THE ROLE OF GATEKEEPERS IN SECURITIES MARKET AND SCOPE OF THEIR LIABILITIES: A COMPARATIVE STUDY OF THREE JURISDICTIONS

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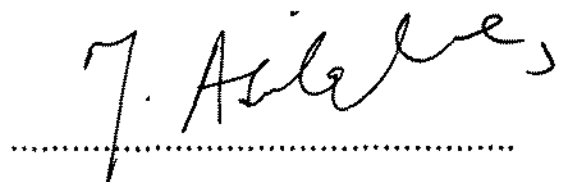

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I, Mohib liaqat son of Liaqat Ali, Registration # 197-FSL/LLMCL/F08, student of LLM Corporate Law, in Faculty of Shariah & Law, do hereby declare that the matter printed in the thesis "the role of gatekeepers in securities market and scope of their liabilities: a comparative study of three jurisdictions" by me in partial fulfilment of LLM degree, is my original work, and has not been submitted or published earlier. I also solemnly declare that it shall not, in future, be submitted by me for obtaining any other degree from this or any other university or institution.

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DEDICATION

I dedicate this research work to my parents who have always encouraged me to pursue my studies and who have always prayed for my success.

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GLOSSARY OF ABBREVIATIONS

ABA	AMERICAN BAR ASSOCIATION
AIM	ALTERNATIVE INVESTMENT MARKET
AICPA	AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
CA, 2006	COMPANIES ACT 2006
CA	CIRCA (PRECEDING A DATE OR AMOUNT)
CAO	CHIEF ACCOUNTING OFFICER
CEO	CHIEF EXECUTIVE OFFICER
CFO	CHIEF FINANCIAL OFFICER
CFR	CODE OF FEDERAL REGULATIONS
CLA	CORPORATE LAW AUTHORITY
CLR	COMPANY LAW REVIEW
CLRC	CORPORATE LAWS REVIEW COMMISSION
CO, 1984	THE COMPANIES ORDINANCE, 1984
FSA	FINANCIAL SERVICES AUTHORITY
FSMA	FINANCIAL SERVICES AND MARKET ACT
GAAP	GENERALLY ACCEPTED ACCOUNTING PRINCIPLES
GAAS	GENERALLY ACCEPTED AUDITING STANDARDS
IAS	INTERNATIONAL ACCOUNTING STANDARDS
IFRS	INTERNATIONAL FINANCIAL REPORTING STANDARDS
NCB	NET CAPITAL BALANCE
SAS	STATEMENTS ON AUDITING STANDARDS
SEC	SECURITIES AND EXCHANGE COMMISSION
SECP	SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
SRO	SELF REGULATORY ORGANIZATION
UK	UNITED KINGDOM
USA	UNITED STATES OF AMERICA

Abstract

The financial scandals of the last decade have called into question the effectiveness of the system of securities regulation in many countries. Articles that have examined the origins of the regulatory crisis have concluded that the classical tools of corporate governance for the supervision of management have lost their force in light of new incentive structures in the financial markets. They see as the solution to the regulatory lacunae the utilization of financial intermediaries and other market participants as gatekeepers. i.e. as agents that ensure compliance of the primary market actor (the issuer) with applicable rules by reviewing its disclosures and withholding their participation in transactions if violations occur.

This research conducts a comprehensive analysis of the US, UK and Pakistani legislation concerning gatekeepers and tries to ascertain whether provisions for the protection of investors are based on, or can be interpreted in light of, the gatekeeper theory. The comparative analysis helps to identify provisions that are conducive to investor protection and the gatekeeper theory. It gives an opportunity to address the controversial issue of the adequate standard of care, which is regulated differently in the countries under investigation. In addition, the Pakistani regulatory regime may profit from a comparative analysis in view of the high level of detail and enforcement that characterises the US and UK system.

In the United States, a plenty of rules, originating from Congress and from the supervisory authority, Securities and Exchange Commission (SEC), which has rule-making power under the Securities Acts, regulates all aspects of disclosure and governance. The rules have been vigorously enforced for many decades and have, therefore, had the opportunity to stand the test of time as opposed to certain measures of Pakistani origin that, while dating back as far as the 20th century, have rarely been invoked by investors or applied by the courts. The US practitioner and the legal scholar are able to take recourse to an extensive body of case law that interprets and develops the codified rules, whereas in Pakistan litigation has been scarce until recently. Finally, the conclusion will provide a summary of the findings and advance a tentative explanation of certain trends of convergence between U.S. UK and Pakistani regulatory mechanisms that can be observed.

CHAPTER 1

Introduction

1.1. Introduction

Securities regulation has come under increased criticism in recent years around the globe. The corporate scandals of the early 21st century like the major financial frauds among the world's leading corporations, notably Enron,[1] and Satyam[2] have caused investors to lose their faith in the integrity of the capital and securities markets. It has sparked much speculation as to their cause, and compelled legislators and regulators to set in place reforms to prevent them from recurring.

Collective blame for these business failures has fallen on gatekeepers such as analysts, underwriters, lawyers and auditors etc. The conventional view is that gatekeepers have shirked their responsibilities and connived illegal conduct of management of corporations/companies. If we clarify and enhance the responsibilities of gatekeepers, some people expect that we will be able to avoid such debacles in the future.[3]These professions are vital in corporate governance, for "all boards of directors are prisoners of their gatekeepers," John C. Coffee says, and no board "can outperform its professional advisors."[4]

As for as legal framework in Pakistan is concerned, over the years it has been noted that we have no effective and comprehensive legislation to oversee and control the conduct and professional responsibilities of gatekeepers. In Pakistan there are different provisions in different laws which deal with role and conduct of gatekeepers but these provisions do not provide complete and strong regulatory framework to monitor the activities of gatekeepers, hence there is

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[1] The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, an American energy company based in Houston, Texas, and the dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. In addition to being the largest bankruptcy reorganization in American history at that time, Enron was attributed as the biggest audit failure. http://en.wikipedia.org/wiki/Enron_scandal (accessed November 22, 2011).

[2] On 7 January, 2009 the then Chairman of Satyam, India's leading information, communications and technology (ICT) company, Mr. Ramalinga Raju made some revelations. He stated that accounts of Satyam were overstated to the tune of INR 50.4 billion (~US$1billion) related to cash & bank balances. The startling revelation has led analysts in India to dub the Satyam scandal as India's own Enron.
The Pakistan Accountant (Magazine of The Institute of Chartered Accountants of Pakistan Vol 43 Issue 1 January-March 2009), 18.

[3] Assaf Hamdani, *Gatekeeper Liability*: (77 S. Cal. L. Rev. 2003), 53, 55.

[4] J.C. Coffee Jr, *"Gatekeepers: The Professions and Corporate Governance"*(Review by Lawrence A. Cunningham, The British Accounting Review 40 2008) 87–88.

need to introduce efficient and stringent mechanism to regulate these important functionaries of capital/securities markets.

Lawyers, investment banks, and accountants, when they act in gatekeeping capacity they remain liable for misstatements and omissions in the public disclosure documents of their clients. After each wave of corporate upheaval, scrutiny invariably descends on business transactions and on apparent errors in corporate disclosures that accompanied them. Professionals are often implicated for having facilitated transactions and having failed to avert disclosure errors.[5]

1.2. Development of Gatekeeping Concept

The concept of gatekeeping and third party liability was developed by Reinier Kraakman in the 1980s. Its general usefulness is now widely accepted in the US. He described gatekeeper liability as a genre of third party liability used by the government to "supplement efforts to deter primary wrongdoers directly by enlisting their associates and market contacts as *de facto* cops on the beat."[6] These *de facto* cops are in fact "gatekeepers," originally defined as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers."[7]

This claim traditionally depended on a rational actor model under which a gatekeeper would prevent misconduct by a primary violator because the gatekeeper's expected liability or reputational harm from failing to prevent misconduct exceeded the benefits gained in fees.[8]

1.3. Gatekeepers in Corporate Context

The term "gatekeepers" connotes some form of independent watchdog, someone who screens out flaws or defects or who verifies compliance with standards or procedures.[9] Within the corporate context, the term 'gatekeeper' is used to mean an independent professional who plays one of two distinct roles, which tend to overlap in practice. First, the gatekeeper may be a professional who is positioned so as to be able to prevent wrongdoing by withholding necessary

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[5] Andrew Tuch, *Multiple Gatekeepers*, (Discussion Paper No. 33 3/2010 Harvard Law School Cambridge, MA 02138), 102.

[6] Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, (J.L. Econ. & Org, 1986), 53.

[7] Sung Hui Kim, *Gatekeepers Inside Out*. (The Georgetown Journal Of Legal Ethics Vol. 21:411 2008), 415.

[8] Reinier Kraakman, *Third Party Liability*: (The New PalgraveDictionary Of Economics And The Law, Peter Newman ed., 1998), 583, 585–586.

