud, people would not waste time and money suing those who fail to find it. Auditors might as well face up to their responsibilities and try to sound positive about them. The negative approach will do nothing to diminish the auditor's duties, but it will help to discredit the profession (p.34).

In its *Audit Agenda*, the APB (1994, para 4.24) reflects the inherent conflict the professional body faces in attempting to protect, simultaneously, the profession's and the public's interest. It first downplays auditors' responsibility even to detect fraud which has a material effect on the financial statements, noting that this is "an aim rather than a requirement of the audit". It then observes that there is "a need for ... greater realism both within and outside the profession about the possibilities of finding fraud, whether material or not". However, it also calls for "greater commitment on the part of the profession to meeting this aim" (para 4.24) and recommends steps the profession may take as part of this increased commitment. The steps include:

- auditors reporting to company boards of directors and/or audit committees their observations based on work specifically undertaken to address the adequacy of the company's system of controls for preventing and detecting fraud - and, in particular, their adequacy to detect fraud by the directors or senior employees [paras 4.27(a) and 4.53];

- the professional bodies which train and monitor auditors considering whether sufficient attention is given in pre- and post-qualifying education to fraud detection and the behavioural aspects of individuals under pressure (para 4.27(b)];

- the professional bodies holding seminars on a regular basis to ensure that directors and auditors are continually aware of the common symptoms of fraud and the characteristics of people who perpetrate it [para 4.27(c)].

CONCLUSION - AND A WAY FORWARD

Over that last 100 or so years, whilst society consistently has expected auditors to detect corporate fraud, the auditing profession has changed its stance from one extreme of recognising fraud detection as a primary audit objective, to the other of denying responsibility in this regard. In more recent years, responding to public and political pressure, the profession has once again acknowledged some responsibility to detect fraud: more particularly, it recognises a duty for auditors to plan and perform their audits so as to have a reasonable expectation of detecting material misstatements in financial statements caused by fraud. The profession has also begun to accept a responsibility to evaluate the adequacy of the internal control systems established by corporate managements to prevent and detect fraud. Further, in recent years, the auditing profession has accepted extended reporting duties: in addition to its duty to report fraud detected during an audit to management and, in

appropriate cases, to shareholders, it has accepted a duty to report detected fraud to a proper authority, when it is in the public interest to do so.

Despite the changes to auditors' duties, corporate fraud continues to be a major and apparently escalating social and economic problem. Companies continue to fail unexpectedly, their failures, all too frequently, being precipitated by massive frauds. Whenever such cases hit the media headlines, the cry of "Where were the auditors?" may be heard. It is clear that auditors' duties - or the performance of those duties - still fall short of society's expectations.

Auditors face significant difficulties with respect to detecting and reporting corporate fraud. For example, fraud (especially by management) may be carefully concealed; additionally, the audit process is such that it requires the maintenance of mutual trust and co-operation between the auditor and auditee which may be undermined if the auditor reports suspected or detected fraud; further, there is no general agreement in society as to the minimum size or type of fraud which is reasonable to expect auditors to detect. Nevertheless, it is suggested that if the auditing profession is to avoid continued public and political criticism - and further erosion of its credibility, - it needs to move closer to meeting society's expectations with respect to detecting and reporting fraud. As noted above, the APB, in *The Audit Agenda* (1994), has outlined some steps the profession can take. In its follow-up document, *The Audit Research Agenda* (1996), the APB expressed continued commitment to resolving the profession's fraud responsibility issue. It stated: "In view of the level of concern expressed on this issue, and the lack of clarity as to whether the auditors' role should extend further than at present, fraud is regarded by the APB as a priority area" (para 31). It also identified (in para 32) questions it considered worthy of research, namely:

1) Given the likelihood of concealment of fraudulent activity, how can an auditor's ability to detect fraud be improved?

2) To what extent can assessment of the control environment assist in detecting the risk of fraud, and to what extent can the role of internal audit assist in reducing such risks?

3) What level of demand exists for more detailed forensic work by auditors?

History has shown that auditors' responsibility to detect and report fraud is a controversial issue and one which is not easy to resolve. As the APB has indicated, it requires greater realism (by the profession on the one hand and the public on the other) about what auditors should be expected to detect, and greater commitment by the profession to meeting society's realistic expectations. The APB has identified steps the auditing profession can take as part of, and to demonstrate. this increased commitment. If these are taken, the gap between what society expects from auditors and what it perceives it receives from them should be narrowed quite significantly.

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ADDENDUM TO: AUDITORS' RESPONSIBILITIES WITH RESPECT TO FRAUD IN ANGLO-AMERICAN COUNTRIES

RECENT CHANGES TO AUDITORS' DUTIES IN THE UNITED STATES

SOME PRELIMINARY THOUGHTS

INTRODUCTION

Statement on Auditing Standards No. 82: Consideration of Fraud in a Financial Statement Audit (SAS 82) was issued by the AICPA in February 1997. It is effective for audits of financial statements for periods ending after 14 December 1997. In this review paper three key questions are addressed, namely:

1. Why was SAS 82 developed?

2. What changes has it introduced?

3. What is its effect?

1. WHY WAS SAS 82 DEVELOPED?

Three main reasons maybe identified as prompting the development of SAS 82. These are as follows (Landsittel and Bedard, 1997; Ray and Mancino, 1996):

i) SAS 82's predecessor, SAS 53 (*The Auditor's Responsibility to Detect and Report Errors and Irregularities*), was issued in 1988 as one of nine standards designed to narrow the audit expectation gap (Guy and Sullivan, 1988). At the AICPA'S 1992 Expectation Gap Rountable, doubts were expressed regarding the success of SAS 53 in narrowing the expectation gap relating to the detection of material misstatements in financial statements resulting from fraud.

ii) In 1993 the Public Oversight Board (POB) of the AICPA'S SEC Practice Section suggested there was significant public concern over the profession's performance with respect to detecting management fraud. The POB recommended that guidance be developed to assist auditors assess the likelihood of management fraud occurring and that additional audit procedures be specified for performance when there is such a likelihood.

iii) Anecdotal evidence indicated that some auditors did not understand their responsibility under SAS 53 and existing standards provided little guidance on how to meet that responsibility.

