

EBRD

Legal Indicator Survey 2007

How Securities Market Legislation works in the EBRD region?

1. Case Study

A bank established in your country underwrote shares of a well known national company in its IPO.¹

The prospectus included audited annual accounts provided by the issuer to the underwriter, but the consolidated financial statements included in the prospectus omitted to count for substantial debts of the affiliated companies of the holding. This omission was due to a mistake in the consolidated financial statements of the issuer's holding.

Shortly after the issue, international newspapers published negative information about the holding, the mistake was revealed and the shares' prices plummeted.

Your client bought shares of the national company during the IPO from the underwriter. He comes to you and asks advice on what can be done to recover the losses.

Please advise your client accordingly.

* * *

*This case study presents a hypothetical scenario. Based on your expertise and the country framework and practice, **please write a short memo (2 pages maximum)** on what your client can do in order to recover the losses also providing him with all necessary information on how to proceed.*

For the sake of comparison with other countries the following information should be included:

- *indication of the party/ies which are more likely to be held responsible for the suffered damage and why;*
- *possible legal action(s) to be taken to recover damages, indicating which one is the most likely to be successful and why. Please also advise on whether referring the case to public authorities (i.e., securities commission, prosecutor etc.) might be helpful to the case or not and why;*
- *assuming the solvency of the responsible party(ies), please also indicate the chances of getting compensation for damages and estimation on how much the Client is likely to be able to recover taking into consideration the action(s) chosen, the country situation, the execution procedure etc. (please suppose that the resulting damage for the Client is 1,000,000 Euro). Please also advise the Client on what needs to be done in order to be sure that the defendant remains in funds and does not hide all its assets before the judgement;*
- *estimate of legal and administrative costs for the action(s)(including execution);*
- *estimate length of the action(s) (including eventual appeal and execution).*

* * *

¹ IPO: Initial Public Offering: An issue of new stock by a once private company to transform itself into a publicly held one. IPOs are usually done to raise cash for growing young companies that need larger sources of capital than the private sector can provide. The new shares are sold to one or more investment banks, which then sell them to the public.

2. Questionnaire

This questionnaire is related to the case study described above, but also includes additional questions as to understand how the securities markets framework works in practice.

*Questions may require both a grade from 0 to 10 (this is indicated with the following mark:[...]) and narrative answers. Please provide both where requested. **Answers need to be given taking into consideration the practice and how the law works in practice and not only stating what the law provides.** Answers should also provide a reference to applicable provisions. Please answer ALL questions, also providing comments and clarifications that you think are necessary for a better understanding of the scenario.*

This case study and questionnaire should be completed by a (senior) lawyer (or a team of lawyers) with experience in litigation and financial markets regulation and practices.

1. PRELIMINARY QUESTIONS

- 1.1. In your experience have you ever dealt or heard of a similar scenario in your country? What would be a possible scenario for securities fraud in your country and why? Any large securities frauds happened in the recent past? If yes, what remedies have been put in place to avoid it in the future? Please explain.

- 1.2. Which are the institutions in charge for the supervision during an IPO of the issuer (i.e. a joint stock company registered in your country, being affiliated to an international holding) and the underwriter (i.e. a Bank registered in your country) and of the auditor. Do you think that supervision is generally effective? [please also grade it from 0= not effective; to 10 = very effective] Please explain

[...]

- 1.3. Are IPOs and “proper underwriting in IPOs” (i.e., the underwriter takes full ownership and pricing risk) a common practice in your country?

2. DISCLOSURE AND LIABILITY

I. PROSPECTUS

Provided that the applicable legislation requires a prospectus to be drafted, please answer the following questions. (If the law does not require a prospectus being prepared for an IPO, please tick this box and provide information on other mechanisms (if any) for informing investors)

- 2.1.1. a. Does the prospectus (or its summary note) need to be handed to retail investors (please refer to the practice and not to the letter of the law and specify if this is an obligation by the issuer, the underwriter or both) or merely deposited at the Regulator or the Stock Exchange? Are there any control and sanctions for breach? Would you consider the control and sanctioning mechanisms effective? [please also grade it from 0= not effective; to 10 = very effective]
- b. Do you think that the role and capacity of the regulator in assessing the prospectus and supervising the procedure is adequate and effective? [please also grade it from 0= not effective; to 10 = very effective] In your opinion what needs to be done to improve the situation? Please explain.
- c. Is the prospectus generally accessible on-line by investors? What is the common practice in this respect?

a. [...]

b. [...]

c.