[9] John C. Coffee Jr, *Gatekeepers: The Professions and Corporate Governance* (New York: Oxford University Press, 2006), 2.

cooperation or consent. For example, an investment banking firm can refuse to underwrite the issuer's securities if it finds that the issuer's disclosures are materially deficient; similarly, an auditor or an attorney who discovers a serious problem with a corporate client's financial statements or disclosures can prevent a merger from closing by declining to deliver an opinion that is a necessary precondition for that transaction. In this first sense, the gatekeeper is a private policeman who has been structured into the process to prevent wrongdoing. By withholding its approval, it closes the gate, typically denying the issuer access to the capital markets.[10]

According to another definition which is more comprehensive and superior "gatekeeper is an agent who acts as a reputational intermediary to assure investors as to the quality of the signal sent by the corporate issuer."[11] It does so by extending its reputational capital to the corporation, thus helping investors or the market to trust on the corporation's own disclosures or assurances where they otherwise might not. "The gatekeeper has such reputational capital because it is a repeat player who has served many clients over many years."[12]

Inherently, gatekeepers are reputational intermediaries who provide verification and certification services to investors.[13]These services can consist of verifying a company's financial statements (as the independent auditor does), evaluating the creditworthiness of the company (as the debt rating agency does), assessing the company's business and financial prospects in relation to its rivals (as the securities analyst does), or appraising the fairness of a specific transaction (as the investment banker does in delivering a fairness opinion). Attorneys can also be gatekeepers when they lend their professional reputations to a transaction.[14]

Gatekeepers work with an enterprise to correct misreporting before it occurs. They do so by threatening to withhold support necessary to complete a report or consummate a transaction. Gatekeepers can deny access to capital markets. So gatekeepers are "intermediaries who provide

[10] Ibid, 3.
[11] Ibid, 3.
[12] Ibid, 3.
[13] Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, (93 Yale L.J, 1984), 857.
[14] John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, (57 Business, Law, 2002), 1403–05.

verification and certification services to investors" by pledging their professional reputations and, by withholding such support, block admission through the gate.[15]

1.4. Importance of Gatekeepers

An epidemic of corporate and financial irregularity crested in the world leading corporations convinced most commentators that corporate governance is needed to be strengthened. Almost reflexively, most commentators focused on the board of directors and suggested ways in which it should be upgraded. Others have stressed the need for higher ethical standards, and a smaller number has suggested enhancing the power of shareholders.

Conversely, researchers now suggest that no reform is likely to achieve its goal unless the corporation's gatekeepers function in an objective and unbiased fashion. In this light, several points need to be made and underlined at the outset.[16]

1.4.1. Gatekeepers influence on capital market

Gatekeepers have manifold powers and role to influence capital market while rendering their expert opinions and professional statements regarding the actual worth and credibility of securities. Gatekeepers enable a corporation to credibly signal above average quality and thereby achieve a lower cost of capital. On the other hand if gatekeepers in connivance with top managerial personal of company issue false and misleading statements, it would result into chaos and mistrust of investors in capital market. hence there is need for a well-organized and controlled environment to avoid such type of misleading statements to influence capital market. If gatekeepers perform their duties as enumerated in relevant legislations around the globe then they have great positive impact to enhance the confidence of investors and foster activities in capital markets.

1.4.2. Board of Directors and Gatekeepers

The board of directors today composed of directors who are essentially part-time performers with other demanding responsibilities. So structured, the board is blind, except to the

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[15] Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers,* (92 Minnesota Law Review, Nov-Dec. 2007), 5.

[16] John C. Coffee Jr, *Gatekeepers: The Professions and Corporate Governance* (New York: Oxford University Press, 2006), 6.

extent that the corporation's managers or its independent gatekeepers advise it of impending problems. In the absence of independent professionals such as auditors, attorneys and analysts boards will predictably receive a stream of selectively edited information from corporate managers that presents the incumbent management in the most favorable light possible.[17]

Over recent decades, the board of directors has already been extensively reformed and is now an independent, harder-working and more proactive body. This is not to claim that no further improvements are possible or that various boards did not make egregious mistakes.
In short, nowadays gatekeepers have evolved their role as actual decision makers because board of directors decision are dependent on the opinions and professional statements of gatekeepers. Again, this suggests that even strong and well-motivated boards are the informational prisoners of their gatekeepers.

1.5. Gatekeeping Model

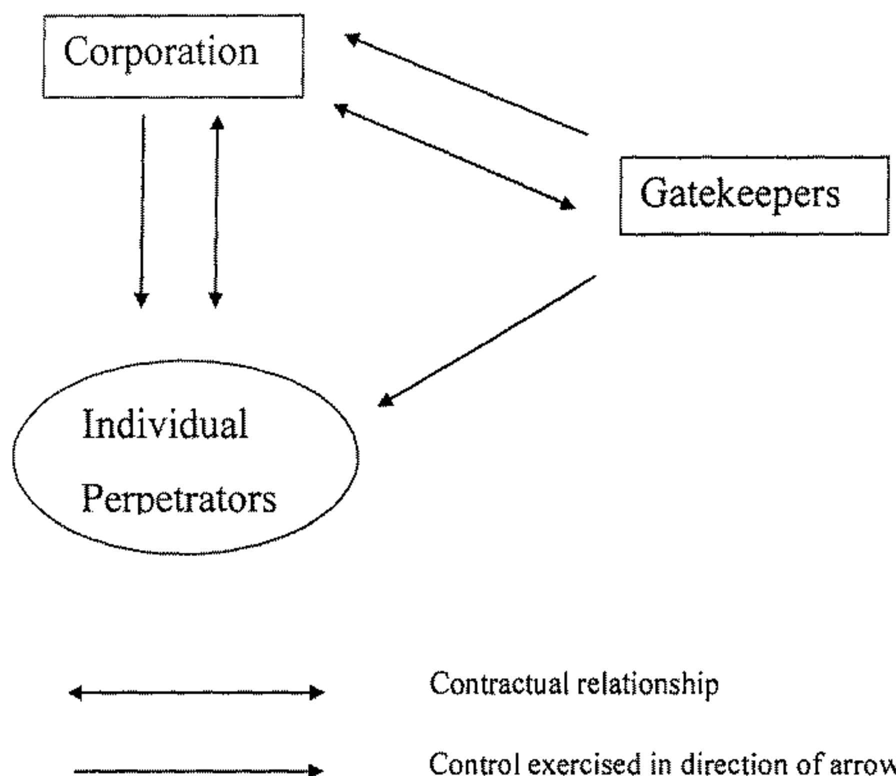
Gatekeepers occupy a position within a broader legal framework. Since a corporation/company is simply a fictional person, the relevant acts comprising securities fraud are performed by an individual or individuals. The fraud may be deterred directly by the imposition of potential liability on the corporate enterprise, as well as on individual corporate managers. Such liability would create incentives for the corporation and its managers to take precautions to exercise their control over individual wrongdoers.

The fraud may also be deterred by gatekeepers, who have existing incentives even without those created by gatekeeper liability to monitor and control corporate conduct. As repeat players expecting to engage in future transactions, gatekeepers have incentives to build and preserve good reputations, since a good reputation will enhance a gatekeeper's prospects of acting on future transactions. The reputational mechanism operates to produce incentives for gatekeepers to certify the disclosures of their clients diligently and honestly.[18]

Gatekeeper liability would only be desirable to supplement enterprise liability and individual managerial liability where these more direct forms of liability and reputational constraints fail to provide sufficient deterrence. The standard case where gatekeeper liability is desirable arises when the corporation has gone insolvent. More direct forms of liability would

[17] Ibid, 7.
[18] Andrew Tuch, *Multiple Gatekeepers*, (Discussion Paper No. 33 3/2010 Harvard Law School Cambridge, MA 02138), 126.

likely then fail to produce sufficient deterrence. The graphical representation below illustrates the relationships among the various actors.[19]



Contractual relationship

Control exercised in direction of arrow

Figure 1 explaining relationships among the various actors of securities market

Securities fraud is intentional wrongdoing, and individuals are therefore assumed to be able to avoid it without cost. By taking precautions, gatekeepers exercise their capacity to monitor and control the corporation's conduct. As depicted in the diagram above, gatekeepers may exercise this power over both corporate management and corporate employees.[20]

[19] Andrew Tuch, *Multiple Gatekeepers*, (Discussion Paper No. 33 3/2010 Harvard Law School Cambridge, MA 02138), 126.
[20] Ibid, 126.