According to the Fraud Task Force (which was given responsibility for developing the new standard), SAS 82 clarifies but does not extend auditors' duties with respect to fraud. Its primary purpose is to provide guidance to assist auditors meet their responsibility in this regard. The Task Force hoped that "improved detection of frauds ...will result, which in turn will improve the public's perception of the profession's activities in the area and the value of audit services in the marketplace" (Landsittel and Bedard, 1997, p.4)

2. WHAT CHANGES HAS SAS 82 INTRODUCED?

Analysis of SAS 82 reveals that it has introduced a number of significant changes. These include the following.

l. The term 'fraud' is used in place of the more euphemistic 'irregularities'. It is defined to include (a) fraudulent financial reporting (intentional misstatements or omissions of amounts or

disclosures in financial statements) and (b) misappropriation of assets (theft of the entity's assets). Additionally, unlike SAS 53 (which deals with both errors and irregularities) SAS 82 is confined to the effect of fraud in a financial statement audit. These changes reflect a more direct and focused approach to auditors' duties with respect to fraud.

2. SAS 82 requires auditors to assess specifically the risk of material misstatement of the financial statements due to fraud and to consider that assessment in planning and performing the audit. In making their assessment auditors are required to both (a) consider whether risk factors that might indicate the existence of fraud are present and (b) make inquiries of management to obtain management's understanding and assessment of the likelihood of fraud in the entity.

3. The standard distinguishes between and describes two groups of fraud risk factors that auditors are required to consider in their fraud risk assessment, namely:

(a) Risk factors relating to misstatements arising from fraudulent financial reporting. Three categories of risk factors (with a total of 39 illustrative examples) are identified: (i) management's characteristics and influence over the control environment; (ii) industry conditions; and (iii) operating characteristics and financial stability.

(b) Risk factors relating to misstatements arising from misappropriation of assets. Two categories of risk factors (with 12 illustrative examples) are identified: (i) susceptibility of assets to misappropriation; and (ii) controls.

4. SAS 82 emphasizes that auditors must respond appropriately to their fraud risk assessment. In developing this response consideration is to be given to:

i) the exercise of professional skepticism

ii) assignment of personnel,

iii) accounting principles and policies adopted by management;

iv) controls in the entity;

v) the impact of the fraud risk assessment on the nature, extent and timing of audit procedures.

5. The standard precludes auditors from hiding behind the excuse of lack of materiality when encountering evidence that fraud may exist. If auditors find evidence that may be indicative of a material misstatement due to fraud they are required to pursue it, even if it seems minor in isolation.

6. At the conclusion of their audits, auditors are required to reassess the risk of material misstatement due to fraud in the fight of all the evidence gathered from the tests performed.

7. SAS 82 requires auditors to document (a) the performance of their fraud risk assessment, (b) the specific risk factors they identified, and (c) their response to those factors. In relation to this change, Landsittel and Bedard (1997) note: "Documentation requirements in the new fraud standard are more explicit than is normally contained in auditing standards, the motive being to add further assurance that the standard will drive change in audit practice" (p.5).

3. WHAT IS THE EFFECT OF SAS 82?

As noted above, the Fraud Task Force asserts that SAS 82 clarifies but does not extend auditors' duty with respect to fraud. However, detailed comparison of SAS 82 and its predecessor, SAS 53, provides grounds for questioning this assertion. The following points maybe cited as examples:

i) Whilst SAS 82 leaves auditors' duty to report fraud virtually unchanged, it appears to extend their duty to detect fraud. Unlike SAS 53, SAS 82 requires auditors to perform a detailed fraud risk assessment. It provides a raft of fraud rink factors they are to

consider in making this assessment and explicitly requires them to respond appropriately to the risk factors identified.

SAS 53 required auditors to assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement and to exercise (a) due care in planning, performing and evaluating the results of audit procedures and (b) the proper degree of professional skepticism, to achieve reasonable assurance that material irregularities would be detected. SAS 82 similarly requires auditors to plan and perform their audits to obtain reasonable assurance that the financial statements are free of material misstatement but, unlike previously, it also seems to require auditors to actively search for fraud.

ii) The overall impression given by the standard is that it recognizes increased responsibility for auditors with respect to fraud. Of particular significance in creating this impression are (a) the fact that SAS 82 deals solely with the issue of fraud in a financial statement audit (rather than with both errors and irregularities), (b) its introduction of detailed requirements pertaining to auditors' fraud risk assessment and response thereto, and (c) its general tenor.

iii) The standard seems to take a first (tentative) step towards recognizing a general duty for auditors to detect fraud. Although SAS 82 carefully couples detecting fraud with material misstatement in the financial statements, it provides far more guidance than hitherto on detecting fraud (particularly as regards detecting misappropriation of assets) and its tenor is indicative of a more general duty to detect fraud. It may be that the Task Force adopted the view that any material fraud will have an impact on the financial statements and, therefore, a general duty to detect fraud is consistent with, and a component of, auditors' duty to obtain reasonable assurance that the financial statements are free of material misstatement.

CONCLUSION

Irrespective of whether SAS 82 extends or clarifies auditors' duty in the US to detect fraud, the standard unquestionably extends the requirements with respect to auditors' performance of their detection duty. Indeed, as noted above (p.2), in issuing SAS 82

the Fraud Task Force (and AICPA) sought to narrow the audit expectation gap by improving auditors' performance in detecting frauds. As Sutton, Chief Accountant of the SEC, observed: 'the new standard is expected to improve auditor performance by causing auditors to spend more time looking for and analyzing evidence of fraud" (1996, p.6). Similarly Noonan, Chair of the Auditing Standards Board, explained:

> [SAS 82] provides additional performance requirements to enable auditors to meet their fraud detection responsibility. It specifically lays down procedures that need to be completed concerning fraud detection when auditors design and perform their audits. In this way, the new standard is expected to change auditor behaviour and drive auditor performance. (as quoted, AICPA, 1996).

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9. SAICA

"SECTION 20(5) OF THE PUBLIC ACCOUNTANTS' AND AUDITORS' ACT,1991

In our original submission to the Nel Commission, we made the point that there appeared to be a number of problems relating to Section 20(5) of the Public Accountants' and Auditors' Act, and hence to the reporting by auditors thereunder. We undertook at that time to revert to you with recommendations on how to address these problems.

After a lengthy consultation and discussion process, ,we have determined what we consider to be the problems inherent in this section and have made recommendations on how to resolve these problems.

Background and objective of Section 20(5)

The purpose of Section 20(5) is clearly to protect the public, ,whether as investors, creditors or any other interested party having some kind of relationship with the company. This objective was revealed by an address by then Minister of Finance (The Hon. N C Havenga) at the opening meeting of the Public Accountants' and Auditors' Board and the Accountants' Registration Advisory Committee on 24 October 1951, where he made the following relevant observations on the purpose of Section 26(3), the predecessor or section 20(5).