- 2.1.2. In your experience, do you think that the prospectus is an effective tool for retail investors to identify risks and obtain information on the proposed investment? [please also grade it from 0= not effective; to 10 = very effective] What are the major advantages and shortcomings (please refer to your country practice)? Please explain.

[...]

- 2.1.3. Would you consider information contained in the prospectus reliable? [please take the information listed in the next chapters as example, and also grade it from 0= completely unreliable; to 10 = absolutely reliable]. Please explain.

[...]

- 2.1.4. Are there any rating agency active in your country? Do they contribute to provide investors with valuable information?

II. COMPENSATION OF DIRECTORS/KEY OFFICERS²

- 2.2. Is compensation to directors/key officers likely to be easily found in the prospectus? What is the practice? Please specify whether (i) the compensation of each director/key officer must be reported in the prospectus; or (ii) only the aggregate compensation of directors/key officers must be reported in the prospectus; or (iii) there is no requirement to disclose the compensation of directors/key officers in the prospectus. Please explain

III. ISSUER'S EQUITY OWNERSHIP STRUCTURE³

- 2.3. Is the name and ownership stake of each shareholder who directly or indirectly, owns more than 10% of the issuer's voting share usually disclosed in the prospectus and easily found (i.e., in a separate section/chapter)? What is the practice? Please specify whether (i) the law or the listing rules require disclosing the name and ownership stake of each shareholder who, directly or indirectly, controls 10% or more of the issuer's voting securities; or (ii) reporting requirements for the issuer's 10% shareholders do not include indirect ownership; or (iii) only their aggregate ownership needs to be disclosed; or (iv) the law does not require disclosing the name and ownership stake of the Issuer's 10% shareholders. What is the common practice in this respect?

What about in case of foreign shareholding (i.e., is the beneficial ownership⁴ normally disclosed)? Are DR⁵ common in your country? What is the practice of disclosing information on beneficial ownership?

IV. INSIDE OWNERSHIP⁶

- 2.4.1. Is information on the shares held by directors/key officers disclosed in the prospectus in a separate section/chapter? What is the practice? Please specify whether (i) the law or the listing rules require that the ownership of the issuer's shares by each of its director/key officers be disclosed in the prospectus; or (ii) only the aggregate number of the issuer's shares owned by its directors/key officers must be disclosed in the prospectus; or (iii) the ownership of the issuer's shares by its directors/key officers need not be disclosed in the prospectus. Please explain.

- 2.4.2. Would you consider insider trading a risk in your country? Please explain why. Any insider trade cases prosecuted in your country? Any convictions?

² The term "Directors/Key officers", throughout this questionnaire, includes (a) the company's directors, (b) members of its administrative, supervisory or management bodies, and (c) nominees to serve in any of the aforementioned positions.

³ When answering this question, please consider that in some jurisdictions, it is quite easy to hide the beneficial shareholding by creating scheme of foreign companies. Please elaborate if this is valid also in your country.

⁴ The term "beneficial owner" of securities refers to any person who, even if not the record owner of the securities, has or shares the underlying benefits of ownership. These benefits include the power to direct the voting or the disposition of the securities or to receive the economic benefit of ownership of the securities.

⁵ DR: Depositary Receipts: A security issued by a depositary bank which represents shares of a foreign corporation held by the bank. Because DRs are quoted in foreign currency and trade just like any other stock, they make it simple for investors to diversify their holdings internationally.

⁶ Please see note no. 3 above.

V. IRREGULAR CONTRACTS

- 2.5. Are the terms of material contracts made by the issuer outside the ordinary course of business disclosed in the prospectus and easy to find (e.g., in a separate section/chapter)? Please specify whether (i) all material contracts made by the issuer outside the ordinary course of its business must be disclosed in the prospectus; or (ii) only some material contracts made outside the ordinary course of business must be disclosed; or (iii) material contracts made by the issuer outside the ordinary course of its business do not need to be disclosed. Do these transactions need to be previously disclosed to shareholders, voted and registered in the company's financial documentation? What is the practice?