1.6. Gatekeepers and capital market

1.6.1. Gatekeepers as Monitors

Known as gatekeeper liability, the liability of professionals for the wrongs of their clients is premised on the ability of professionals to monitor and control their clients' conduct.[21] The imposition of potential liability provides powerful incentives for professionals to exercise their ability to monitor and control, and thereby to deter, corporate wrongs. While the professions oppose the notion of themselves as gatekeepers, securities laws nonetheless impose on them liability for the disclosure failings of their clients, and an extensive literature has developed to consider what liability rules would induce gatekeepers to take optimal precautions to deter client wrongs.[22]

1.6.2. Gatekeepers as Interlocking Web of Protection against Securities Fraud

Multiple distinct gatekeepers participate in business transactions, forming an interlocking web of protection against securities fraud. For business transactions, including high-stakes securities offerings and mergers and acquisitions, a corporation will routinely engage a law firm, investment bank, and an accounting firm—and often several of each—to plan, negotiate, and execute these transactions. After all, business transactions are complex and raise myriad legal, financial, accounting, and other hurdles for the corporations that undertake them.[23]

1.6.3. Gatekeepers Promote Fair Disclosure in Securities Transactions

A gatekeeping monitoring model can promote fair disclosure in securities transactions. If those primarily responsible fail, a regulatory authority steps in. In systems that interpose a secondary group of responsible parties between the primary party and the regulatory authority, misleading reporting can be prevented, not just punished. True, secondary group failure will lead to punishing both primary and secondary actors. But fewer occasions requiring such punishment should arise. As a result, it is customary in the literature to define as gatekeepers only the group

[21] My use of the term "gatekeeper" is consistent with the definition used in the law and economics literature. For example, Kraakman (1986) defines gatekeepers as 'parties who are in a position to prevent misconduct by others by withholding their cooperation.'

[22] Andrew Tuch, *Multiple Gatekeepers*, (Discussion Paper No. 33 3/2010 Harvard Law School Cambridge, MA 02138), 103.

[23] Ibid, 103.

of secondary private professional firms and to treat the regulatory apparatus as a further backstop rather than as a gatekeeper.[24]

1.7. Types of Gatekeepers

The emphasis on gatekeepers in the financial markets is not new. The early securities laws recognized the difference between independent and dependent gatekeepers in the context of directors.[25] We can distinguish independent from dependent gatekeepers by examining the roles of four types of gatekeepers: auditors, analysts, lawyers, and underwriters.

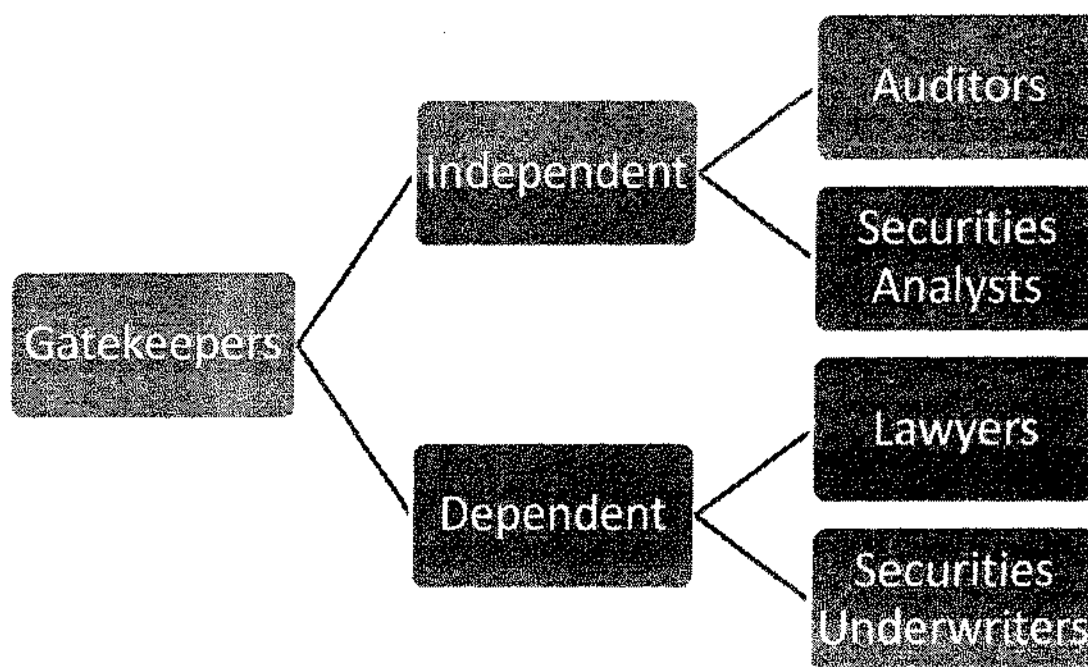


Figure 2 explaining the types of gatekeepers

1.7.1. Independent Gatekeepers

Gatekeepers are retained as agents to perform a task or a series of tasks for a principal. In the course of doing so, they receive information, as the access theory suggests, that puts them in a unique position to evaluate whether the principal has violated, or is about to violate, the law. But the tasks they perform and the relationships with their principals vary. Some gatekeepers are

[24] Peter Oh, *Gatekeeping*, (29 IOWA J. CORP. L, 2004), 735.
[25] Arthur B. Laby, *Differentiating gatekeepers*, (Brook. J. Corp. Fin. & com. L. Vol. 1, 2006), 123.

supposed to be independent of their clients in order to critically evaluate a set of facts and render an unbiased opinion for an unknown audience.[26]

1.7.1.1 Auditors

Auditors has significant role as gatekeeper of financial market. As per scope of work, they are independent from top management of corporation/company. They have responsibility to evaluate the accounts of company accurately and to bring on record any discrepancies in financial records. The capital required for the business of a Company is contributed by its shareholders who may not necessarily be the persons managing the Company. In the case of a listed Company, the general public also contributes towards the equity of the Company. Such persons do not have any direct control over the Company except that they elect directors and entrust the affairs of the Company to them in the hope that they will manage the Company to their benefits. The shareholders are, therefore, the stakeholders and the ultimate beneficiaries. It 'was, therefore, necessary that there must be some arrangement in place whereby the shareholders who are the real beneficiaries must get some independent view as to how the directors have managed the affairs of the Company. The law, therefore, recognizing this situation, has provided that the shareholders should appoint an auditor who shall be responsible to audit the accounts and books of account and make out a report to them at the end of each year. It is, therefore, extremely important for the Auditors to be vigilant and perform their duties and obligation with due care while auditing the accounts and books of accounts.[27]

The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. Auditors, in effect, serve as watchdogs or gatekeepers for investors and creditors.[28]

An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client.[29]

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[26] Arthur B. Laby, *Differentiating gatekeepers*, (Brook. J. Corp. Fin. & com. L. Vol. 1, 2006), 124.
[27] 2008 C L D 861.

[28] Mark Jickling, *Barriers to Corporate Fraud* (New York: Nova Science Publishers, 2009), 18.
[29] Arthur B. Laby, *Differentiating gatekeepers*, (Brook. J. Corp. Fin. & com. L. Vol. 1, 2006), 124.

1.7.1.2. Securities Analysts

The second important example of an independent gatekeeper is the securities analyst. "Analyst" means a person who is primarily responsible for, contributes to, or is connected with, preparation of the substance of written reports/presentations, public appearances, or the basis for a recommendation, for distribution to clients or prospective clients of the firm or the investing public. An analyst can be a partner, director, officer, employee or an agent of a financial institution, independent research firm, brokerage firm, fund management house or institutional investor, as long as the research and/or recommendation prepared is disseminated to clients or investing public.[30]

Investors have traditionally looked to research analysts employed by investment banks to help decide which stocks to buy (or sell). For investment banking firms in the business of selling securities to the public, the temptation to use analyst reports as a sales tool is clearly a potential source of conflicts of interest. An analyst is supposed to research a company to judge its value as an investment.[31] The analyst's role should be to review corporate information and present an unvarnished view of the company to investors or potential investors. The analyst's role should not be to advocate on behalf of the company, but rather, like the auditor, to objectively analyze the facts. Conflicts of interest must be disclosed.

The analyst's role should be to review corporate information and present an unvarnished view of the company to investors or potential investors. The view of the analyst as independent is under attack.[32]

1.7.2. Dependent Gatekeepers

While some gatekeepers like auditors and analysts are supposed to be independent of their principal, others are not. Dependent gatekeepers provide advice and recommendations to assist a client in meeting its goals. They often act in a fiduciary capacity, owing both a duty of loyalty and a duty of care to the client. As a fiduciary, these agents must act for the client's

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[30] Code of Conduct for Analysts Preliminary Draft for Comments, 2. <http://www.secp.gov.pk/DraftAmendments/CodeofConductforAnalysts(new).pdf>

[31] Jill E. Fisch& Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, (88 Iowa L. Rev 2003), 1035-1040.