> *" To my mind a most important aspect of this piece of legislation is Parliament's recognition of the principle that an auditor owes a duty not only to his client but also to the public. For many years auditors have been in doubt as to their responsibility to the public. Parliament has now given a clear and unequivocal answer. I wish, in this connection, to refer particularly to sub-section (3) of section 26. Although it is not claimed that the provisions of this sub-section will give complete protection in the interests of creditors and local and overseas investors, advantages as yet unforeseen will undoubtedly accrue from the recognition of the principle embodied in that sub-section.*
>
> *In conclusion I wish to say that although the auditor has often been referred to as the watchdog, not only of his client, but also of a rather impersonal public, I would remind our auditors that the rather impersonal public in fact also embraces persons both inside and outside the Union whose views of the financial stability and the standards of morality in our businesses and undertakings are important to a prosperous way of life in the Union. May I ask them, therefore, to be watchful also of the interests of the greater public and so protect the good name of the Union inside and outside its borders."*

While there have been some changes to the relevant sections of the Act since 1951, the intention and objective of the section has clearly not changed. What is problematic, however, is the practical implementation of the requirements of the section. These problems arise because of the wording used in the section, which make it unclear under exactly what circumstances reporting is required.

Appendix to Statement of South African Auditing Standard (SAAS) 240, Fraud and Error, issued in April 1997, provides guidance to auditors in assessing 'whether or not a material irregularity in terms of Section 20(5) has taken place. This appendix, which was based on legal advice, does not however have legal standing, and clearly cannot address all the difficulties inherent in the section. The detailed problems with proposed solutions are outlined below.

In the capacity of auditor

Both Sections 20(5) and 20(7) make reference to the term "in the capacity of auditor". There is a great deal of uncertainty as to what is meant by this term, and therefore under what circumstances a person "is acting in the capacity of auditor". This issue has become increasingly pertinent in the last few years because of the fact that audit firms are offering a broad range of other services to their audit clients. This will also be aggravated by the possible emergence of multidisciplinary practices in the future. To illustrate this problem, if the auditor of an entity provides the company with tax and tax advisory services, would he be required to report a material irregularity if it came to his attention not during the course of the audit but during the course of providing that ancillary service? The answer to this question, although not clear, is probably no, since the auditor in this case is not acting in the capacity of auditor, but in the capacity of tax advisor. Therefore, on a plain reading of the Act, one could fairly conclude that there is no duty to report in these circumstances.

However, we do not believe that this was the intention of the legislature, as we believe that in the interest of public protection, the legislature would have wanted reporting in these circumstances. Section 20(7) of the Act, which was inserted in the 1991 Act, we believe, was an attempt to widen the ambit of reporting. However, as it also contains the words "in the capacity of auditor" it suffers from the same shortcomings as section 20(5).

To remedy this problem, we recommend that the words "any person acting in the capacity of auditor" are deleted from Sections 20(5) and 20(7) replaced with the words "an auditor".

Auditor

"Auditor" is not defined in the Act. However it is interpreted as the individual registered with the PAAB.

In accordance with Section 274 of the Companies Act, a firm of auditors may be appointed to hold the office of auditor of the company, This provision is also included in other legislation relating to regu1ated industries. The General Note on Section 274 of the Companies Act included in *Henochsberg of the Companies Act* states that, in effect, the appointment contemplated by the section would amount to an appointment of all the partners of the firm.

It is submitted that the reference to auditor could only relate to the individual in a firm of auditors that is responsible for conducting the audit and signing the audit opinion an the entity's annual financial statements. There may be instances where this individual may not be aware of an irregularity that has taken or is taking place in regard to his/her client, although the firm of auditors collectively may have such knowledge. For example, auditor A, during the audit of B, may become aware of an irregularity that is taking place at C, which is a client of 'the same audit firm but audited by auditor D. Based on the above, there is no responsibility on auditor A to notify auditor D or to report the irregularity in terms of the proposed section. In fact, due to the confidentiality provisions, A is not allowed to notify D.

Therefore, it is suggested that a definition of registered auditor is included in the Act, indicating that it is the person, i.e. individual, registered with the PAAB who is responsible for the audit of the entity and not the firm appointed as auditor in terms of relevant legislation. It is further suggested that section 20(5)(a) is amended to refer to "a registered auditor who acts as auditor of an entity".

Report addressee

One of the practical problems faced by auditors is the identification of the party to whom the report should be addressed to in the first place. Therefore, it is suggested that, in addition to the person in charge, the report also goes to all members of 'the board or controlling body. In addition to providing certainty, this also ensures that the report reaches the maximum range of persons responsible for the conduct of the affairs of the entity.

In the conduct of the undertaking's affairs

Section 20(5) requires reporting where a material irregularity has taken place 'in the conduct of the affairs of such undertaking'. It is unclear whether these words are referring to the management of the undertaking or whether in fact they would extend to all aspects of the undertakings affairs, including acts performed by employees not responsible for managing the undertaking. For example, if a fraud was perpetrated by a junior member of staff would this constitute a material irregularity? Our interpretation is that this would not constitute a material irregularity. However, it would be a material irregularity should there be a failure on the part of the management of the undertaking to take steps to remedy the situation.

Furthermore, the Act should make it clear that it includes acts on behalf of the entity, as well as acts against the entity. An example of the former would be bribes in order to get business and an example of the latter would be a fraud by, for example, a director of the undertaking.

We, therefore, suggest that the term "in the conduct of the affairs of the undertaking" is deleted and that the proposed definition of a reportable irregularity is worded to clarify these matters.

The term "material irregularity"

The term "material irregularity" used in the section itself raises some questions, particularly regarding what the term "material" applies to, and whether material relates purely to a quantitative measure or whether it relates to both a quantitative measure and the nature of the irregularity.

In our original submission to the Nel Commission, it was argued that the adjective "material" in the section should relate to the loss incurred or likely to be incurred and should thus be juxtaposed with the reference to the actual or possible loss.

However, we believe that irregularities to be reported should not be limited to matters material in the financial sense, but should also include unlawful acts or omissions that constitute fraud or that represent a material breach of fiduciary duty on the part of management.

