Protecting the Investor in a Public Company A Comparative View

> Sunlight is said to be the best of disinfectants,
> electric light the most efficient policeman.
> Brandeis, *Other People's Money*[1]

I. Introduction

Over sixty years ago and many years ahead of his time, United States Supreme Court Justice Louis Brandeis propounded his theories in his book, *Other People's Money.* The period which he spoke of then exists now. Today, vast fortunes are entrusted to corporations and managed by corporate directors. This phenomenon has a number of important ramifications: the first being that the centre of financial and economic power is shifting. Private accumulations of wealth are fast disappearing into the hands of incorporated bodies. This stems from the proliferation of corporations and the enlarged scope of their activities, as well as from the heavy duties and taxes imposed on capital and its transfer, on income, and on estates. Secondly, the increased sphere of corporate activity has widened the gap between the shareholders who own the company and the directors who manage it. Thirdly, widespread international transactions and the need to command large sums of money have prompted companies to turn to the public for necessary financing. The publicly-owned corporation is thus today characterized by great concentrations of capital representing thousands of investors, with the result that the interest of any one investor is very small and there is no direct supervision of directors by interested shareholders. Ultimately it is the duty of the government to protect such investors. Finally, these developments have bred a new generation of professional directors who own either no shares in the company or a very small percentage only. Their goals need not always coincide with those of the company and its shareholders; they may be personally motivated and consequently engage in prestigious transactions, or even hide unlawful or unsuccessful activities.

In these circumstances, how can the public be protected against the exploitation of its good faith? The right to raise money from the public is a privilege which the state grants to specific bodies. So long as securities are held by the public, the state must therefore supervise these bodies, both at the stage of raising the money as

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[1] (1914), ch.15.

well as during later periods. Those who wish to make use of the public's money should inform the public at large of all the material facts needed for the formation of intelligent investment decisions.

Nevertheless, most countries have refrained from direct control over the capital market, for fear that it might crumble under supervision. The United States was the first nation to activate government control as part of President Roosevelt's New Deal policies, following the economic crisis of 1929.[2] Canada was influenced by American policies and legislation in this regard and, following the 1965 Report of the Attorney General's Committee of Securities Legislation in Ontario,[3] the various provinces adopted securities statutes similar to the American legislation.[4] Ontario implemented the proposals of the *Kimber Report* almost in their entiretv in *The Securities Act* of 1966.[5] Substantially uniform statutes have since been adopted in most of the other provinces.[6]

Israel also followed the American example. In 1963, the Yadin Commission[7] recommended changes in methods of regulatory control, and, five years later, a system of government control over the floatation of securities was enacted by the Israeli Parliament: The Israel Securities Law, 1968.[8] The new Israeli securities law was transplanted into a system of company law which is essentially copied from the English *Companies Act, 1929*.[9] The only material

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2 The *Securities Act of 1933*, 15 U.S.C. §77a *et seq.* (1976) and the *Securities Exchange Act of 1934*, 15 U.S.C. §77b *et seq.* (1976). The various States have their own laws. See Loss and Cowett, *Blue Sky Law* (1958).

3 Hereinafter referred to as the *Kimber Report* (1965).

4 For discussion of securities regulations in Canada, see: Williamson, *Securities Regulation in Canada* (1960) and *Supplement* (1966); Bray, "Recent Development in Securities Administration in Ontario" in Ziegel (ed.), *Studies in Canadian Company Law* (1967), vol.1, ch.14; (1973), vol.2, ch.8.

5 R.S.O. 1970, c.426, as am. by S.O. 1971, cc.1, 31; and S.O. 1973, c.11. The current securities legislation has just undergone revision before the Ontario Legislature. *The Securities Act*, 1978, Bill 7, (1978), 2d Sess., 31st Leg. (Ont.) was introduced on Feb. 28, 1978 and passed through third reading on June 23, 1978. Numerous areas in the Act have been altered to ensure increased investor protection. The most important changes include increased requirements for detailed rules concerning take-over bids, timely disclosure of material information and a new pattern of exemptions from prospectus filing requirements.

6 See, *e.g.*, R.S.A. 1970, c.333; R.S.B.C. 1967, c.45; R.S.M. 1970, c.S-50; R.S.N.S. 1967, c.280; R.S.Q. 1964, c.274 as am. by S.Q. 1966-67, c.82; S.Q. 1971, c.77; S.Q. 1973, c.67.

7 The Committee on Floatation of Securities, appointed on March 14, 1962.

8 *Sefer Ha-Chukkim* No.541 (1968), 234.

9 *Companies Act, 1929*, 19 & 20 Geo. V, c.23.

change in this law over a period of fifty years has been the new law on securities.[10] Thus the Israeli experiment, as the first of its kind outside North America and Japan,[11] constitutes an interesting example for the understanding and application of a new, modern approach to the securities market.

Even in England there are those who favour abandoning the existing system and establishing greater government control over publicly held corporations. Professor Gower states that it is now widely acknowledged that continued reliance on private agencies will not suffice:

> The trouble is that Queensberry rules not subject to legal sanctions are inadequate to preserve a code of conduct, at any rate in the heat of a take-over battle. No rules for disclosure, however all-embracing, no City code, however clearly drafted, and no Panel, however prestigious, can really be an adequate substitute for a single authority with statutory powers over the whole field of securities regulation.[12]

He concludes:

> What seems to be needed is a statutory body — a smaller (poor man's) S.E.C. ... and which would be provided with a staff adequate to lay down rules and to police them, and be armed with powers to co-ordinate and supervise the activities of the private agencies.[13]

II. Participation of the public in corporate capitalization and the importance of suitable legislation

A. *The importance of the capital market to the economy*

Today, problems of public financing are of primary concern in modern economics on both the national and international levels. The trend which characterizes the capital market in the Western world is toward multiplication of companies seeking capital from the public, on the one hand, and an increase in the number of investors prepared to invest in such companies, on the other. The opportunity to raise money from a large segment of the population, by means of companies with limited liability has created important sources for financing company activities. This point was rightly

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[10] *Sefer Ha-Chukkim* No.541 (1968), 234.