[32] Ibid, 1043. ("The traditional hands-off approach to analyst regulation, which was premised on the theory that analysts functioned as independent gatekeepers, is no longer appropriate.").

benefit, furthering its ends. Courts maintain that the essence of the fiduciary duty is to act with utmost good faith for the benefit of the principal and single-mindedly pursue the interests of those to whom a duty of loyalty is owed. Regardless of the context, fiduciary cases are replete with language about how the fiduciary must act to further the objectives of the principal.[33]

A fiduciary relationship is characterized by values such as longevity and mutual trust, and fiduciary cases refer to a close bond that exists between the fiduciary and the principal. Those same bonds, however, are anathema to relationships held by independent gatekeepers, such as auditors and analysts. And an auditor is not considered a fiduciary to the client when performing the audit function.[34]

The differences in the type of relationships independent and dependent gatekeepers have with their clients are striking. The characteristics of dependent gatekeepers are illuminated by examining more closely the role of attorneys and underwriters.

1.7.2.1. Lawyers

Lawyers act as gatekeepers alongside other professionals, such as accountants, auditors, brokers, and other actors. As a gatekeeper, by placing its name on a transaction or document, a reputable law firm often dispels whatever degree of insecurity that an investor might otherwise feel. The firm's name and reputation provide investors with assurance that the firm would all but guarantee the legality of the transaction. This assurance is important since attorneys' clients—the issuing corporations/companies are likely prone to more risk-taking than the lawyers because they usually have a substantially greater financial interest at stake. Because a law firm typically derives only a small percentage of its business from any given client, it is capable of being a functional gatekeeper. Withdrawal as counsel from one client would not be financially fatal to the firm, thus simplifying the choice between the loss of one client and greater loss of reputational capital.[35]

In the adversary system, lawyers are not meant to be impartial. An attorney is required to advance the client's lawful objectives and interests. In describing the lawyer's role, it is useful to

[33] Arthur B. Laby, *Differentiating gatekeepers*, (Brook. J. Corp. Fin. & com. L. Vol. 1, 2006), 128.
[34] Ibid, 128.
[35] Marianne C. Adams, *Breaking Past The Parallax: Finding The True Place Of Lawyers In Securities Fraud*, (Fordham Urb. L.J. Vol. XXXVII), 962.

contrast it with the role of the judge. The lawyer, particularly in litigation, seeks to achieve success for his or her client to the disadvantage of the opposing client; the judge interposes herself between the two positions, seeking justice. The judge's ethical norm is impartiality; the lawyer's is loyalty.

The lawyer's role as gatekeeper is clearest when giving legal opinions; it is there one should look to determine whether a lawyer is independent of his client. A legal opinion is an informed judgment, usually reduced to writing, on discrete legal issues. An opinion generally provides the recipient with the lawyer's judgment on how a particular court would resolve a discrete issue. Lawyers provide opinions to clients and non-clients on a number of matters that allow a transaction to go forward.[36] In giving an opinion, the lawyer does not function as a conventional advocate. Rather, the goal of the opinion giver should be to fairly and accurately provide a legal conclusion based on the relevant facts. When a lawyer gives an opinion and he knows or has reason to know that a third person is likely to rely on it, the lawyer owes the third person a duty of reasonable care.

1.7.2.2. Securities Underwriters

"Underwriter" includes a person who has made a contract with an issuer to subscribe and pay in cash for those securities as are not fully subscribed by the public issue or a person who has initially bought the securities from an issuer for the purpose of selling such securities by means of a public offer;[37]

An investment bank acting as an underwriter in a public securities offering plays an important gatekeeping role but, the underwriter is a dependent gatekeeper in many respects. This may be surprising because the underwriter is said to play a special role as the only participant who, as to matters not certified by the auditor, has the background and knowledge to conduct a sufficient investigation to protect the investor. The role of the underwriter, however, is more complex,[38] because underwriters assume a large measure of risk in the event an IPO fails, they have a direct interest in the IPO's success. Moreover, underwriters perform multiple services for

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[36] In public offerings, an underwriting agreement often will require outside counsel to give a negative assurance that nothing has come to counsel's attention to lead them to believe that the registration statement or the prospectus is materially misleading.

[37] Securities and Exchange Ordinance 1969, s 2(p).

[38] Arthur B. Laby, *Differentiating gatekeepers*, (Brook. J. Corp. Fin. & com. L. Vol. 1, 2006), 132.

their clients. The very provision of advice can turn a non-fiduciary relationship into a fiduciary one by dint of reliance by the principal on the skills and expertise of the agent and the trust and confidence reposed in him.[39]

1.8. Enron and Arthur Andersen & Co.; an Important Example of Gatekeeper Failure:

Consider the relationship of Enron and Arthur Andersen & Co., its auditor. Both for Enron and its senior management, a policy of inflating its financial results made at least short-term sense, because it enabled them to make acquisitions, avoid bankruptcy, and exploit stock options worth billions of dollars. For Arthur Andersen, however, the trade-off was very different. Enron was a valuable client that it saw as potentially worth as much as $100 million a year in revenues. Yet, in its final year before the Enron scandal forced its dissolution, Andersen made revenues of over $9 billion.[40] Thus, to the extent that the Enron scandal destroyed it, Andersen is an example of (i) a gatekeeper that faced (and suffered) a loss of reputational capital far exceeding its expected gain from the client, and (ii) an agent that should logically have been more easily deterred than its principal.

But Andersen was not deterred and it was destroyed. Thus, the Enron/Andersen example is instructive both to the extent that it shows the obvious logic of a law enforcement strategy focused on gatekeepers and the limits of that logic. Similarly, this study is premised on the belief that focusing enforcement on gatekeepers could work but has not worked adequately to date.

1.9. Instances of Corporate Frauds in Pakistan

Some pertinent cases making news, where management was involved in deceiving shareholders through various manipulative ways, are cited below.

Case I: 2005 Karachi Stock Exchange Scam

The KSE experienced a steady bull run as reflected in both the KSE 100 index and trading volumes, starting just after the last stock market crisis in May 2002, which accelerated towards the end of 2004. The KSE 100 saw an unprecedented rise of 65 percent, from 6,218 on December 31, 2004 to 10,303 on March 15, 2005, along with an increase in the value traded

[39] Ibid, 134.

[40] John C. Coffee Jr. *Gatekeepers: The Professions and Corporate Governance* (New York: Oxford University Press, 2006), 6.

from around $300-400 million to $1-2 billion per day. The market turned negative in the second half of March, 2005 and index dropped to as low as 6,939 on April 12, 2005, a decline of 32.7 percent from its peak. The sharp rise in the index could not be explained by any change in the fundamentals. The following precipitous fall is also somewhat of a puzzle. Such a meteoric rise in index and a subsequent crash is indicative of a classical speculative bubble in the equity market.[41]

Badla has been blamed as one of the reasons for the March 2005 crisis. Pakistan's influential financial newspaper Business Recorder stated that there were two problems. First, badla financing was only open to a small number of market players, which also includes financial institutions, as opposed to share trading. Second, badla financing was provided by short-term investors and the hot money can disappear overnight.[42]

After the March 2005 crisis, a task force was set up by the Chairman of Securities and Exchange Commission of Pakistan (SECP) to identify the causes for the situation arising at the country's three stock exchanges in March 2005 and to propose measures for strengthening and consolidating the regulatory regime, particularly with a view to enabling emergency intervention, preventing systematic risk and promoting market stability. The task force completed its report in July 2005 identifying a few areas that contributed to the instability in the stock prices. The Task Force recommended that there was a need for structural reforms and steps were needed to protect public interest by ensuring that the financial might that has been accumulated by the stock brokerage and badla financing institutions should be effectively checked and brought to a reasonable size to ensure that they are unable to manipulate the market.[43]

But the task force only pursued institutional restructuring mainly focusing on replacement of the badla system. No criminal or civil charges were filed, and no recovery was sought. This response may have been perceived by the market as weak, and may not have conveyed a strong signal to the market regarding government's resolve for effective enforcement.[44]

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[41] Jamshed Y. Uppal And Inayat U.Mangla, *Market Volatility, Manipulation, and Regulatory Response: A Comparative Study of Bombay and Karachi Stock Markets,* (The Pakistan Development Review 45 : 4 Part II Winter 2006), 1076.

[42] Ibid, 1076.

[43] Ibid, 1076.

[44] Ibid, 1082.

Case II: Norrie Textile Mills Limited

In 2008 on intimation by the Central Depository Company (CDC), the SECP noted the existence of share fraud in the accounts of M/s Norrie Textile Mills. The eligible securities in Central Depository System (CDS) and paid-up capital report stated in accounts disclosed huge differences; Paid-up capital of PKR48.6 million was reported in the quarterly accounts for the period ended March 31, 2008, while eligible securities of PKR598.6 million were registered in CDS. These differences coupled with unusual trading pattern transpired that counterfeit shares of the company were in circulation in the market. The decision by the regulator of this case is still pending.[45]

Case III: Islamic Investment Bank Ltd. (IIBL)

In 2005 a financial scam of PKR634.4 million, moved forward by the Client/SECP, was unearthed implicating 20 high-profile executives including the president and directors of Islamic Investment Bank Ltd (IIBL) and a former registrar of the Supreme Court. The 22 high-profile figures were found involved in embezzling a bank guarantee of PKR634,393,898given by Fecto Belarus Tractors to the Supreme Court. Former registrar of the Supreme Court was accused to have misappropriated the money in connivance with the president and directors of the Islamic Investment Bank Ltd.[46]

Case IV: Bank of Punjab (BOP)

Within the financial sector, the scandal at Bank of Punjab is relatively recent. In 2008 despite internal auditors' warnings that some loans exceeded limits and the borrower did not satisfy all requirements, bank management failed to take action. As a result, BOP's CY07 accounts carried an auditor's qualification which subsequently led to a change in bank's management. The particular loan in question is still outstanding, and has been restructured. Shareholder activism has been largely silent on this issue despite BOP share price collapsing from more than PKR100/share to just abovePKR10/share.[47]

[45] Ibid, 20.
[46] Ibid, 21.
[47] Ibid, 21.