VI. RELATED PARTY TRANSACTIONS⁷

- 2.6. Are transactions in which related parties have an interest⁸, disclosed in the prospectus and easy to find (e.g., in a separate section/chapter)? Please specify whether (i) the law or the listing rules require that all transactions in which related parties have, or will have, an interest be disclosed in the prospectus; or (ii) only some transactions between the issuer and related parties must be disclosed in the prospectus; or (iii) transactions between the issuer and related parties need not be disclosed in the prospectus.

VII. INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

- 2.7. Does the prospectus include a section on the operational and financial situation of the company drawn according to IFRS or other international standards (please refer to the common practice)? Are national standards fully compliant with international standards? Please explain.

⁷ In 2005, the EBRD dedicated the LIS to related party transactions. Please read more on this on:
<http://www.ebrd.com/country/sector/law/corpgov/lis/index.htm>

⁸ Generally, transactions between the issuer and its directors, officers, and/or large shareholders are considered related party transactions. Related party transactions are also considered transactions or loans between the company and (a) enterprises that directly or indirectly through one or more intermediaries, control or are controlled by, or are under common control with, the company; (b) associates; (c) individuals owning, directly or indirectly, an interest in the voting power of the company that gives them significant influence over the company, and close members of any such individual's family; (d) key management personnel, that is, those persons having authority and responsibility for planning, directing and controlling the activities of the company, including directors and senior management of companies and close members of such individuals' families; and (e) enterprises in which a substantial interest in the voting power is owned, directly or indirectly, by any person described in (c) or (d) or over which such a person is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the company and enterprises that have a member of key management in common with the company. Close members of an individual's family are those that may be expected to influence, or be influenced by, that person in their dealings with the company. An associate is an unconsolidated enterprise in which the company has a significant influence or which has significant influence over the company. Significant influence over an enterprise is the power to participate in the financial and operating policy decisions of the enterprise but is less than control over those policies. Shareholders beneficially owning a 10% interest in the voting power of the company are presumed to have a significant influence on the company.

3. **LIABILITY STANDARDS**

I. ISSUERS AND DIRECTORS

In case of a liability case against the ISSUER or its DIRECTORS, please advise on what are the circumstances which must be proven by the plaintiff.

- 3.1. Please specify on whether the plaintiffs:
- (i) are only required to prove that the prospectus contains a misleading statement; or
 - (ii) must also prove that they relied on the prospectus and/or that their loss was caused by the misleading statement; or
 - (iii) must also prove that the issuer/director acted with negligence; or
 - (iv) restitution from issuer/director is either unavailable or the liability standard is intent or gross negligence.

II. DISTRIBUTOR/SPONSOR/UNDERWRITER

In case of a liability case against the DISTRIBUTOR/SPONSOR/UNDERWRITER, please advise on what are the circumstances which must be proven by the plaintiff.

- 3.2. Please specify on whether the plaintiffs:
- (i) are only required to prove that the prospectus contains a misleading statement; or
 - (ii) must also prove that they relied on the prospectus and/or that their loss was caused by the misleading statement; or
 - (iii) must also prove that the distributor/sponsor/underwriter acted with negligence; or
 - (iv) restitution from distributor/sponsor/underwriter is either unavailable or the liability standard is intent or gross negligence.

III. ACCOUNTANT/AUDITOR

In case of a liability case against the ACCOUNTANT/AUDITOR, please advise on what are the circumstances which must be proven by the plaintiff.

- 3.3. Please specify on whether the plaintiffs:
- (i) are only required to prove that the audited financial information accompanying the prospectus contains a misleading statement; or
 - (ii) must also prove that they relied on the prospectus and/or that their loss was caused by the misleading statement; or
 - (iii) must also prove that the accountant/auditor acted with negligence; or
 - (iv) restitution from accountant/auditor is either unavailable or the liability standard is intent or gross negligence.