[11] Japan enacted the *Securities Exchange Law* of 1948 which is modelled on the U.S. securities acts of 1933 and 1934, 15 U.S.C. §77a *et seq.* (1976), 15 U.S.C. §77b *et seq.* (1976).

[12] Gower, *Principles of Modern Company Law* 3d ed. (1969), 310. See also the Green paper published by the U.K. Labour Party on *The Community and the Company* (1974), 19, para.4: "We do not believe that, left to its own devices, the Stock Exchange can operate effectively and fairly".

[13] *Ibid.*

stressed in the Command Paper on Company Law Reform presented to the English Parliament:

> In this free enterprise system, it is the limited liability company that provides the framework through which the savings of individual citizens are channelled both directly, and indirectly through institutions such as pension funds and banks, into the industry and commerce of the country. It enables capital to be accumulated and invested in risk-taking enterprises, which create economic expansion, provide jobs and produce goods and services.[14]

The "Securities Industry" has become a sign of modern economy in capitalist countries. Execution of giant projects in industry and commerce would be impossible but for the ability of large companies to raise sums of capital from a multitude of investors. The creation of the corporation as a device for the large-scale raising of public funds, the investors being guarded against personal liability, is the largest and most ingenious contribution of law to the world of economics.

B. *The importance of the capital market to the investor*

The existence of a central market for securities, mainly through the stock exchange or over-the-counter market, assures regular two-way traffic between buyers and sellers, and thus attracts investors. The investor is able to go from one investment to another speedily and with minimal costs. From the point of view of liquidity there is no investment like traded-securities, for on any given business day the investor may materialize his investment, in whole or in part, and receive its value in cash, subject to certain limitations which exist in every stock exchange.

The securities quoted daily in the newspapers enable the investor to keep track of the value of his investments and furnish up-to-date information to guide him. There are, in addition, periodic and immediate reports which, by providing information on companies issuing securities, allow the investor to examine the desirability of acquiring or selling securities.

It is in the interest of every state and every stock exchange to preserve rules of proper business conduct for securities transactions. Thus, even a person lacking expertise in financial matters may join the large investing public without it being necessary for him to examine independently the financial situation of the company in which he is investing. The exposure of companies to public scrutiny, through the duty of disclosure in prospectuses and reports, and

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[14] Cmnd no.5391 (1973), 5.

the comparison between the publicly-traded securities of various companies of the same type, tend to cause proper pricing and to discourage companies without a sound economic base from turning to the public.

C. *Considerations in protecting the investor*

As the circle of investors broadens, and additional capital from hundreds of thousands of investors streams into the securities market, the demand for investor protection and the need for cautious, precise reports on company activities increases. The object of all securities legislation is to create confidence, and therefore the main point in securities legislation must revolve around the protection of the investor.[15] The machinery to provide full information to the investor and the creation of a marketplace free of manipulation are the immediate objectives of the legislation and its administration.[16]

The fear does exist, however, that emphasis on the principle of investor protection may hamper the company's business and, in so doing, eventually damage the shareholder too. For example, detailed reports are necessary to help the investors make intelligent choices, but total disclosure to all may reveal the company's business secrets, hinder its transactions and thus place it in a position inferior to its competitors. However, these two aspects need not always conflict.

The securities market relies upon public confidence and this confidence, in turn, is based upon information as to the financial status of the company. As confidence grows, the public increases its investments and the company profits. This consideration holds true both as regards the primary market for new capital to finance new economic activity and the secondary market for resale and revaluation of outstanding securities. Although the two markets fulfil separate and distinct functions, if there were no reliable information and continuous reports in the trading market, the public would cease to place its confidence in it and thus the primary market would be adversely affected.

To the extent that the legislation emphasizes the principle of "protecting the investor", public confidence in the securities market increases and is strengthened. As was stated in the *Kimber Report*, "[o]nly through public confidence in the institutions of both

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[15] This, in turn, facilitates the flow of capital to all areas of the economy.
[16] See Bray, *supra*, note 4.

markets will capital be readily raised to finance the vital economic developments of the nation".[17]

III. Basic principles in supervision of the capital market

The quality of securities offered to the public depends upon the financial strength of the issuing company. The investor receives a proprietary certificate which bears no relation to the company's financial condition. The company, its directors and promoters, have all the pertinent information; they have the opportunity to clarify and verify all relevant facts which may shed light on the company's financial status. It is only fair to require the company and its directors to disclose this information to the public, to whom the securities are being offered.

Thus, the concept underlying all modern securities legislation is full disclosure by the company, so that the future investor may be furnished with all relevant facts when considering whether or not to invest in the securities offered. In bringing the *Securities Act of 1933*[18] before the United States Congress for approval, President Roosevelt said:

> There is ... an obligation upon us to insist that every issue of new securities ... shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
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> This proposal adds to the ancient rule of *caveat emptor*, the further doctrine, "let the seller also beware". It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.[19]

This view has been adopted as the basic rule of the securities market. The famous Special Study of Securities Markets in the United States headed by Milton Cohen stated that "the keystone of the entire structure of Federal securities legislation is disclosure".[20] Recently, the *Wheat Report* again stressed this point by saying that "disclosure is and has from the outset been a central aspect of national policy in the field of securities regulation".[21]

Thus the purpose of the disclosure system is to provide an equality of opportunity for all investors in the market place, sellers

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[17] *Supra*, note 3, para. 1.12.