1.10. Regulatory structure in Pakistan

Pakistan has a fairly long history in securities markets. Soon after its independence in August 1947, the Karachi Stock Exchange came into existence in September 1947, and was incorporated as a company limited by guarantee in March 1949.[48] Another important step towards development of securities market was promulgation of Securities and Exchange Ordinance in 1969. It made compulsory for the stock exchanges to be registered under this ordinance. In 1997 Securities and exchange act came which replaced the CLA (Corporate Law Authority) with SECP (Securities and Exchange Commission of Pakistan) which proved more dynamic and vibrant regulatory authority for the regulation of capital market. SECP became operational in 1999 and since then it has come up with numerous laws to ensure fairness and transparency in capital markets. CLRC (Companies Law Review Commission) has been established to improve the legal framework in line with best international practices

The Securities and Exchange Commission of Pakistan (SECP) is an autonomous statutory body that is entrusted with the integrated administration and regulation of, *inter alia*, the capital markets, corporate sector and financial (non-banking) sectors in Pakistan.[49] The "Securities and Exchange Commission of Pakistan" (SECP) was established in pursuance to the "Securities and Exchange Commission of Pakistan" Act, 1997. (SECP) has been assigned the task to regulate the corporate sector in Pakistan. The commission has derived powers from SEC Act 1997 and Companies Ordinance 1984. SECP was given "administrative authority and financial independence in carrying out its regulatory and statutory responsibilities".

The commission became operational in January 1999 and has come a long way since then. The basic purpose for which the law has been promulgated is the establishment of the securities and exchange commission of Pakistan for the beneficial regulation of the capital markets, superintendence and control of corporate entities and for matters connected and incidental thereto. The commission "was initially concerned with the regulation of corporate sector and capital market only, later on its mandate has expanded to include supervision

[48] Fazal Hussain and Muhammad Ali Qasim, *The Pakistan Equity Market in 50 Years: A Review*, (The Pakistan Development Review, 36:4 Part II, Winter 1997), 863-872.

[49] Speech delivered on "Capital Markets Developments in Pakistan and Role of Regulatory Authority" to the officers of the 85th National Management Course at the Pakistan Administrative Staff College. Lahore on November 8, 2006.

therewith and regulation of insurance companies, non-banking finance companies and private pensions. The commission has also been entrusted with oversight of various external service providers to the corporate and financial sectors, including chartered accountants, credit rating agencies, corporate secretaries, brokers, surveyors etc.

Commission, as a regulator was obliged to look into the affairs of the entities it regulated, to ensure that those were not being managed in a manner which would deprive its members of a reasonable return on their investments; that the affairs of the company were managed in accordance with sound business principles and prudent commercial practices etc.

1.10.1 Existing Regulatory Laws in Pakistan

The statutes regulating the securities market in Pakistan includes The Securities And Exchange Ordinance 1969, The Companies Ordinance 1984, The Securities And Exchange Commission Of Pakistan Act 1997, Code of Corporate Governance 2012, Central Depositories Act 1997, Insurance Ordinance 2000 and the listing regulations provided by the three stock exchanges.

1.10.2 Need of new legislation enhancing the liabilities of gatekeepers in Pakistan

Securities laws do not adequately define the duties and liabilities of financial intermediaries and other market participants which act as gatekeepers in securities market and their role is largely invisible and poorly understood. There is need of unambiguous and comprehensive legislative framework regarding the duties and liabilities of gatekeepers in securities market and an effective monitoring and surveillance system at the SECP to monitor and effectively regulate the gatekeepers. Any kind of professional misconduct by auditors, lawyers, underwriters, lenders, stock analysts and other gatekeepers shall not be tolerated. There is a need to make the laws more stringent and penalties harsher for any misdemeanors by these professionals. A re-examination of the role of gatekeepers as service providers within the Pakistani securities market is needed at this stage.

CHAPTER 2

Provisions of Gatekeeper Liability in Pakistan

2.1. Introduction

In Pakistan, securities regulation has significantly improved in recent past; however, much needs to be done. Securities and Exchange Ordinance 1969 and Companies Ordinance, 1984 provide the base for securities regulation in the country. Securities and Exchange Ordinance 1969 was specifically promulgated for the protection of investors, regulation of markets and dealings in securities.

Following are the important liability provisions related to gatekeepers.

2.2. Section 17 of Securities and Exchange Ordinance 1969

"Prohibition of fraudulent acts, etc.-

No person shall, for the purpose of inducing, dissuading, effecting, preventing or in any manner influencing or turning to his advantage, the sale or purchase of any security, directly or indirectly,-

(a) employ any device, scheme or artifice, or engage in any act, practice or course of business, which operates or is intended or calculated to operate as a fraud or deceit upon any person; or

(b) make any suggestion or statement as a fact of that which he does not believe to be true; or(c) omit to state or actively conceal a material fact having knowledge or belief of such fact; or

(d) induce any person by deceiving him to do or omit to do anything which he would not do or omit if he were not so deceived; or

(e) do any act or practice or engage in a course of business, or omit to do any act which operates or would operate as a fraud, deceit or manipulation upon any person, in particular-

(i) make any fictitious quotation;

(ii) create a false and misleading appearance of active trading in any security;

(iii) effect any transaction in such security which involves no change in its beneficial ownership;

(iv) enter into an order or orders for the purchase and sale of security which will ultimately cancel out each other and will not result in any change in the beneficial ownership of such security;

(v) directly or indirectly effect a series of transactions in any security creating the appearance of active trading therein or of raising of price for the purpose of inducing its purchase by others or depressing its price for the purpose of inducing its sale by others;

(vi) being a director or an officer of the issuer of a listed equity security or a beneficial owner of not less than ten per cent of such security who is in possession of material facts omit to disclose any such facts while buying or selling such security."[50]

Explantion

Section 17 of Securities and Exchange Ordinance, 1969, would only be applicable in the case of company, if the creation of false trading and misleading appearance of active trading in any security was meant to operate as a fraud, deceipt or manipulation.[51]

Relevant case law shows that this charge is very difficult to prove and SECP mostly imposes penalties on such perpetrators of manipulative and deceptive practices.

2.3. Section 18 of Securities and Exchange Ordinance 1969

"Prohibition of false statements, etc.-

No person shall, in any document, paper, accounts, information or explanation which he is, by or under this Ordinance, required to furnish, or in any application made under this Ordinance, make any statement or give any information which he knows or has reasonable cause to believe to be false or incorrect in any material particular."[52]

Explantion

Deficiencies in calculation of Net Capital Balance (NCB). Securities and Exchange Commission, ordered an inspection of the books and records required to be maintained by the company. Report submitted by Inspection team highlighted major deficiencies in the calculation of Net Capital Balance of the company. Record had shown that, if Net Capital Balance was calculated in strict compliance with the requirements of Securities and Exchange Rules, 1971, same would have been in negative thereby implying that the company by submission of false Net Capital Balance had not only attained the certificate of registration as broker, but also much higher trading exposure thereby increasing the systemic risk in the market. Net Capital Balance

[50] Securities And Exchange Ordinance 1969, S 17, Prohibition Of Fraudulent Acts.

[51] 2012 C L D 612.

[52] Securities and Exchange Ordinance 1969, s 18, Prohibition of false statements, etc.

as calculated by the company was not in accordance with Third Schedule of Securities and Exchange Rules, 1971 and company, by submission of overstated Net Capital Balance had submitted statement and given information, which it had reasonable cause to believe to be false or incorrect in material particular in violation of S.18 of Securities and Exchange Ordinance, 1969. Violation of Ordinance, Rules and Regulations, was a serious matter. In view of regulatory violations, in exercise of the powers under S.22 of the Securities and Exchange Ordinance, 1969, the company was directed to deposit a sum of Rs.500,000 (Rupees Five Hundred Thousand) to the Commission by way of penalty. Company was further directed to ensure full compliance with the Ordinance, rules, regulations and directives of the Commission in future.[53]

2.4. Section 22 of Securities and Exchange Ordinance 1969

"Penalty for certain refusal or failure.-

(1) If any person

a. refuses or fails to furnish any document, paper or information which he is required to furnish by or under this Ordinance; or
b. refuses or fails to comply with any order or direction of the Commission made or issued under this Ordinance; or
c. contravenes or otherwise fails to comply with the provisions of this Ordinance or any rules or regulations made thereunder;

the Commission may, if it is satisfied after giving the person an opportunity of being heard that the refusal, failure or contravention was willful, by order direct that such person shall pay to the Commission by way of penalty such sum not exceeding fifty million rupees as may be specified in the order and, in the case of a continuing default, a further sum calculated at the rate of two hundred thousand rupees for every day after the issue of such order during which the refusal, failure or contravention continues.