Based on the above, it is suggested that;

- the word "material" is linked to the word financial loss,

- irregularities to be reported include unlawful acts or omissions that constitute fraud or that represent a material breach of fiduciary duty on the part of management, and

- the word "material" in relation to "irregularity" is replaced with the word "reportable".

It is important that the Act is as clear as possible on what a reportable irregularity is and it is suggested that the broad principles thereof are included in a definition.

For this purpose, our suggestion is that a reportable irregularity is defined as follows:

"Any unlawful act or omission by any person in the conduct of the management or control of an entity that:

- has caused or is likely to cause material financial loss to the undertaking or to any of its members or creditors, and/or ".

- is fraudulent or amounts to theft, and/or

- represents a material breach of the fiduciary duty of such person to the entity "

Body to whom the report should be submitted

As was noted in our origina1 submission on the Nel Report, it serves little purpose for section 20(5) reports to be submitted to the PAAB. Bearing in mind what the objective of the section is, we believe that the reports should be submitted to the Regulatory Body responsible for the entity concerned. This may be, for example, the Registrar of Companies, the Registrar of Banks, the Financial Services Board, etc. Only in those instances where no such Regulator exists should the report be submitted to the PAAB.

Clearly, for the section to be .effective and to meet its objective, it is critical that the regulators be given the appropriate powers to take any action deemed appropriate in the circumstances to investigate and deal with any reportable irregularities. We believe that these powers should include the right to appoint an independent person to investigate the entity concerned and to take corrective action such as suspending the entity from conducting business or putting it under judicial management. These powers should be provided for in relevant legislation.

30-day period provided for in Section 20(5)(b)

The Act requires the auditor to give management 30 days within which to determine the existence or non-existence of the irregularity and to remedy the situation, before the auditor is entitled to submit the appropriate report to the PAAB.

While there may be instances where allowing a 30 day period may he appropriate, we believe that in the interest of public protection, the Act should be amended to allow for (i.e. not to require) immediate reporting in those cases where, based on the risk of loss to the entity, its members or creditors, the auditor deems it appropriate to report immediately to the Regulator. An example of such a circumstance could be where the auditor considers that there are indicators that the business is being conducted recklessly or fraudulently.

Therefore, our recommendation is that the Act is amended in effect to allow the auditor to judge, based an the circumstances of each case, whether or not it is appropriate to provide management a certain period of time before the irregularity is reported to the Regulator. We would, however, suggest that a maximum period of 30 days is retained.

Section 20(5)(b) recovery/prevention of Loss

This section provides that where the auditor is satisfied that sufficient steps have been taken to prevent or recover the loss, then no report needs to be furnished to the PAAB. We agree with this part of the section and we do not suggest that any change is made in this Act in respect thereof. However, we do believe that in the interest of transparency and keeping stakeholders informed, such 'unreported irregularities' should be reported on in the annual financial statements of the entity concerned. We, therefore, suggest that consideration is given to amending, for example, the Companies Act, the Banks Act, etc. to require the directors to report on the particulars of the irregularity and on the steps that were taken to address it.

Clearly, in cases where an irregularity has been reported in terms of Section 20(5), we would also recommend that the particulars of the irregularity is required to be disclosed in the annual financial statements of the entity.

Section 25(6)

From a practical perspective, it is suggested that the subsection dealing with companies placed in liquidation is deleted. It is submitted that by the time a company is placed in

liquidation and under the control of a liquidator or the court, the primary objectives of detection and prevention of ongoing fraud are generally no longer relevant.

Conclusion

In developing our comments and recommendations on the whole question of material irregularities, we have attempted to balance the objective of the section, being public protection, with the need to prevent the section from becoming unwieldy resulting in a proliferation of reports on trifling matters. We believe that our recommendations as best as possible achieve this balance and will also help to resolve the lack of clarity that is inherent in the current section. Clearly, however, an issue of this nature will always involve an element of judgement and therefore cannot be entirely clear cut.

We thank you for providing us with the opportunity to comment on this issue and we trust that our comments will be seen in the constructive light in which they are intended. The annexure to this letter contains our proposed revision to the relevant sections of the Act, based on our recommendation set out above.

Annexure

PROPOSED REVISED LEGISLATION

S20(5)(a) For the purposes of S20(5), a reportable irregularity shall mean any unlawful act or omission by any person in the conduct of the management or control of an entity which -

(i) has caused or is likely to cause material financial loss to the entity or to any of its members or creditors, and/or
(ii) is fraudulent or amounts to theft, and/or
(iii) represents a material breach of the fiduciary duty of such person to the entity.

S20(5)(b~~a~~)(i) ~~If any person acting in the capacity of~~ A registered auditor who acts as auditor of an ~~to any~~ undertaking who is satisfied or has reason to believe that ~~in the conduct of the affairs of such undertaking a material~~ a reportable irregularity has taken place or is taking place ~~which has caused or is likely to cause financial loss to the undertaking or to any of its members or creditors, he~~ shall forthwith despatch a report in writing to the person in charge of that

undertaking and all the members of the board of director or controlling body thereof giving particulars of the irregularity, at the same time drawing the attention of such persons ~~in charge~~ to ~~the provisions in~~ paragraphs ~~(b) and~~ (c) of this subsection and requesting all such persons individually or collectively ~~him~~ to acknowledge receipt of such report in writing.

S20(5)(b)(ii) If in the opinion of the registered auditor, the risk of financial loss to the undertaking or to any of its members or creditors would be materially increased by any delay, the registered auditor may simultaneously with despatch of the report in terms of S20(5)(b)(i) furnish the statutory regulator(s) of the undertaking concerned with copies of the report and such other particulars as he may deem fit.

S20(5)(~~b~~)(c)(i) Unless within 30 days after the registered ~~an~~ auditor has despatched such a report, he has been satisfied that no reportable ~~such~~ irregularity has taken place or is taking place or that such unlawful conduct has ceased and adequate steps have been taken for the recovery of any ~~such~~ loss ~~so caused or for the prevention of any, such loss likely to be so caused~~, he shall forthwith furnish the ~~board~~ statutory regulator(s) of the undertaking concerned with copies of the report and of any acknowledgement of receipt thereof and reply thereto and such other particulars as he may deem fit.

S20(5)(c)(ii) Where the registered auditor has previously furnished a copy of the report to the regulator(s) in terms of paragraph (b)(ii) of this subsection, he shall forthwith furnish the regulator(s) with any further information he deems appropriate, including copies of management's acknowledgement of receipt and reply thereto.

s20(5)(d)(i) Where no specific regulator exists for the undertaking concerned, then the reports required in terms of paragraphs (b)(ii) and (c) of this subsection, should be submitted to the board.