[18] 15 U.S.C. §77a *et seq.*

[19] Federal Supervision of Traffic in Investment Securities in Interstate Commerce, H.R. Rep. No.85, 73d Cong., 1st Sess. 2 (1933).

[20] Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No.95, 88th Cong., 1st Sess. 1 (1963), part 3.

[21] Report of the Disclosure Policy to the Securities and Exchange Commission (1969), 10.

as well as buyers. The object is to make available on a timely basis all material facts the investor requires in order to make an informed investment judgment.[22]

A. *Disclosure without intervention: the classic approach (the United Kingdom)*

Can we be satisfied with proper disclosure, or must we create some supervisory institution to verify a full disclosure? The basic principle of English company law is that disclosure and publication are the best guarantees. This principle was first enunciated in the Report of the Select Committee on Joint Stock Companies in England, chaired by Gladstone[23] (who served then as President of the Board of Trade) and was expressed by the duty to publish a prospectus. It was the Committee's opinion that there should be no limitation on public offerings of securities. Full and exact disclosure of the nature of the offer and the company should be attached in a document known today as a prospectus, which must include details that enable the potential investor to reach a decision.[24] It was not, however, until 1867 that an English statute set forth the requirements and contents of the prospectus in detail.[25]

The *Companies Act, 1900*[26] abolished these requirements as to the prospectus and replaced them with a more broadly detailed list of the contents of the prospectus. The statute of 1900 was enacted in the wake of the report of the 1895 Commission headed by Lord Davey.[27] This report is especially interesting for its approach to the duty of detailing and disclosure in the prospectus. Addressing itself to the controversy over whether the state should be satisfied

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[22] Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure raised for Investors by Business Combinations and Private Placements (1970), 15. (*Merger Report,* Dept. of Financial and Commercial Affairs.)

[23] 1844, B.P.P., vol.7, 5. This was the first in a series of reports on company law. In addressing Parliament on the Report, Gladstone said: "The most wholesome remedy for a public evil is that of giving a power of public opinion" (1844) 63 Parl.Deb. 1755.

[24] *An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies,* 7 & 8 Vict., c.110 (U.K.), enacted on the recommendations of the Committee, first established the requirement of registration of the prospectus prior to issuance of securities to the public.

[25] *The Companies Act, 1867,* 30 & 31 Vict., c.131, s.38 (U.K.). On this subject see Hunt, *The Development of the Business Corporation in England, 1800-1867* (1936).

[26] 63 & 64 Vict., c.48, ss.9-11 (U.K.).

[27] Cd. no 7779, para.42 (1895).

with disclosure alone or whether it should investigate, regulate and intervene in the contents of the prospectus, the committee concluded that:

> [I]t would be an attempt to throw what ought to be the responsibility of the individual on the shoulders of the State, and would give a fictitious and unreal sense of security to the investor and might also lead to grave abuses.[28]

The statutory provisions of 1900 on questions of disclosure were reinforced by a series of subsequent committees[29] following which Parliament enacted the statutes of 1908, 1928, 1947 and 1967.[30] Running through this English legislation is the notion that the best protection is to make available to the public the information necessary to allow it to determine for itself, in every case, the quality of the securities offered.

Just about a century after the Gladstone Committee Report, the concept was again expressed, as devoutly as ever, by the Cohen Committee:

> [T]he fullest practical disclosure of information concerning the activities of companies will lessen such opportunities [of abuses] and accord with a wakening social consciousness.[31]

The new White Paper presented to the English Parliament in July 1973 repeated the basic principle:

> Disclosure of information is an essential part of the working of a free and fair economic system. ... The more people can see what is actually happening, the less likely they are to harbour general suspicions — and the less opportunity there is for concealing improper or even criminal activities. Openness in company affairs is the first principle in securing responsible behaviour.[32]

Today, publication and registration of the prospectus with the Companies' Registrar is required by law. But, the Registrar has no power to refuse registration of a prospectus which meets the formal

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[28] *Ibid.*

[29] This conservative view was never changed by the Labour Party when it came into power. It was, in fact, the Labour Party which, in 1948, adopted the majority of the recommendations of the Cohen Committee which had been appointed by Winston Churchill. It was Wilson's Labour Government which adopted the Report of the Jenkins Committee (although appointed by a Conservative Government).

[30] See the *Companies (Consolidation) Act, 1908*, 8 Ed. VII, c.69; the *Companies Act, 1928*, 18 & 19 Geo. V, c.45; the *Companies Act, 1947*, 10 & 11 Geo. VI, c.47; the *Companies Act, 1967*, 1967, c.81 (U.K.).

[31] Report of the Committee on Company Law Amendment, Cmd. no.6659 (1945), 7, para.5.

[32] *Supra*, note 14, 7, para.10.

requirements of the statute.[33] Legislators in England, Israel and other common law countries, have not granted the Companies' Registrar any power to examine the various details of the prospectus or the authenticity of its contents; they have contented themselves with the imposition of civil and criminal sanctions for furnishing fraudulent information in the prospectus.

B. *Is disclosure enough? (the American approach)*

Whereas England persists in its liberal tradition and leaves supervision over issuance of securities in private hands (the issuing houses and the stock exchange, for example), the economic crisis which ravaged the United States in 1929 provoked a departure from the British approach and the development of a system of greater regulation over the issuance of securities to the public at both the federal and state levels. As was later explained in one of the cases:

> Because judicial remedies could only be invoked after the harm had been done, and because there were so many procedural difficulties in the way, the net result of what the courts ... accomplished has been disappointing. Nowhere is there better proof of the adage that an ounce of prevention is worth a pound of cure.[34]

1. Securities legislation on the state level

State regulatory statutes, popularly known as "The Blue Sky Laws",[35] preceded the federal *Securities Act of 1933*.[36] The United States Congress preferred to preserve state laws rather than to exhaust the federal government's regulatory powers.[37] The chaotic state of the securities market and the floatation of worthless securities prompted the various states to enact special legislation to protect the public against fraud by promoters of companies and by

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[33] *Cf. Reuss (Princess of)* v. *Bos* (1871) L.R. 5 H.L. 176, 192; *Rex* v. *Registrar of Companies* [1914] 3 K.B. 1161. When, in 1925, the English Companies' Registrar appeared before the Green Committee to Amend the Companies Law, he was asked whether it would not be proper to enlarge his authority with regard to the prospectus. He refused the offer, saying: "We are not judicial functionaries". (Cmd. no.2657, 99 (1926)).