(2) Any sum directed to be paid under sub-section (1) shall be recoverable as an arrear of land revenue.

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[53] 2013 C L D 566.

(3) No prosecution for an offence against this Ordinance shall be instituted in respect of the same facts on which a penalty has been imposed under this section."[54]

Explantion

Trading by individual clients of the company extensively in shares of other companies. Trading data of Automated Trading System of Stock Exchange had shown that five individual clients of the company traded extensively in share of a number of companies. Said individual clients, as a result of such trading, earned a cumulative profit of over Rs.8.70 million in their accounts. Trading pattern of individual clients and their synchronization with trading of foreign and local institutional clients of the company along with the observation of strong relationship of some of the individual clients with senior executive of the company, prima facie, indicated that the company failed to provide best execution to its foreign and local institutional clients. Company therefore, failed to protect confidential information relating to large trading orders and investment decisions of those individual clients, which was being used by individual clients for their own trading purposes. Employees of the company misused the information regarding trading decisions provided by the foreign and local institutional clients of the company. Trading by the individual clients was not by any means in accordance with the legitimate and fair market practices. Time span of around two years involved in the suspected trading by the individual clients, which was in collusion with the employees of the company, was quite significant; which had caused suspicion that those activities went undetected by the company, despite the strong control and policies as signified by the company. Employees of the company, including the senior officials, were assisting and aiding in the suspected activities of the individual clients, compromising the fair execution to foreign and local institutional clients. Company, quite likely, was not aware of the activities of the individual clients in collusion with its employees to trade on the basis of material non-public information, but failure of detection mechanism of the company, despite all its stated control and policies established to averse the activities of its employees, was of deep concern. Company was reproached and censured for conduct which did not commensurate with high standards of conduct expected of the company. Company was advised to ensure that no employee or their associated person should be allowed or given any opportunity to take unfair advantage of their position at the expense of other clients of

[54] Securities and Exchange Ordinance 1969, s 22, Penalty for certain refusal or failure

the company. Company was directed to ensure compliance of the laws and policies and directives of the Commission.[55]

2.5. Section 23 of Securities and Exchange Ordinance 1969

"Civil liabilities.-

(1) Every contract made in contravention of any provision of this Ordinance or any rule made thereunder shall be voidable as regards the rights of any party to the contract contravening such provision or any person not being a party to the contract who acquires any right under the contract with actual knowledge of the facts by reason of which its making or performance was in such contravention and any person affected by such contract not being himself a party to the contravention may sue to rescind any such contract to the extent it has been consummated or for damages when recision is not possible.

(2) Any person who makes or causes to be made, in any application, report, or document filed with the [Commission] or a Stock Exchange pursuant to this Ordinance or any rule made thereunder, any statement which was false or misleading with respect to any material fact, at the time and in the light of the circumstances under which it was made, shall be liable to any person who has purchased or sold a security in reliance on such statement for damages caused by such reliance, without regard to the presence or absence of any contractual relationship between the two, unless the person who made or caused to be made the application, report or document proves that he acted in good faith and had no knowledge or reasonable ground to believe that the statement was false or misleading.

(3) Any person who participates in any act or transaction in contravention of section 17 shall be liable to any person who has purchased or sold a security in reliance on such act or transaction for damages caused by such reliance, without regard to the presence or absence of any contractual relationship between the two, unless the person so contravening proves that he acted in good faith and had no knowledge or reasonable ground to believe that there was any fraud, untruth or omission.

(4) Every person who directly or indirectly exercises control over the affairs of any person liable under this section shall also be liable to the same extent as the person whose affairs

[55] 2012 C L D 1120.

are so controlled, unless he proves that he acted in good faith and did not directly or indirectly induce the act or acts giving rise to the cause of action.

(5) Liability under this section shall be joint and several, and every person who becomes liable may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment, unless the plantiff was, and the defendant was not, guilty of fraudulent misrepresentation.

(6) No suit for the enforcement of any right or remedy provided for in this section shall lie after the expiry of three years from the date of the accrual of the cause of action.

(7) The rights and remedies provided by this Ordinance shall be in addition to any other rights and remedies available under any other law for the time being in force."[56]

2.6. Section 24 of Securities and Exchange Ordinance 1969

"Penalty.-

(1) Whoever contravenes the provisions of section 17 shall be punishable with imprisonment for a term which may extend to three years, or with fine which may extend to [five hundred] thousand rupees, or with both.

(2) Where the person guilty of an offence referred to in sub-section (1) is a company or other body corporate, every director, manager or other officer responsible for the conduct of its affairs shall, unless he proves that the offence was committed without his knowledge or that he exercised all diligence to prevent its commission, be deemed to be guilty of the offence."[57]

2.7. Section 59 of Companies Ordinance 1984

"Civil liability for mis-statements in prospectus.-

(1) Subject to the provisions of this section, where a prospectus invites persons to subscribe for shares in or debentures of a company, the following persons shall be liable to pay compensation to every person who subscribes for or purchases any share or debentures on the faith of the prospectus for any loss or damage he may have sustained by reason of any untrue statement included therein namely,—

[56] Securities And Exchange Ordinance 1969, S 23, Civil Liabilities
[57] Securities And Exchange Ordinance 1969, S 24, Penalty

(a) every person who is a director of the company at the time of the issue of the prospectus;

(b) every person who has authorised himself to be named and is named in the prospectus either as a director, or as having agreed to become a director, either immediately or after an interval of time;

(c) every person who is a promoter of the company; and

(d) every person who has given consent to the issue of the prospectus under section 55 or sub-section (5) of section 57:

Provided that where, under section 55, the consent of a person is required to the issue of a prospectus and he has given that consent, or where, under sub-section (5) of section 57, the consent of a person named in a prospectus is required and he has given that consent, he shall not, by reason of having given such consent, be liable under this sub-section as a person who has authorised the issue of the prospectus except in respect of an untrue statement, if any, purporting to be made by him as an expert.

(2) No person shall be liable under sub-section (1), if he proves:-

(a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent;

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave reasonable public notice that it was issued without his knowledge or consent;

(c) that, after the issue of the prospectus and before allotment thereunder, he, on becoming aware of any untrue statement therein, withdrew his consent to the prospectus and gave reasonable public notice of the withdrawal and of the reason therefor; or

(d) that:-

(i) as regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he had reasonable ground to believe, and did up to the time of the allotment of the shares or debentures, as the case may be, believe, that the statement was true; and

(ii) as regards every untrue statement purporting to be a statement by an expert or contained in what purports to be a copy of or an extract from a report or valuation of an expert, it

was a correct and fair representation of the statement, or a correct copy of, or a correct and fair extract from, the report or valuation; and he had reasonable ground to believe, and did up to the time of the issue of the prospectus believe, that the person making the statement was competent to make it and that that person had given the consent required by section 55 to the issue of the prospectus and had not withdrawn that consent before delivery of a copy of the prospectus for registration or, to the defendant's knowledge, before allotment thereunder; and

(iii) as regard every untrue statement purporting to be a statement made by an official person or contained in what purports to be a copy of or extract from a public official document, it was a correct and fair representation of the statement, or a correct copy of, or a correct and fair extract from, the document:

Provided that this sub-section shall not apply in the case of a person liable, by reason of his having given consent required of him by section 55, as a person who has authorised the issue of the prospectus in respect of an untrue statement purporting to be made by him as an expert.

(3) A person who, apart from this sub-section would, under sub-section (1), be liable by reason of his having given a consent required of him by section 55, as a person who has authorised the issue of the prospectus in respect of an untrue statement purporting to be made by him as an expert, shall not be so liable, if he proves:-

(a) that, having given his consent under section 55 to the issue of the prospectus, he withdrew it in writing before delivery of a copy of the prospectus for registration;

(b) that, after delivery of a copy of the prospectus for registration and before allotment thereunder, he, on becoming aware of the untrue statement withdrew his consent in writing and gave reasonable public notice of the withdrawal and of the reason therefor; or

(c) that he was competent to make the statement and that he had reasonable ground to believe, and did up to the time of the allotment of shares or debentures believe, that the statement was true.