S20(5)(~~e~~)(d)(ii) The board may disclose any information supplied to it in terms of paragraph (d)(i) of this subsection ~~paragraph (b)~~ to any state official, ~~attorney-general or the Registrar of Banks any officer in the public service~~ or any member or creditor of the undertaking concerned or

any juristic person of whom the undertaking is a member or who has authority ~~control~~ over the undertaking or who has the power to take disciplinary steps against the undertaking, or to the committee of any stock exchange on which shares of the undertaking are listed, or, if the board believes it to be in the best interests of the public, to any other person, institution or body.

S20(5)(~~d~~)(e) For the purpose of determining whether any irregularity contemplated by this subsection has taken place or is taking place, a registered ~~an~~ auditor may carry out such investigation as he may deem fit.

S20(5)(e)(f) Nothing in this subsection contained shall be construed as conferring upon any person any right of action against a registered ~~an~~ auditor which, but for the provisions of this subsection, he would not have had.

~~**S20(6)(a)** If any person who was acting in the capacity of auditor to any undertaking immediately prior to its sequestration or liquidation (whether provisional or final), is satisfied or has reason to believe that at or before the date of the sequestration or liquidation a material irregularity in the conduct of the affairs of such undertaking was taking place or had taken place which had caused or was likely, to cause financial loss to the undertaking or to any of its members or creditors, and such person did not comply with the provisions of subsection 5(a) in respect of such irregularity before the said date, he shall forthwith despatch a report in writing, giving particulars of such irregularity, to the person appointed as trustee or provisional trustee or as liquidator or provisional liquidator, as the case may be, of such undertaking, and at the same time supply copies of such report to the person in charge of such undertaking and to the board.~~

~~**S20(6)(b)** If any person who was acting in the capacity of auditor to any undertaking immediately prior to its sequestration or liquidation (whether provisional or final) and who has not taken action in terms of subsection 5(a) or despatched a report in writing in terms of paragraph (a) of this subsection, is at any time requested in writing to do so by the person appointed as trustee or provisional trustee or as liquidator or provisional liquidator, as the case may be, of such undertaking, he shall forthwith inform the person so requesting~~

~~whether or not a report in writing is required by paragraph (a) of this subsection, and in the event of his informing the person so requesting that such report is so required, he shall forthwith despatch the report to him, and at the same time supply copies of such report to the person in charge of such undertaking and to the board.~~

~~S20(6)(c)~~ ~~The provisions of subsection 5(c) shall mutatis mutandis apply with reference to any information supplied to the board in terms of paragraph (a) of this subsection, and the provisions of subsection 5(c) shall mutatis mutandis apply with reference to any provision of this subsection.~~

S20(6~~7~~) A registered ~~An~~ auditor shall, in performing any duty referred to in subsection (5) ~~and (6)~~, have regard to all the information which comes to his knowledge ~~in his capacity of auditor to any undertaking and all the information which comes to his knowledge~~ from any ~~other~~ source".

10. See Chapter 18.

.....

CHAPTER 18 – THE AUDITING PROFESSION - ETHICS - THE PUBLIC OVERSIGHT BODY

18.1 The auditing profession in South Africa as in many other jurisdictions which were part of the erstwhile British Empire, evolved during the 19th century when the growth of company law in England and elsewhere created a need for qualified accountants.

18.2 It must be borne in mind that the auditing profession in England evolved at a time when

— the crime of fraud as it is known in South Africa, did not exist in England;

— for centuries past, promoters and directors of companies had lied with virtual impunity about the affairs of companies;

— companies were encouraged to suppress profit figures, not only to mislead competitors but also to mislead their employees;

— the compulsory audit of the balance sheets of companies was only reintroduced in 1900, after a lapse of almost half a century;

— Courts leaned over backwards to accommodate incompetent and negligent directors.

18.3 It is against this background that

— the manipulation of income and expenditure figures to suit the aims of management became not only common place, but also acceptable to the profession, as long as it conformed to 'generally accepted accounting practice';

— the so-called 'common law' duty of confidentiality evolved which is so often used as an excuse not to divulge information about maladministration.

18.4 As pointed out in Chapter 13, public confidence in the auditing profession and the veracity of audited financial statements started to decline during the 20th century.

18.5 The decline in public confidence had many causes, some are

— the denial by the auditing profession of its erstwhile duty to detect fraud;

— the perception that the auditing profession had lost its independence;

— the demise of companies shortly after the external auditors had signed unqualified audit reports.

18.6 In 1977 and in an attempt to stop the erosion of public confidence in the auditing process and to forestall Federal intervention, the **American Institute of Certified Public Accountants** (AICPA) created an independent **'Public Oversight Board'** for the profession, composed of

"prominent individuals of high integrity and reputation".

18.7 In 1994 and in recognition of the growing distrust of the public in the efficacy of self-regulating professions, the **Institute of Chartered Accountants in England and Wales** proposed the creation of a public oversight board for the auditing profession.

18.8 In the Interim Report of its Regulation Review Working Party, the following was stated

"(9) The regulation of accountants comprises the activities of setting standards for their conduct (eg ethical standards) monitoring their compliance with these standards in certain areas, investigating cases in which accountants appear to have fallen short of these standards, and disciplining those who are shown not to have achieved them.

(10) Against this definition, the regulation of accountants should be based on a number of fundamental principles:

(1) the system should be unitary — so that all cases are handled within a single structure.

(2) regulation must be practioner-led: practitioners, whether members in business or members in practice, must be heavily involved in all aspects of the regulatory process if it is to be effective.

(3) all related activities (eg discipline, regulation and standard-setting) should be under the control of a single organisation

(4) **regulation and regulated activities should be distinct and separate from the other activities of a professional body**

(5) **the public interest must be clearly and unequivocally articulated.**

.....

(42) As noted in the December 1994 report:

'.....There has been much complaint from members that increasing the Institute's duties as a regulator imperils the Institute's responsibility to act as a representative and support for its members. The external mirror image of this internal concern is the often heard complaint that the Institute's dual roles as a regulator and representative create conflicts which undermine its effectiveness as a regulator.' (See paragraph 33)

(43) **In the working party's view, it is not practicable to cope with the concerns either of members or of people outside the Institute unless the Institute's disciplinary, regulatory and standard-setting mechanisms are manifestly distinct and separate from its other activities and in particular those which are involved in member support and representation.** In one sense, of course, these mechanisms are already separate from the Institute's other activities. For example, discipline is the responsibility of the Professional Conduct Directorate and regulation is the responsibility of the Practice Regulation Directorate. These Directorates do not have responsibility for other activities. In this sense, therefore these activities are already distinct and separate. In practice, however, they are clearly not perceived to be distinct and are certainly not distanced from the Institute's other activities in the minds either of members or non-members.