[34] See *Jeffs* v. *Utah Power & Light Co.* 136 Me 454, 12 A.2d 592, 595 (1940).

[35] To protect the investors against companies who "have no backing for their securities except water or blue sky", *Hall* v. *Geiger-Jones Co.* 242 U.S. 539, 550 (1917).

[36] 15 U.S.C. §77a *et seq.* (1976).

[37] Loss, *Securities Regulation* 2d ed. (1961), vol.1, 30 *et seq.;* MacChesney, *Further Development in "Disclosure" under the Securities Act* (1938) 33 Ill.L.Rev. 145; Loss, *The Conflict of Laws and the Blue Sky Laws* (1951) 71 Harv.L.Rev. 209. For a comprehensive bibliography of Blue Sky Laws, see Loss and Cowett, *supra*, note 2, app.4.

those who issue securities.[38] During the 1920's there had been no statute protecting the public, and the artificial remedies created by judges who tried to prevent the perpetration of fraud on the public were fruitless attempts, closing the barn door after the horse was gone.

2. Federal securities legislation

It was the hard blow suffered by New York with the outbreak of economic crisis in October 1929 and the great losses encountered by the shareholding public that drove home to the Federal Government the positive need for comprehensive legislation to regulate and control interstate trading in securities. The legislation had three basic purposes: to furnish the public with all such facts on the business and financial status of a company as would allow the potential investor to consider properly whether to invest his money in the offered securities;[39] to guarantee a basis of proper conduct in the trading of securities by establishing norms for the supplying of appropriate information; to disclose fraudulent acts, prevent them and punish those responsible. The federal government did not assume any responsibility for examining the stability and soundness of the securities; this was left to the judgment of the individual. In presenting the bill to Congress, President Roosevelt emphasized that:

> [t]he Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that ... issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.[40]

Such limited state intervention was not without its critics. Professor William Douglas, for example, later named Justice of the United States Supreme Court, was against the system of disclosure devised and called it a throw-back to nineteenth century legislation which totally ignored the fact that people do acquire shares without examination. He called for broader control over companies, investment plans and fund raising, stimulating the economy with a view to better protecting the public:

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[38] See Cook, *Watered Stock — Blue Sky Laws* (1920) 19 Mich.L.Rev. 583, 591.

[39] Any one who intends to offer securities for sale to the public must send to the Securities and Exchange Commission (S.E.C.) a "registration notice" together with a prospectus which contains important facts on the corporation and its securities. These documents are open to public perusal as soon as they are filed with the S.E.C. The registration notice must include within it, extensive material, and those who present it must answer in detail the numerous questions set forth in the various forms.

[40] 77 Cong.Rec. 2931 (1931).

> Those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant.[41]

The stand taken by Douglas, who was one of Roosevelt's New Deal devotees, did not find its expression in the legislation. Recently, however, several states adopted a modified approach by enacting the American Uniform Securities Act,[42] which provides for a comprehensive list of facts to be included in the prospectus and empowers the regulatory body to prohibit dissemination of a prospectus on a number of grounds.[43]

IV. The approach of the Israel Securities Law

A. *Disclosure without intervention*

As between these two basic approaches the Israeli legislator favoured supervised disclosure over state intervention. The Securities Law, 1968 leaves examination and determination of the quality of securities to the public. The legislator does not deny the individual his basic right to be a fool; it seeks merely to prevent others from making a fool of him. This, astonishingly enough, represents a change from the legal situation prevailing in Israel prior to the new law. The Securities Committee which previously acted as advisory committee to the Minister of Finance acted without a clear statutory basis. The Committee was unfettered by any provisions whatsoever and its recommendations were dependent on the fulfilment of certain preliminary requirements which, in part, bore the character of intervention into the manner in which information was presented in the prospectus.[44] Such intervention is now precluded by statute, the Israeli legislator having decided that statutory regulation of disclosure is sufficient.

The Yadin Committee rejected recommendations of the American experts who contended that Israel was too poor a country to allow itself failures in the securities market. The American experts argued for minimal standards enforced by state intervention: a minimum

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[41] Douglas, *Protecting the Investor* (1934) 23 Yale Rev. (N.S.) 521; *Cf.* Meeker, *Preventive v. Punitive Security Laws* (1926) 26 Colum.L.Rev. 318.

[42] 9c U.L.A. 86 (1957).

[43] *E.g.*, where "the offering has worked or tended to work a fraud upon purchasers or would so operate" (§306(a)(E)). See the Federal Securities Code (Tentative Draft No.2, 1973).

[44] *E.g.*, the voting ratio between shares offered to the public and those retained by the promoters; who may act as trustee to debenture holders, *etc.*

time period during which the company must operate; a minimum investment by the promoters, *etc.* For them, disclosure was a primary but not an exclusive goal.[45]

The "full disclosure" theory actually adopted by the Israeli legislator has a dual effect. On the one hand, it is apt to deter fraudulent transactions which will be exposed by publication and to discourage those transactions that cannot stand the light of public scrutiny; on the other hand, the judgment of those capable of absorbing the details presented to them, will influence the market price of the securities.