(4) Where:-

(a) the prospectus specifies the name of a person as a director of the company, or as having agreed to become a director thereof, and he has not consented to become a director, or has withdrawn his consent before the issue of the prospectus, and has not authorised or consented to the issue thereof; or

(b) the consent of a person is required under section 55 to the issue of the prospectus and he either has not given that consent or has withdrawn it before the issue of the prospectus:

the directors of the company, excluding those without whose knowledge or consent the prospectus was issued, and every other person who authorised the issue thereof, shall be liable to indemnify the person referred to in clause (a) or clause (b), as the case may be, against all damages, costs and expenses to which he may be made liable by reason of his name having been inserted in the prospectus or of the inclusion therein of a statement purporting to be made by him as an expert, as the case may be, or in defending himself against any suit or legal proceeding brought against him in respect thereof:

Provided that a person shall not be deemed for the purposes of this sub-section to have authorised the issue of a prospectus by reason only of his having given the consent required by section 55 to the inclusion therein of a statement purporting to be made by him as an expert.

(5) Every person who becomes liable to make any payment by virtue of this section may recover contribution, as in cases of contract, from any other person who, if sued separately, would have been liable to make the same payment, unless the former person was, and the latter person was not, guilty of fraudulent misrepresentation.

(6) For the purposes of this section:-

(a) the expression "promoter" means a promoter who was a party to the preparation of prospectus or a portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company; and

(b) the expression "expert" has the same meaning as in section 55."[58]

Explanation

Section 59 of the Companies Ordinance 1984 incorporates the provision relating to the civil liability for misstatement in prospectus. It provides very clearly that where a prospectus invites persons to subscribe for shares in or debentures of a company liability accrues to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damage he may have sustained by reason of any untrue statement

[58] CO 1984, S 59, Civil Liability For Mis-Statements In Prospectus.

included therein. Every person who becomes liable to make any payment by virtue of such misrepresentation may recover contribution as in cases of contract from any other person who, if sued separately, would have been liable to make the same payment unless the former person was and the latter person was not guilty of fraudulent misrepresentation.[59] The measure of damages for the loss suffered by reason of the untrue statement, omission, etc. is the difference between the value which the shares would have had but for such statement or omission and the true value of the shares at the time of allotment. In applying the correct measure of damages to be awarded to compensate a person who has been fraudulently induced to purchase shares, the crucial criterion is the difference between the purchase price and their actual value. It may be appropriate to use the subsequent market price of the shares after the fraud has come to light and the market has settled.[60]

2.8. Section 60 of Companies Ordinance 1984

"Criminal liability for mis-statements in prospectus.-

(1) Where a prospectus includes any untrue statement, every person who signed or authorised the issue of the prospectus shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to ten thousand rupees, or with both, unless he proves either that the statement was immaterial or that he had reasonable ground to believe, and did up to the time of the issue of the prospectus believe, that the statement was true.

(2) A person shall not be deemed for the purposes of this section to have authorised the issue of a prospectus by reason only of his having given:-

(a) the consent required by section 55 to the inclusion therein of a statement purporting to be made by him as an expert, or

(b) the consent required by sub-section (5) of section 57."[61]

Explanation

Section 60 of the Companies Ordinance 1984 incorporates the provision relating to the criminal liability for misstatement in prospectus. It provides that where a prospectus includes any

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[59] CO 1984, S 59, Civil Liability For Mis-Statements In Prospectus.

[60] Manendra Singh, Liability for Misstatement in Prospectus: Where to Stop?, (Chartered Accountant Practice Journal (CAPJ), December (1st) 2010, Manupatra Publishing Pvt. Ltd., India), 23.

[61] CO 1984, S 60, Criminal Liability For Mis-Statements In Prospectus.

untrue statement, every person who authorised the issue of prospectus shall be punishable with imprisonment for a term which may may extend to two years, or with fine which may extend to ten thousand rupees, or with both,

It has to be noted that under such cases, once the prosecution establishes the falsity of statement in a prospectus signed by a director, etc., the onus is shifted to the defendant of proving either that the statement was immaterial or that he believed it to be true.

An expert who has given the consent will not be deemed to be ipso facto a person who authorised the issue of prospectus.

2.9. Section 260 of Companies Ordinance 1984

"Penalty for non-compliance with provisions by auditors.-

(1) If any auditor's report is made, or any document of the company is signed or authenticated otherwise than in conformity with the requirements of section 157, section 255 or section 257 or is otherwise untrue or fails to bring out material facts about the affairs of the company or matters to which it purports to relate, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document, and in the case of a firm all partners of the firm, shall, if the default is wilful, be punishable with fine which may extend to 2[one hundred] thousand rupees.

(2) If the auditor's report to which sub-section (1) applies is made with the intent to profit such auditor or any other person or to put another person to a disadvantage or loss or for a material consideration, the auditor shall, in addition to the penalty provided by that sub-section, be punishable with imprisonment for a term which may extend to 1[one year] and with fine which may extend to 2[one hundred] thousand rupees."[62]

Explantion

The Companies Ordinance 1984 is the basic law which deals and governs the corporate sector of Pakistan. In addition to the rules for the establishment of company it also enumerates duties and liabilities of auditors.

Pakistan has adopted International Financial Reporting Standards. Statutory auditors are required to perform their audits according to International Standards on Auditing and report

[62] CO 1984, S 260, Penalty For Non-Compliance With Provisions By Auditors.

whether financial statements have been prepared in accordance with International Financial Reporting Standards and the local reporting framework.[63]

Tariq Bakhtawar, Director Enforcement of Securities and Exchange Commission of Pakistan in the matter of Messrs Kamran & Co., Chartered Accountants (hereinafter referred to as the "Auditors) observed that the Auditors had failed to perform their statutory obligations by giving contradictory and misleading information to members and in that way, had failed to perform their professional duties with reasonable degree of care and skill. Auditors knowingly and recklessly ignored their observations and gave a clean bill of health to company's accounts. Auditors in circumstances had committed a breach of fiduciary duty cast upon them by shareholders of company concerned. Proprietor of Auditors' Company, had signed audit report otherwise than in conformity with requirements of S.255 of Companies Ordinance, 1984 and by so doing had made himself liable for punishment under subsection (1) of S.260 of the Ordinance. Auditors being ultimate watch-dog of share-holder's interest, were required to give a report on the accounts and books of accounts, after conducting the audit in accordance with prescribed procedure and requirements of Companies Ordinance, 1984, international accounting and auditing standards. If Auditors found any irregularity, which was material with regard to those accounts, they were required to issue qualified report. Share-holders were ultimate entity to whom the Auditors were responsible and they must keep that fact in mind while auditing the books of accounts and reporting thereon. Auditors must realize their true role and restrain themselves from performing their duties indulgently. Share-holders, who were stake-holders and ultimate beneficiaries, had no control over the way the Company was managed by the Directors appointed by them and it was necessary that there must be some arrangement in place where shareholders who were the real beneficiaries, must get some independent views as to how the Directors had managed the affairs of the company. Law having recognized that situation, had provided that shareholders should appoint an Auditor who would be responsible to audit accounts and books of accounts and make out a report to them at the end of each year which was the only safeguard provided by law to share-holders and extremely important for the Auditors to be vigilant and perform their duties and obligations with due care while auditing accounts and books of accounts. Fine of Rs.25,000 under S.260(1) of Companies Ordinance, 1984, was

Accession No TH-14857

[63] *The Pakistan Accountant* (Magazine of The Institute of Chartered Accountants of Pakistan Vol 43 Issue 1 January-March 2009), 15.

imposed on the proprietor of Auditing Company for making report otherwise than in conformity with requirement under S.255 of the Companies Ordinance, 1984.[64]

"In the 19th century English case namely, Kingston Cotton Mills Company Ltd. (1896) Lord Justice Lopes stated: The auditor is a watch dog and not a bloodhound.

The responsibility for preparation of financial statements essentially vests upon management. An auditor expresses an opinion about the fairness or otherwise relating to duly certified financial statements. The management needs to be reminded about this time and again. In this respect, sound internationally accredited values system to strengthen moral aspects be popularized, disseminated and operationalized. Divine Value System from Quran is quoted below:

"Allah commands justice, the doing of good, and liberality to kith and kin, and He forbids all shameful deeds, and injustice and rebellion*: He instructs you, that you may receive admonition." (16:90)"[65]

2.10. Synopsis

Section 17 and 18 of Securities and Exchange Ordinance 1969 can be seen as the most important provisions which incorporate the principles of gatekeeper liability. Section 17 prohibits all kind of fraudulent acts and whoever infringes it will be punished by the punishment provided in section 24 which can be imprisonment that may extend to three years, or fine which may extend to five hundred thousand rupees, or both. Section 17 would only be applicable in the case of company, if the creation of false trading and misleading appearance of active trading in any security was meant to operate as a fraud, deceit or manipulation.[66] Section 24 provides due diligence defence to directors, managers and other officers of company or other body corporate, responsible for the conduct of its affairs. They shall not be deemed to be guilty of the offence unless it proves that the offence was committed with their knowledge or that they failed to exercise all diligence to prevent its commission. Section 18 prohibits furnishing of fabricated and

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[64] 2006 C L D 1023.