(44) From the point of view of members, ensuring that these activities are perceived to be distinct and separate should ease the Institute's task of demonstrating that no member need fear making use of the Institute's support functions by reason only of concern about the Institute's role as regulator.

(45) Conversely, distinctness and separation should assist the Institute in demonstrating in the public interest that its role in the maintenance of professional standards is not constrained or undermined by its parallel functions as a representative of and support for members.

(46) The working party believes that the activities related to regulation should be distinct and separate from the other activities of the Institute".

18.9 The Working Party concluded as follows:

"101. In the working party's view, a Public Oversight Board (POB) should be created to exercise oversight of the activities related to regulation.

.....

105. Although the working party has not attempted at this stage to prepare a detailed description of the way in which such POB would be created and how it would operate, the working party envisages that the proposed board would have the following characteristics:

(1) **Membership**

The POB would consist of a few members of high standing and repute drawn from commerce and other professions (possibly including a member of the Institute), and appointed for fixed terms of 3 – 5 years.

(3) **Nomination**

It is important that the process of nominating members of the POB should be made independent of the Institute. The working party envisages that commercial and other professional institutions (outside the accounting profession) should be invited to accept the responsibility of nominating members to the POB.

(3) **Scope**

The POB would be charged with exercising public oversight over the Institute's discharge of the regulatory, disciplinary and standard-setting responsibilities. This oversight would be complementary to, and would not displace, the direct oversight exercised (under statute) by the DTI and SIB.

(4) **Staff**

The POB should have its own small staff separate from the Institute's secretariat.

(5) **Manner of working**

The POB would have access to all of the committee papers and reports produced by the relevant committees and would be entitled to send its own representative to attend monitoring visits, committee hearings, meetings and tribunal hearings as appropriate. The POB would also have access to the reports of any reviews of the effectiveness of the regulatory and monitoring arrangements.

(6) **Complaints**

The POB should also be authorised to deal with and investigate the circumstances surrounding any complaints about the regulatory system (as opposed to complaints about members' or firms' conduct) made directly to the POB either by members or non-members.

(7) **Reporting**

The POB would report (not less than annually) in public on matters within its purview.

106. This description is consciously based upon the experience of the Public Oversight Board in the United States. That Board was created by the AICPA in response to criticism in the 1970s of the state of regulation of the United States accounting profession. It has developed into a strong and, for the profession, occasionally awkward voice for the public interest. Its authority as an independent authority on the regulation of the profession is now accepted.

107. In the working party's view, the existence of such an independent review body should do much to demonstrate the integrity of the mechanisms for the regulation of accountants.

108. Firstly, it would, for the first time, provide a public assessment of the effectiveness of the regulation of accountants. Thus far, apart from the report prepared by Professor Peter Moiser for the DTI, the only material in the public domain based on a close knowledge and analysis of the Institute's performance has emanated from the Institute itself.

109. Secondly, the existence of such a body would be a public spur to the Institute to maintain the effectiveness of the regulation of accountants in the public interest".

18.10 In a letter to this Commission (November 1995), the Deputy-President of the Institute, **Mr Brian Currie**, said the following:

"The debate here continues, both at the Westminster level and the Brussels level. In all our debates about regulating the profession, I am reminded time and time again that it is absolutely crucial for those taking part in the debate to focus on the fundamental principles. These are the principles set out in the report of the Regulation Review Working Party on page 2 (paragraph 10) by way of summary and in more detail in section IV, starting on page 6.

Above all, it appears crucial that the regulation of any practitioner activity be led by practitioners who have current experience and prestige in the practising area. Every profession has found that to be necessary. Without it, the regulatory body finds it almost impossible to secure and retain, in the long term, the support and commitment of practitioners as a group. Without it, an antipathy springs up between the regulator and the regulated which turns wholehearted compliance into mere lip service and sceptical compliance with form.

The trouble is that many people suppose there ought to be a close analogy with non-professional types of regulation. If you can regulate utilities or workplace conditions, or fire regulations by providing a regulator with adequate technical knowledge but coming from outside the industry, people expect that you can regulate professions in the same way. But a professional activity is much more than a technical activity. Those who overlook the additional dimensions to professional activity are bound to fail to understand how regulation must work.

The result of having a practitioner led system is that it will appear self-serving. It will appear that the profession is rule maker, judge and prison warder in its own cause. That is why we already reinforce the practioner working groups with independent members who look for fair play. Since this on its own never satisfies the public at large (though it is, in fact, extremely effective internally) it becomes necessary to devise other ways of establishing transparency and reassuring the public that the processes are <u>not</u> conducted in a self-serving way, even if the opportunity is there..

The public oversight mechanism must, therefore, have skilled technical and independent officers who can access every aspect of the executive regulatory apparatus and report on it to the oversight board itself. The oversight board must weigh the effectiveness of all aspects of the regulatory system and report both to the regulators and to the public at large, and to whatever political or administrative arm of government is responsible.

In every country I go to, I see each profession hitting the same issues and obstacles. I am sure there is no perfect solution, but I do believe that the principles that we have described are crucial to any solution that is going to work and carry conviction in the long term".

18.11 The members of the Institute were not in favour of the creation of a public oversight body, and the proposal fell away.

18.12 However, within two years the Labour Party won the General Election in the UK. Its Business Manifesto published in April 1997 included a commitment to

> **'ensure there is a framework of independent regulation for the accounting profession'.**

18.13 In an attempt to accommodate the commitment of the Government to establish independent regulation of the accountancy profession, the Institute again proposed the creation of an independent oversight body.

The Government accepted the proposal in principle and agreed to a five year trial period.

18.14 This has led to the formation of an independent Accountancy Foundation for the accounting profession which will oversee the activities of a Review Board, an Auditing Practices Board, an Ethics Standards Board and an Investigation and Discipline Board, with all four having a majority of independent members.

18.15 The UK Department of Trade and Industry issued a Consultation Document, 'A Framework of Independent Regulation for the Accounting Profession', in which it sets out the key features which the Government expected to see.