B. *Establishment of the Securities Authority*

Disclosure is not left to the company alone; it is a matter of public interest and therefore Israel has adopted the American view to the extent that it recognizes the necessity of establishing an Authority whose function "shall be to protect the interests of the public investing in securities".[46] The Authority is not a government body as in the United States and Canada, but rather an independent body composed of members of both the government and the public.

The Securities Authority in Israel operates with a significant measure of success within the limited scope of its powers as defined by statute. Although its control is exercised primarily at the time of issue of securities to the public, for some reason, unlike the American Securities and Exchange Commission, the Authority has not been empowered to deal with "take-over bids" which is one of the most important problems in this area. There is no effective difference in the protection of the investor between cases of take-over and cases of offering securities to the public.

C. *The test of "public offering"*

The Israel Securities Law prohibits any offering of securities to the public other than by means of a prospectus, the publication of which has been permitted by the Securities Authority.[47] The term "securities" has been most broadly defined in the statute as including "certificates issued in series by a company, a cooperative society or any other body corporate and conferring a right of

[45] Testimony of Professor L. Loss, given 28 Dec. 1962 (unpublished).

[46] *Laws of the State of Israel no.56, 1968,* s.2 (hereinafter referred to as *Securities Law*).

[47] *Ibid.,* s.15(a): "A person shall not offer securities to the public otherwise than under a prospectus the publication of which has been permitted by the Authority".

membership or participation in it or a claim against it and includes... certificates conferring a right to acquire securities...".[48] The key point is the public nature of the offering; if it is not public the provisions of the law do not apply. The Act does not define the term "public", and, in the absence of a definition, its meaning must be interpreted in conformance with the statute's general purpose — the provision of information concerning the issuing company. Where the offer is made to a limited number of persons, the interested parties can request and receive all information necessary to allow them to make an informed decision. Intervention and protection by the legislator in such a case is superfluous. In order to determine whether or not an offering is "public", there are two tests which may be applied, the "circumstances test" and the "need of protection test".

The circumstances test requires an examination of all factors connected with the offer including, *inter alia*, the possibilities of access to the sources of information and the relationship between the offeror and the offeree. The number of people to whom the offer is made is a significant component of this test but in itself is not conclusive,[49] although it does carry the greatest weight. For example, the Securities and Exchange Commission in the United States turns a blind eye to an issue of securities to less than twenty-five people, unless it is proved that this group intends to sell its shares to others and is acting as underwriter.[50]

The need of protection test is, in fact, added to the circumstances test. In construing the concept of "public", the court, in addition

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[48] *Ibid.*, s.1.

[49] *Cf.* Viscount Sumner in *Nash* v. *Lynde* [1929] A.C. 158, 169 (H.L.): "No particular number are prescribed. Anything from two to infinity may serve; perhaps even one, if he intended to be the first of the series of subscribers but makes further proceeding needless by himself subscribing the whole."

While the U.S. Supreme Court relied on this position in *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119, 125 (1953), a number of states in the U.S.A. waive the requirement of publishing a prospectus if the offer is made to a small number of persons, say up to 20.

The American *Uniform Securities Act*, s.402(b)(9), also waives the prospectus requirement where the offer is made to not more than 10 people over a period of 12 months, and the seller is convinced that the acquisition is for investment purposes.

Under *The Securities Act, 1978*, Bill 7, (1978), 2d Sess., 31st Leg.(Ont.), the exemptions from prospectus requirements are found in ss.71-73.

[50] *Cf.* Op.Gen. Counsel Sec.Act.Rel. 285 (1935): "Under ordinary circumstances an offering to not more than approximately 25 persons is not an offering to a substantial number and presumably does not involve a public offering"; Orrick, *Some Observations on the Administration of the Securities Laws* (1957) 42 Minn.L.Rev. 25, 33.

to reviewing the circumstances of the offer, must consider the aims of the law and the interest it is designed to protect. The court must consider whether the group of persons to whom the securities have been offered is in need of the protection of the statute. Is the group capable of taking care of itself as regards this investment and sufficiently sophisticated to do without the statute's protective wing?[51] Both tests should be used to determine the "public" served by securities legislation.

D. *The prospectus*

The basic provision of every securities act requires companies which intend to raise money from the public to publish a prospectus containing the facts necessary to enable the potential investor to consider the advisability of the investment and arrive at an "investment decision" concerning the offered securities. In Israel, the details which must be included in the prospectus have been laid down by regulation but are not exhaustive.[52] Section 17(a) of the statute requires that:

> An offeror who submits to the Authority a draft of a prospectus shall notify the authority of everything *likely to be important for a reasonable investor* who considers acquiring the securities offered ... .[53]

The Securities Authority may require the offeror to include in the prospectus the additional material supplied under this section, the broad language of which allows the Authority to decide which of the additional details will be included in the prospectus.[54] It is difficult to understand why this requirement of including *every fact* which may be important to the investor was not made obligatory by the statute, instead of being left to the Authority's discretion.[55]

However, section 20 of the *Securities Law* contains an important general provision: "Everything mentioned in the prospectus shall be faithfully presented and the prospectus shall contain no misleading particular." Contravention of this section creates both civil and

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[51] "The focus of inquiry should be on the need to the offerees for the protections afforded by registration", *S.E.C.* v. *Ralston Purina Co., supra,* note 49, 127. "An offer can be made to a large class and not be public, and conversely to a small class and be public", *Central Bank & Trust Co.* v. *Robinson,* 137 Colo. 409, 417, 326 P.2d. 82, 87 (1958). An offer of securities to institutional investors was approved by the S.E.C. without a prospectus, Orrick, *supra,* note 50, 33.

[52] *Securities Regulations* (Details of Structure and Form of the Prospectus), 5729-1969. *Securities Regulations* (Preparation of Financial Reports), 5729-1969.

[53] *Securities Law* [emphasis added].