4. MARKET REGULATOR

This section aims to assess the characteristics of the Regulator, in particular, concerning its Independence, Rule Making Powers, Investigative Powers and Sanctioning Powers.

I. INDEPENDENCE OF THE REGULATOR

- 4.1. STRUCTURE Did the regulator reform its structure in the last five years? If yes, please explain what the main rationale for the reform was. According to you has the competence, experience and capacity of the regulator improved and the supervision become more (or less) effective after the reform?

- 4.1.2. BUDGET Is the budget allocated each year to the regulator, publicly disclosed? If yes, what was the budget for 2006? Is there any division and specific allocation to the supervision department? (in case of consolidated supervision (i.e., the regulator is also in charge of others sectors as banking, insurance, pension funds etc), please advise whether the share allocated to the securities market supervisor is publicly available). Is the regulator's budget drawn from the state budget or from the market? Would you consider it as an appropriate method to fund the regulator?

- 4.1.3. HUMAN RESOURCES What is the total workforce of the regulator? How many officers in the supervision department? In case of consolidated supervision (i.e., the regulator is also in charge of others sectors as banking, insurance, pension funds etc) please indicate the staff dedicated to the securities market).

- 4.1.4. INDEPENDENCE Would you consider the regulator able to act independently (i.e. free from political or economic pressure) in your country? Does the system guarantee the regulator's independence? Do you think that the regulator has enough resources (financial and human) to perform its duties? Do regulator officers need to disclose the source of their income and any conflict of interest (is there a Code of Ethics or similar in place)? Is such disclosure effective to guarantee independence? Please explain.

II. RULE MAKING POWERS OF THE REGULATORS

- 4.2.1. Can the Regulator autonomously issue and enforce binding legal acts (including sanctions)? Is this practice well implemented and effective? [0= not effective; 10 = very effective]. Is the resulting framework coherent and workable? Please explain

[...]

III. INVESTIGATIVE POWERS

- 4.3.1. a. Is the regulator in charge for protecting investors? Is this practice well implemented and effective? [0= not effective; 10 = very effective].
b. Can investors directly petition the regulator? Does the regulator have the capacity and competence to receive and investigate claims (i.e. on-line; dedicated office or telephone line etc.)? Is the practice experimented and well working?
c. Would you consider the regulator able to properly investigate a breach of securities law involving an international component? [0= completely unable; 10 = very effectively able]. Please explain.

a. [...]

b.

c. [...]

- 4.3.2 a. Can the regulator issue administrative order commanding all persons (and not only directors of supervised entities) to turn over documents? Have you ever heard of this practice being implemented?
b. Can the regulator subpoena all persons (and not only directors of supervised entities) to give testimony? Have you ever heard of this practice being implemented?

- 4.3.3. Would you rely on public enforcement authorities to do all preliminary investigations before starting your liability case?⁹ Would you ask the regulator to provide evidence in a liability case or intervene in the case to support the thesis of the plaintiff/defendant? What is the practice?

⁹ Recent legal scholarship has focused on the fact that private litigants in the United States often rely on public enforcement authorities doing the preliminary legal spadework that makes plaintiffs' lawsuits more likely to succeed. Further it has been shown those private lawsuits are much more likely to be brought in the US when the SEC initiates its own parallel enforcement proceedings.

IV. SANCTIONS

ADMINISTRATIVE ORDERS

This section addresses the “stop and do” orders that can be addressed by the Regulators to the issuer, underwriter and accountant.

- 4.4.1. Based on your expertise, please comment on the effectiveness of the possible actions that the regulator can order the ISSUER to do and to refrain in case of a defective prospectus.**

Please specify whether the issuer can be ordered to (i) refrain from a broad or range of actions; or (ii) only be ordered to desist from limited actions; and whether the issuer can be ordered to (iii) perform a broad range of actions to rectify the violation; or (iv) may only be ordered to perform limited actions.

Do you think that these actions (and the sanctions provided) are appropriate and allow the regulator to effectively deal with the situation? [0= not effective/appropriate; 10 = very effective/appropriate]. Please explain, possibly referring to concrete examples.

[...]