Relevant sections of the Document read as follows:

> "(6) The consultation reflects the Government's strong view that the regulation of the accountancy profession is a matter of interest and of importance to a wide range of groups, not just the users of their services in business and industry, but also in the community at large. It is right, therefore, for there to be an opportunity for public comment before any new arrangements are introduced. For this reason this document is aimed at the general reader as much as at the professional. It therefore outlines the proposals in general terms and focuses on those issues on which the Government would welcome views.
>
> .....
>
> (10) There is a legitimate and substantial public interest in arrangements to ensure that professional activities in whatever field are conducted effectively and with integrity. The public is not always well placed to assess directly the quality of the professional services on offer, but has a reasonable expectation that it can rely on the professional title. Equally, the members of the profession have a powerful long term self-interest in maintaining the reputation of the profession as a whole. There is, therefore, a close alignment

between public and private interests in maintaining and developing rigorous professional standards.

(11) The question for public policy is what system of regulation and discipline of the accountancy profession not only best serves, and is seen to serve the overall public interest but also has the capacity to adapt as public interest considerations develop. The Government believes that these objectives are best met by a system of regulation which works closely with the profession but is independent of it.

The Foundation

(24) The CCAB [Consultative Committee of Accountancy Bodies] proposals see the creation of an independent Foundation as a key element underwriting the independence and transparency of the new system of regulation.

(25) The CCAB proposals envisage the Foundation as the legal owner of the proposed Review Board, a reformed Auditing Practices Board (APB) and the proposed Investigation and Discipline Board (IDB). (Each body and the issues relating to it are discussed later in this document.) The Foundation would have the responsibility for making appointments to these three bodies. The accountant members of those bodies would, however, be appointed in conjunction with the Chairman of the CCAB. The role of the Foundation would be to safeguard the independence of the Review Board and the other bodies to ensure that the system is providing an effective way of representing the public interest in relation to the setting of standards, discipline and the other regulatory responsibilities of the bodies. The Foundation would publish an Annual Report.

(26) The Government very much welcomes these proposals as underlining the commitment of the accountancy profession to an independent system of regulation. However, it considers that a number of requirements must be met at the outset if the Foundation is to meet these expectations.

(27) The Government made clear in the September 1998 announcement that the new Ethics Standards Board (ESB), as one of the key elements in the regulatory framework, should also come within the ownership of the Foundation. The Foundation should also have responsibility for making appointments to the ESB.

(28) Above all the Foundation must be able to guarantee adequate, long term 'no strings' funding to the principal bodies charged with delivering the independent system of regulation.

(29) The Government considers it important that the 'ownership' and membership of the Foundation must lie visibly outside the accountancy profession. Its membership should not therefore include any practising accountants. The members should be appointed by those outside institutions and representative bodies with the closest interest in the regulation of the accountancy profession. The individuals nominated should carry substantial weight in their own area".

18.16 The UK Company Law Review Steering Group's Consultation Document, 'Developing the Framework', states the background as follows:

"5.136 While the ethos of the big firms has become more commercial, reflecting the changing composition of their profits, the growth of competitive tendering has weakened the auditors' position. If the directors want to remove a rigorous auditor, there is no need to go through the procedure of dismissal. In the year following a contentious argument over the accounts, the audit may be put out to tender for apparently sound reasons. The 'difficult' auditor is not chosen for the job. Any representations the auditor then makes can be dismissed as sour grapes. It is arguable therefore that, despite the safeguards, the framework of incentives and pressures within which the audit is undertaken may have become less robust as a protection for shareholders and other stakeholders. There is a question therefore, given the centrality of the auditors' independence as a check and balance in the system, whether the existing statutory requirement for auditor independence combined with self regulatory system of rules and discipline is adequate. There is, moreover, a danger after a long period of economic recovery and market buoyancy that the risks of abuse of this conflict are currently being underestimated. Yet restricting companies' freedom to choose their own advisers would raise costs

and introduce other practical difficulties. It is impossible to quantify the trade-off between those higher costs and enhanced audit objectivity.

5.137 We have noted that substantial change is currently being made to the system of regulation for accountants and auditors. This follows an agreement between the Government and the profession last year to introduce a new independent framework of regulation, on a non-statutory basis, and subject to a review after 5 years. An important element is the establishment, under an independent Foundation, of a new Ethics Standards Board (ESB), 60 per cent of whose members will be non-accountants. Although the detailed working arrangements for the ESB have yet to be announced, it would be surprising were this body not to address the question of auditor independence. Running alongside these domestic developments is an attempt by EU Member States to reach a closer agreement and understanding on what is meant in practice by auditor independence. It seems unlikely that these discussions will lead to binding Community rules, but guidance at the European level is likely to be highly influential. Most global accountancy firms are also themselves considering hiving off, or structurally separating, their management consultancy businesses, or proposing to do so.

5.138 Against this background, we recognise that the independence issue needs to be kept in mind, but have concluded that it would not be helpful to make specific proposals on auditor independence at this stage. We will keep the matter under review and would welcome comments on these issues".

18.17 Recently, and following upon the perceived massive failure by the auditing profession in **Ireland** to report serious irregularities, a Review Group was appointed to examine and report upon the following issues:

— "Whether accountancy firms appointed to undertake external audit should be involved in the provision of other services to the same financial institution;

— Whether the external audit function is compromised or undermined by the extent of modern-day intermingling of functions – audit, tax advice, consultancy, etc;

— How the issue of fees can be determined in such a way as to give primacy to the interests of shareholders and in a manner that respects the central importance of the audit process;

— What the Sub-Committee perceives as possible over dependence of the external auditor on a management that in practice appoints and remunerates the external auditor;

— If the balance of relationships between audit and other functions is reflected correctly in the statutory provisions of the Companies Acts and related codes;

— The role of the external auditor in ensuring compliance with Statutory provisions (e.g., the D.I.R.T. legislation) and whether the existing statutory audit requirements adequately address this issue;

— The Sub-Committee's view that the Central Bank should prescribe the scope of management letters issued by external auditors to financial institutions and that the Central Bank receive and discuss management letters with management and its external auditors on an annual basis;

— The Sub-Committee's view that the specific audit standards pertaining to financial institutions be strengthened;

— The suitability of having joint auditors to financial institutions one of which to be proposed and appointed by the Central Bank;

— The view of the Sub-Committee that there should be a maximum term of 5 years for any auditor to a financial institution after which a new audit firm must be appointed;

— Whether self-regulation in the auditing profession is working effectively and consistently;

— Whether any new or revised structures and arrangements are necessary to improve public confidence, and if so, what form should they take".