[54] *Ibid.,* s.18.

[55] South Africa *Companies Act,* No.61, 1973, s.148(1)(a): "Every pros-

criminal liabilities.[56] Perhaps section 20 means that the duty of disclosure is broader than that apparently required by the regulations, since a "misleading particular" is defined in the statute to include "a thing likely to mislead a reasonable investor and such absence of a thing as is likely so to mislead".[57] Thus a general obligation not to exclude from the prospectus any important fact the absence of which is likely to mislead a reasonable investor would seem to be created.

The duty of disclosure is not limited to information on the parent company alone but relates to subsidiary companies,[58] affiliated companies,[59] associated companies,[60] and significant affiliates.[61] Great weight is attached to disclosure of the entire group. In the past, companies hid certain of their activities behind affiliated companies, hence the requirement of consolidated financial reports for all subsidiary companies[62] together with balance sheets of all associated companies.[63]

The legislator's increased demands as to the contents of the prospectus and the serious legal liability involved have, predictably, prompted issuing companies to include vast amounts of substantial matter in their prospectuses. Less predictably, the net result has been that many important facts drown in this sea of information and the prospectus becomes prolix and obscure. The average investor is incapable of digesting or interpreting all the facts and figures. The Israeli experience is no exception; following enactment of the law, prospectuses swelled in comparison with their former sizes. It is clear that other means must be found to accomplish what the disclosure provisions have failed to do.

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pectus issued in terms of this Act shall contain a fair presentation of the state of the affairs of the company, the shares of which are being offered and shall state at least the matters specified in, and set out the reports referred to in Schedule 3."

[56] *Securities Law*, ss.31, 53(a)(i).

[57] *Ibid.*, s.1.

[58] "'Subsidiary' means a company ... in which fifty percent or more of the nominal value of the issued share capital, or of the voting power, is held by another company, or of which one half or more of the directors, or the general manager, may be appointed by another company", *ibid.*

[59] Where the interest is 10%, *ibid.*

[60] Where the interest is 25%, *Securities Regulations* (preparation of financial reports), s.1 (hereinafter referred to as *Financial Regulations*).

[61] Where 25% of its capital is invested in another company. *Securities Regulations* (Particulars of the Prospectus), 1969, s.1.

[62] *Financial Regulations*, s.48.

[63] *Ibid.*, s.61.

V. Continuous supervision over corporate business activities

A. *Periodical reports*

The capital market consists of two closely related components, the primary market for new capital and the secondary market for the re-sale and the continuous trading of securities. Because public confidence must be directed to both, thorough reporting on both is essential. The Israel Securities Law, faithful to the principle of disclosure alone, treats the subject of the secondary market only partially. The statute establishes a duty to furnish periodical reports to the Securities Authority and to the Companies' Registrar providing details of corporate activities, benefits granted to interested parties during the past year, changes in stock holdings, and a long line of additional details required by the regulations.[64] The periodical report may thus be viewed as a minor, annual prospectus. It is open to public perusal at the Companies' Registrar office and its importance lies in the continual stream of information which it assures to shareholders.

B. *Immediate reports*

In addition to these periodical reports, the company must furnish immediate reports to the Companies' Registrar, the Securities Authority, and to the Stock Exchange on particular events which have taken place.[65] The list of events which require the filing of such reports is long, but the fundamental concept underlying the requirement is to disclose to the public, with utmost speed, information on important events which are likely to influence trading in the company's securities.

C. *Investigations*

The Securities Authority in Israel has not been empowered to conduct investigations into corporate affairs, as is the Securities and Exchange Commission in the United States,[66] or the Ontario Commission in Canada.[67] However, the Authority in Israel has re-

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[64] *Securities Law,* ch.6; *Recurrent Reports and Securities Regulations* (Immediate and Periodical Reports), 5730-1970.

[65] *Securities Regulations* (Immediate and Periodical Reports), 1970, ch.C.

[66] *Cf.* Loss, *supra,* note 24, 1945 *et seq.* The U.S. Commission may conduct investigations "to aid in the enforcement of the provisions of this title, in the prescribing of rules and regulations thereunder, or in securing information...".

[67] See *The Securities Act, 1974,* Bill 75, (1975), 4th Sess., 29th Leg.(Ont.). Part V, s.11 states that "the Commission may, by order, appoint any person

cently assumed such powers indirectly. It summoned the directors of The Israel Corporation to furnish certain details which would enable the Authority to determine whether the corporate prospectus, published some months before, should be revised. Whether the Israeli Securities Authority should be given statutory investigatory powers such as now exist in the United States and Canada, to supplement its assumed powers, is still open to debate.

D. *Insider trading*

One of the main weaknesses of the Israeli Statute is the absence of any proper treatment of insider trading. A company insider may for his own advantage exploit information which he obtains as a result of his position or in the course of his work. The company itself may suffer no loss as a result, but such activity on the part of directors would tend to undermine shareholder confidence. This is not to suggest that directors and insiders be prohibited from owning stock in their companies, as the granting of stock options and other opportunities to employees to acquire shares in the corporation is a universally accepted practice. Nevertheless, it is necessary that guidelines for permissible trading in these shares be clearly delineated.

Under English common law, directors and employees are unauthorized to profit personally from inside information which reaches them as a result of their position in the company. The same rules apply in Israel, but more are needed. The Israeli legislators would do well to follow the recommendations of the *Kimber Report* in Ontario:

> ... the law should clearly provide that the use by insiders, for their own profit or advantage, of particular information known to them but not available to the general public is wrong and that the law should give appropriate remedies to those aggrieved by such misuse.[68]

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to make such investigations as it deems expedient for the due administration of this Act, and in the order shall determine and prescribe the scope of the investigation."