- 4.4.2 Based on your expertise, please briefly comment on the effectiveness of the actions that the Regulator can order the UNDERWRITER to do and refrain in case of a defective prospectus.**

Please specify whether the underwriter (i) may be ordered to refrain from a broad range of actions; or (ii) may only be ordered to desist from limited actions; and whether the underwriter (iii) may be ordered to perform a broad range of actions to rectify the violation; or (iv) may only be ordered to perform limited actions.

Do you think that these actions (and the sanctions provided) are appropriate and allow the regulator to effectively deal with the situation? [0= not effective/appropriate; 10 = very effective/appropriate]. Please explain, possibly referring to concrete examples.

[...]

- 4.4.3 Based on your expertise, please briefly comment on the effectiveness of the actions that the Regulator can order the AUDITOR/ACCOUNTANT to perform and refrain in case of a defective prospectus.**

Please specify whether the auditor/accountant (i) may be ordered to refrain from a broad range of actions; or (ii) may only be ordered to desist from limited actions; and whether the auditor/accountant (iii) may be ordered to perform a broad range of actions to rectify the violation; or (iv) may only be ordered to perform limited actions.

Do you think that these actions (and the sanctions provided) are appropriate and allow the regulator to effectively deal with the situation? [0= not effective/appropriate; 10 = very effective/appropriate] Please explain, possibly referring to concrete examples.

[...]

CRIMINAL SANCTIONS

This section addresses the criminal sanctions applicable to directors/key officers/auditors when the prospectus omits material information.

4.4.4 Can directors/key officers (please distinguish in case the provisions on directors and key officers are different) of the issuer be criminally charged in case the prospectus is misleading? Please specify whether (i) directors/key officers cannot be held criminally liable when the prospectus is misleading; or (ii) directors/key officers can be held criminally liable when aware that the prospectus is misleading; or (iii) directors/key officers can also be held criminally liable when negligently unaware that the prospectus is misleading.

4.4.5 Can the distributor (or its officers/directors) be criminally charged in case the prospectus omits material information? Please specify whether (i) the distributor (or its officers/directors) cannot be held criminally liable when the prospectus is misleading or (ii) the distributor (or its officers/directors) can be held criminally liable when aware that the prospectus is misleading; or (iii) the distributor (or its officers/directors) can also be held criminally liable when negligently unaware that the prospectus is misleading

4.4.6 Can the accountant/auditor (or its officers/directors) be criminally charged in case the financial statements accompanying the prospectus are misleading? Please specify whether (i) the accountant/auditor (or its officers/directors) cannot be held criminally liable when the financial statements accompanying the prospectus are misleading; or (ii) the accountant/auditor (or its officers/directors) can be held criminally liable when aware that the financial statements accompanying the prospectus are misleading; or (iii) the accountant/auditor (or its officers/directors) can also be held criminally liable when negligently unaware that the financial statements accompanying the prospectus are misleading.

4.4.7 Can the regulator initiate criminal proceedings or must defer the case to the prosecutor? What is the capacity and experience of the prosecutor in investigating and pursuing a securities fraud in a national and international context? [0= not effective prosecution; 10 = very effective prosecution]

5. STOCK EXCHANGE

Please provide the following information on the stock exchange(s) in your country:

How many active/inactive stock exchanges are present in your country? (please specify if they are dealing with equity/bonds/ State Debt etc). Any OTC¹⁰ market active in your country?

Is the price fixing mechanism for equities set in a transparent way? Is the price of listed equities and the quantity traded clearly available in real time (e.g., electronic displays at the stock exchange, internet web-site) during trading hours? Can retail investors trade equity on-line in your country? (please specify if this can be done through a bank/investment firm website or with a link directly to the stock exchange/OTC)

**How many IPOs in the last 12 months? 24 month? What was the value of these IPOs?
How many company listed on the stock exchange at end of 2006?
How many transactions a day (equity only – average 2006)?
Any national company listed (or having issued depository receipts listed) abroad?**

[if available, please provide information on the last 5 years]

Thank you!

¹⁰ OTC: Over-the-Counter: A market for securities made up of dealers who may or may not be members of a securities exchange. OTC firms conduct business over the telephone and act either as principals or dealers (buying and selling stock from their own inventory and charging a markup) or as a broker or agent and charging a commission.