18.18 The Group published 'The Report of the Review Group on Auditing' during July 2000.

18.19 The Review Group stated the primary purpose of regulation in any economic sector as (p. 107)

"to provide, for reasons of public interest, a counterweight to free market forces and to counteract market failure. If allowed to operate unchecked, these forces may merely serve to benefit individuals in society to the disadvantage of society as a whole".

18.20 The group also stated that regulation is a critical part of the business environment

"providing, for a wide range of parties, such as suppliers, customers and banks, the confidence to trade or engage in economic transactions with limited companies. **Reliable, independent auditing of the financial statements of limited companies is a core principle underpinning this overall regulatory framework and is often the baseline from which regulatory authorities and other State agencies conduct their functions.**

It is vital to the maintenance of a competitive marketplace that the organisations concerned and their supervisory authorities, usually Government, keep abreast of marketplace or societal developments, so that their role remains relevant and proportionate to the needs of society. Often this involves regular incremental changes in the regulatory role, such as the decision in the Companies (Amendment) (No. 2) Act, 1999 to remove small companies from the requirement of statutory audit. Sometimes, this may involve more substantial change, such as the termination of a particular regulatory function or the establishment of a new regulator. This process of review and renewal is an ongoing one, and some of the regulators identified in an earlier paragraph are currently involved in a similar process of change.

The review and renewal of the external auditing function and of auditing regulation should be seen in this context. It is the case that the present review is more fundamental than any other in recent years, but it is a necessary one having regard to the recent disclosures of corporate malpractice that impinge on the auditing profession.

.....

In summary therefore, reports **by auditors on financial statements are widely used for decision-making in our economic lives. Reliable and respected financial reporting and audit are fundamental elements in supporting the reputation of Irish business, in avoiding financial losses, in encouraging trade and ensuring the efficient operation of the Irish financial markets and more generally, in enhancing the attractiveness of Ireland as a location of business development.**

.....

It is vital that the duties of auditors and of the regulators of audit activity are exercised in accordance with appropriate legal and professional standards, in order to provide and maintain a credible form of public assurance in the auditing function. **Unless the system of auditor regulation is strong enough to demand and enforce such standards, then the whole *raison d'être* for auditing as a function of independent public assurance would be undermined".**

18.21 Some of the conclusions and recommendations of the Review Group are

"7.1 In the opinion of the Review Group, the objective of the system of auditing regulation should be to monitor and protect the quality of the external audit function and thereby to maintain public confidence in the value of the external audit function.

7.2 The task of supervising the framework for audit regulation operated by the accounting bodies should be transferred from the Department of Enterprise, Trade and Employment, to a statutory Oversight Board which would have enhanced powers to enable it to deliver a more effective and equitable system of regulation than applies under the current arrangements.

7.4 Bearing in mind the desired attributes for effective and fair audit regulation, the Review group concluded that the new arrangements would require to:

- be predominantly independent of the auditing profession but be accessible, consistent and transparent in the performance of its work, while building on the existing infrastructure for supervision and discipline of auditors and their firms;

- display leadership in co-ordinating the work of the various recognised bodies and interfacing with the international players in audit regulation to maintain and further enhance the existing high standards and reputation of auditors in Ireland;

- be responsive to the needs of stakeholders in particular those who heretofore have not been adequately catered for. This suggests the need for an external body with authority to intervene in appropriate circumstances in the monitoring, investigation and disciplinary areas and act on its own

account. The effectiveness of such a body also suggests that like other regulators, its activities need to be supported by statute, so that it can implement (and enforce if necessary) its decisions. Without strong statutory backing, the Review Group believes that such a body would not have the required authority to act as an effective regulator of the audit profession.

8.1 The Review Group has already noted that 'self-regulation' is a misnomer in that the Companies Acts (and some other legislation) delegates to certain recognised accountancy bodies supervisory responsibility over the activities of their members and member firms. It follows that the bodies should be accountable for the exercise of those delegated functions and that their performance should be brought to public attention on a more regular basis than has been the case in the past. Such transparency would assist both in encouraging good performance and in creating public assurance that proper professional and ethical standards were being applied and enforced (where necessary) on a consistent basis.

The Oversight Board should be given sufficient statutory powers:

- to encourage adherence to high professional standards in the profession;

- to undertake effective supervision of the accountancy bodies in the discharge of their delegated regulatory functions;

- to intervene where accountancy bodies are not carrying out their delegated regulatory functions to a sufficiently high standard.

9.5 Having considered the various options for the location of the functions appropriate to an Oversight Board, the Review group has concluded that there is ample justification for the establishment of a stand alone Oversight Board on a statutory basis, viz:

— the role and functions of the Oversight Board have sufficient scale to justify the establishment of a separate entity;

  – a separate Oversight Board would provide a visible public focus for resolving matters of concern relating to the standards of the profession;

  – an Oversight Board outside the direct control of Government and the profession would provide assurance both to the profession and to the public at large that matters relating to professional standards were being properly managed;

  – a separate Oversight Board would permit the development of a distinct ethos, enabling independent solutions to be developed to the demands of its remit, free from any dominant influences which might arise from incorporation in an existing body;

  – a separate Oversight Board would permit reasonable certainty in the planning and execution of its supervisory remit".

18.22 As pointed out in Chapter 17, the Coordinating Committee of the South African National Accounting Forum has drafted a new 'Accountancy Profession Bill' 2001. Unfortunately, when drafting the Bill no attention seems to have been paid to

– the increasing distrust of the auditing profession by the public;

– the necessity for independent regulation;

– the developments in jurisdictions such as the United States, the United Kingdom and Ireland.

18.23 Any semblance of independence in the proposed Bill amounts to little more than window-dressing. It is a pity that the profession was not prepared voluntarily to entertain the concept of a truly independent oversight body, not only in the public interest but also in the interest of its members.

Time has not stood still but the profession still clings to the outmoded and outdated model of self-regulation which is perceived by the public, by regulators and even by governments as nothing more than self-interest.

This is not acceptable in a profession which has been created for the protection of investors and whose integrity is so vital to the wellbeing of the economy.

18.24 It is recommended that an independent Public Oversight Body be created for the auditing and accounting professions with all such powers as would be necessary to regulate and oversee their activities.

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