[68] *Supra*, note 3, para.2.03. This recommendation has been implemented in s.113(1) of *The Securities Act* of Ontario (R.S.O. 1970, c.426):

"Every insider of a corporation or associate or affiliate of such insider, who, in connection with a transaction relating to the capital securities of the corporation, makes use of any specific confidential information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of such securities, is liable to compensate any person or company as a result of such transaction, unless such information was known or ought reasonably to have been known to such person or company at the time of such transaction, and is also account-

1. The policy behind the rule

In the United States far-reaching doctrines of liability covering the exploitation of information by corporate insiders have been developed through rule 10b-5,[69] a regulation promulgated by the Securities and Exchange Commission in 1943. Rule 10b-5 provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:
>
> (a) To employ any device, scheme or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or,
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

This provision[70] expresses one of the basic purposes of securities legislation, that of assuring maximum propriety in stock transactions by making full information about material facts relating to

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able to the corporation for any direct benefit or advantage received or receivable by such insider, associate or affiliate, as the case may be, as a result of such transaction."

The section has been somewhat altered by *The Securities Act, 1978*, Bill 7, (1978), 2d Sess., 31st Leg.(Ont.).

"131(1) Every person or company who sells or purchases the securities of a reporting issuer with knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed and every person who, directly or indirectly, knowingly informs the vendor or purchaser of the material fact or material change other than in the necessary course of business is liable to compensate the purchaser or vendor of the securities for damages as a result of the trade unless,

(a) the person or company had reasonable grounds to believe that the material fact or material change had been generally disclosed;

(b) the material fact or material change was known or ought reasonably to have been known to the other party to the sale or purchase or

(c) the vendor, purchaser or informer, as the case may be, proves that he did not make use of knowledge of the material fact or material change in purchasing or selling the securities.

. . .(3) Every person or company referred to in subsection 1 who is also an insider of the reporting issuer, or who is an associate or affiliate of such insider, is, in addition to the liability imposed by subsection 1, accountable to the reporting issuer for any benefit or advantage received or receivable by the insider or associate or affiliate, as the case may be."

[69] 17 C.F.R. §240.106-5 (1943).

[70] See Bromberg, *Securities Law: Fraud* (1975), 22.6 for a discussion of the accidental way in which this provision came about.

the corporation available to the investing public. The criminal prohibition against exploitation of inside information for personal advantage is a necessary extension to the policy of full disclosure for two reasons: firstly, the insider's privileged position allows him direct or indirect access to sources of information designed for the exclusive use of the corporation and not for anyone's personal advantage; secondly, one party to a transaction exploiting inside information to which he knows the other party has no access is inherently improper.[71]

In addition to the criminal liability, established by rule 10b-5, civil liability was gradually imposed on the insider by American courts, and an obligation was developed to restore to the company profits realized through exploitation of inside information which had not been brought to the public's attention or which had not been sufficiently "digested" by it. Following the decision in *Kardon* v. *National Gypsum Co.*,[72] a series of cases crystallized the rule allowing a civil wrong — a tort derived from a crime — to be based on the criminal provisions of the securities laws. Since these provisions were designed to protect the investing public, the courts deemed it only proper to provide civil remedies to the public which had been adversely affected.

The duty of disclosure is addressed to "material facts",[73] a concept broadened by the courts over the years. It was held in *S.E.C.* v. *Texas Gulf Sulphur Co.*[74] that materiality must be examined from the point of view of the reasonable investor at the time that he is considering whether to buy, sell or continue to hold the securities in his possession.[75]

The breach of this duty involves failure to disclose the details of the inside information to both the company and the third party, and confers a cause of action on the company and on any person damaged. While the remedies available to a private claimant relying on the rule include indemnification for the actual damage caused as a result of the non-disclosure as well as equitable relief, punitive damages are not available. The importance of the relief lies not in

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[71] *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

[72] 69 F.Supp. 512 (E.D.Pa 1946).

[73] *Kohler* v. *Kohler Co.*, 319 F.2d. 634 (7th Cir. 1963).

[74] 401 F.2d 833 (2d. Cir. 1968).

[75] *Ibid.* See also *List* v. *Fashion Park*, 340 F.2d 457 (2d Cir. 1965); *S.E.C.* v. *Great American Industries Inc.* 359 U.S. 920 (1969), 407 F.2d 453, 459 *et seq.* (2d Cir. 1968), *cert.* denied 395 U.S. 920 (1969).

the grant of damages to the injured party, but in depriving the defendant of profits so as to prevent his unjust enrichment.[76]

2. The Israeli approach

Neither in the Companies Ordinance[77] nor in the Securities Law did the Israeli legislator address himself specifically to the question of the exploitation of inside information, although the Yadin Committee Report emphasized the duty to disclose the directors and main shareholders in both the prospectus and periodic reports. The Report also dealt with the interests in the company,[78] the various means available to combat dangers inherent in insider trading,[79] and specifically recommended the enactment of provisions against insider fraud.[80] One of the Committee's main considerations was that investment and trading in the stock market be under clear, effective legislative and administrative control, in order to reinforce public confidence, at home and abroad, in Israel's stock market.[81] It was also recommended that, in addition to the punitive provisions, the statute contain general provisions preventing acts which contradict the spirit of the proposed regulation and which might in some way mislead the investing public.[82] Realizing the importance of civil liability in protecting the investor, the Committee recommended that the statute make explicit that all provisions requiring disclosure or reporting are designed to protect the investor, and that anyone damaged by breach of these requirements might, in an action for breach of a statutory duty, demand compensation from the party in breach.[83] Yet despite all these recommendations, the statute contains no specific provisions on questions of insider trading.

Is it possible, then, to bring an action against an insider who has exploited inside information for his own advantage? As far as directors and employees of the company are concerned, it would appear that general principles of fiduciary law, under both English

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[76] Loss, "The Rationale of Rule 10(b)5", *Second Annual Institute on Securities Regulations* (1971), 11.

[77] Ordinance No.18 of 1929.

[78] Report of the Committee on the Securities Market in Israel (1963), chs 68, 71, 123, 126, 128.

[79] *Ibid.*, ch.5, para 207-14.

[80] *Ibid.*, ch.6, para 207-14.

[81] *Ibid.*, para.11.

[82] *Ibid.*, para.207.

[83] *Ibid.*, para.214. The Committee further recommended enactment of a provision which would make "any breach of the general provisions against

and Israeli law, may be applied to enforce restoration to the company of profits realized as a result of use of inside information. But this remedy is available to the company and not to a third party. It is likewise limited to directors[84] and employees,[85] and does not apply to other insiders.

3. New trends in insider trading

The British government was recently forced by the pressure of public opinion to agree to make insider dealing a criminal offence. A White Paper of 1973 stated that, "[t]he object of legislation on insider dealing must be to ensure that anyone who is in possession of information which would be likely, if generally known, to have a material effect on the price of the relevant securities, refrains from dealing until the material information has properly been made generally available".[86] Thus, *The Companies Bill, 1973*[87] of Great Britain covers various aspects of insider trading. For example, section 12(1) states that:

> Subject to section 14 below, a person who is, or at any time in the preceding six months has been, connected within the meaning of this section with a company shall not deal in any securities of that company if he is in possession of information which is not generally available but, if it were, would be likely materially to affect the price of those securities.

This Bill has, however, not yet been enacted into law. Similarly in Israel, a law proposed in 1971 that would make it a criminal offence to exploit inside information, was not enacted.[88] The South African *Companies Act*, 1973,[89] and the Ontario Securities Bill of

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fraud carry with it civil liability to pay damages to the extent that monetary damage was caused".

[84] *Regal (Hastings) Ltd.* v. *Gulliver* [1942] 1 All E.R. 378 (H.L.); *Boardman* v. *Phipps* (1967) A.C. 45 (H.L.).

[85] *Reading* v. *Attorney General* (1951) A.C. 507 (H.L.).

[86] Cmnd. 5391, (1973), 9, para.17. See also the Green Paper, *supra*, note 12, para.8.

[87] Bill 52, 1973, 4th Sess., 45th Parl. (U.K.).

[88] Companies Ordinance (Amendment No.13) Bill, 5732-1971, H.H.936, 5732, 129. "A member of a board of Directors or a business manager of a company who exploits information in his hands for his personal advantage or for the advantage of a person other than the company shall be liable to one year's imprisonment of a fine of IL.20,000."

[89] See s.233: "Every director, past director, officer or person who has knowledge of any information concerning a transaction or proposed transaction of the company or of the affairs of the company which, if it becomes publicly known, may be expected materially to affect the price of the shares or debentures of the company and who deals in any way to his advantage, directly or indirectly, in such shares or debentures while such information

1974,[90] have more recently devoted greater attention to the problem. In Germany, a Committee of Stock Exchange Experts was appointed by the Federal Minister of National Economy in 1968. Its 1970 recommendations did not propose any new legislation, but instead recommended that all companies whose stock is traded on a German exchange ensure, *through individual agreements* with their directors and employees, that the following rules are observed:

> (1) Members of the executive board (*Vorstand*) and of the supervisory board (*Aufsichtstrat*) may not(at any time and in any way), to their own profit or to the profit of third persons, engage in transactions concerning shares quoted on the stock exchange and issued by their company or an affiliated company, or offered to the public with a view to having them listed on a stock exchange, by use of confidential information that may influence the valuation of such shares and that came to their knowledge as a result of their position in the company.
>
> (2) Information of this nature includes knowledge about important changes in earnings or about important facts that may influence changes in earnings; changes in the dividend rate; measures for raising capital or reduction of capital stock; planned mergers, transfers of assets, reorganizations, takeover bids or dissolution of the company before official announcement.[91]

Similar agreements are to be entered into with other employees who may have access to confidential information and, in addition, the Committee recommended allowing a stock exchange to investigate an inquiry by the company in question, into suspected illicit insider trading.[92]

No formal legal remedy exists in the United Kingdom or in Israel against directors who exploit inside information, save by virtue of the common law. Securities Law or Companies Acts can no longer be excused for ignoring this subject in both its civil and criminal aspects. Given the intricacies of securities regulation and their sometimes unsuspected ramifications, the American solution seems preferable; existing common law and equitable remedies should be allowed to complement statutory remedies. There can be no doubt, however, that the current legal situation in the United Kingdom and in Israel, as in many other countries, is far from satisfactory

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has not been publicly announced on a stock exchange or in a newspaper or through the medium of the radio or television, shall be guilty of an offence."

[90] *The Securities Act, 1974,* Bill 75, (1975), 4th Sess., 29th Leg.(Ont.).

[91] See (1975) 30 The Business Lawyer 667 and Loss, *Multinational Approaches to Corporate Insiders* (1976), ch.9.

[92] See Zahn, *Regulation of Insider Trading in the Federal Republic of Germany* (1974) 2 Int'l Bus.Law. 82; Bruns, *Der Wertpapierhandel von Insiders als Regelungsproblem* (1973); Hopt and Will, *Europaisches Insidernrecht* (1973).

and that specific, explicit statutory provisions must be enacted.

Israel is only starting to depart from the common law rules in this complicated area of protecting investors. There is still much to be done. However, the integrated disclosure system is a goal to be pursued even if its complete refinement and efficiency cannot be envisaged.[93] It will be interesting to see how Israel adapts its common law heritage to changing policies in an extremely complicated area of the law.

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[93] Compare with Emerson, "An Integrated Disclosure System for Ontario Securities Legislation" in Ziegel, vol.2, *supra*, note 4, 400.

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