[65] *The Pakistan Accountant* (Magazine of The Institute of Chartered Accountants of Pakistan Vol 43 Issue 1 January-March 2009), 24.

[66] 2012 C L D 612.

untruthful statements in any document, paper, accounts, information or explanation which are required by or under this ordinance.

Section 22 provides that if any person refuses or fails to furnish any document, paper or information which he is required to furnish by or under this Ordinance shall pay to the Commission by way of penalty such sum not exceeding fifty million rupees as may be specified in the order and, in the case of a continuing default, a further sum calculated at the rate of two hundred thousand rupees for every day after the issue of such order during which the refusal, failure or contravention continues.

Section 23 provides right to file civil suit for damages against a person who's false and misleading statements caused loss to any person who has purchased or sold a security in reliance on such statement. Liability under this section is joint and several, and every person who becomes liable may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment, unless the plaintiff was, and the defendant was not, guilty of fraudulent misrepresentation. Limitation period for filing the suit is three years from the date of accrual of the cause of action. Only court of session and above can take cognizance of any offences under this ordinance on a report in writing of the facts constituting the offence by an officer authorised in this behalf by the Commission.[67]

Section 59 of companies ordinance 1984, states civil liability for misstatements in prospectus and section 60 states criminal liability for misstatements in prospectus. Section 260 says that if any auditor's report is untrue or fails to bring out material facts about the affairs of the company or matters to which it purports to relate, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document shall, if the default is wilful, be punishable with fine which may extend to one hundred thousand rupees. If the auditor's report is made with the intent to profit such auditor or any other person or to put another person to a disadvantage or loss or for a material consideration, the auditor shall, in addition to the penalty provided, be punishable with imprisonment for a term which may extend to one year and with fine which may extend to one hundred thousand rupees.

Auditors must realize their true role and restrain themselves from performing their duties indulgently. Capital required for the business of a listed company is contributed by its shareholders who could not necessarily be the persons managing the company. Share-holders are

[67] Securities and Exchange Ordinance 1969, s 25, Cognizance of offence.

stakeholders and ultimate beneficiaries, but they had no control over the way their company was managed by the directors appointed by them. Law; in circumstances had provided that shareholders should appoint Auditor who would be responsible to audit accounts and books of accounts and make out a report to them at the end of each year; so it was extremely important for the Auditors to be vigilant and to perform their duties and obligation with due care while auditing the accounts and books of account.[68] Lapses and non-compliance of mandatory provisions of law on the part of auditors could not be taken lightly.[69]

[68] 2007 C L D 1256.
[69] 2006 C L D 399.

CHAPTER 3

Provisions of Gatekeeper Liability in United States

3.1. Introduction

United States has long history of capital and securities market. US has different laws to control capital market activities and initially these laws were introduced after depression of early 20th century. Securities Act of 1933 and Securities and Exchange Act of 1934 were two major enactments regarding securities and capital market. These two enactments remained enforced till recent corporate failures of early 21st century.

Thereafter along with above stated laws a new and stringent law regarding securities market has been introduced named Sarbanes Oxley. The Sarbanes-Oxley Act came into force in July 2002 and introduced major changes to the regulation of corporate governance and financial practice. It is named after Senator Paul Sarbanes and Representative Michael Oxley, who were its main architects, and it set a number of non-negotiable deadlines for compliance.[70]

The Securities Act was Congress' opening shot in the war on securities fraud with Congress primarily targeting the issuers of securities. Companies which issue securities (issuers) seek to raise money to fund new projects or investments or to expand; thus, companies have an incentive to present the company and its plans in the rosiest light possible. The Securities Act serves the dual purpose of ensuring that issuers selling securities to the public disclose material information to investors, and that any securities transactions are not based on fraudulent information or practices. In this context, "material" means information that would affect a reasonable investor's evaluation of the company's stock. The goal is to provide investors with accurate information so that they can make informed investment decisions.[71]

The Securities Act effectuates disclosure through a mandatory registration process in any sale of any securities. In reality, due to a number of exemptions for trading on the secondary market and small offerings, the Act is mainly applied to primary market offerings by issuers.[72]

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[70] http://www.soxlaw.com/introduction.htm.
[71] Http://Www.Law.Cornell.Edu/Wex/Securities Act of 1933.
[72] Ibid.

In contrast to the Securities Act, the Exchange Act primarily regulates transactions of securities in the secondary market - that is, sales that take place after a security is initially offered by a company (the issuer). These transactions often take place between parties other than the issuer, such as trades that retail investors execute through brokerage firms. The Exchange Act operates somewhat differently from the Securities Act. To protect investors, Congress crafted a mandatory disclosure process that is designed to force companies to make public information that investors would find pertinent to making investment decision. In addition, the Exchange Act provides for direct regulation of the markets on which securities are sold (the securities stock exchanges) and the participants in those markets (industry associations, brokers, and issuers).[73]

Congress enacted the Sarbanes-Oxley Act of 2002, a series of somewhat disjointed reforms targeting securities market intermediary institutions. Sarbanes-Oxley first established a new Public Company Accounting Oversight Board (the Oversight Board) to oversee the auditing profession. Under the Act, the Oversight Board consists of five members, two of whom must be or have been certified public accountants, while the remaining three must not be CPAs. Following the tactics taken in other areas of securities regulation, Congress established the Oversight Board as a self-regulatory organization relying on the expertise of industry members to guide the regulation of auditors. [74] As with other SROs, the SEC has oversight responsibility over the Oversight Board.[75] The Act also provides for a greater direct role for the SEC in monitoring public company filings (with a corresponding increase in the SEC's budget).[76]

The important liability provisions of US securities law for the regulation of the primary and secondary market are as follows

3.2. Section 11 of Securities Act of 1933

"In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring

[73] Http://Www.Law.Cornell.Edu/Wex/Securities_Exchange_Act_Of_1934.

[74] Sarbanes-Oxley Act 2002,s 103 - Among other things, the Public Company Accounting Oversight Board must: (2) establish, or adopt, by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;" (3) conduct inspections of accounting firms; (4) conduct investigations and disciplinary proceedings, and impose appropriate sanctions.

[75] Sarbanes-Oxley Act 2002, s 107.

[76] Sarbanes-Oxley Act 2002, s 408, 601.

such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue;

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person."[77]

Explanation

Section 11 of the Securities Act of 1933 is about Civil liabilities on account of false registration statement and is addressed to the signatories of the registration statement, i.e. the issuer and, inter alia, its CEO, CFO, and CAO, its directors, experts (accountants, engineers, appraisers etc.), and the underwriters. It divides the defendants into three groups: Liability for the issuer is strict. The other defendants may escape liability if they show that they have conducted a reasonable investigation of the registration statement and, after such investigation, had

[77] US Securities Act of 1933, s 11.

reasonable ground to believe that the documents were correct and complete.[78] Finally, as regards defendants other than experts who rely on expertised portions of the registration statement (e.g. the audited accounts of the issuer), all that is necessary is that they had "no reasonable ground to believe and did not believe" that anything contained in the expert opinion was untrue. An independent investigation is not required.[79] Therefore, section 11 establishes a "sliding scale of responsibility". The issuer as the primary originator of the registration documents is held to the highest standards. Experts have to apply their expertise when reviewing the registration statement. Other defendants may assume, at least in respect to expertised portions, that the information stemming from third parties is accurate. The courts have further refined this sliding scale. The first important opinion concerning the due diligence defence emphasised: "It is all a matter of degree." If a defendant is "directly concerned with writing the registration statement and assuring its accuracy, more is required of him in the way of reasonable investigation than can fairly be expected of someone who has no connection with this work." Furthermore, the requisite level of care depends on the cost involved in verifying the issuer's disclosures: "To require an audit might be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable." This approach has led courts to draw a distinction between corporate insiders (executive directors) and outsiders (non-executive directors and third parties, e.g. the underwriters), imposing stringent requirements on the former and being more lenient in case of the latter. However, this dichotomy does not change the fact that the "sliding scale" is gradual and that within the two groups of insiders and outsiders the standard of care continues to depend on the specific position of the defendant and his access to the issuer. It can be seen that section 11, as interpreted by the courts, anticipates and epitomises the guiding principles of the gatekeeper theory. Essentially, the courts have adopted a cost-benefit analysis that seeks to determine the efficient measure of precautionary or supervisory activity.[80]

3.3. Section 10 and Rule 10b-5 of Securities Exchange Act of 1934

"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

[78] US Securities Act of 1933, s 11(b)(3)(A), (B).

[79] US Securities Act of 1933,s 11(b)(3)(C).

[80] Carsten Gerner-Beuerle: The Market for Securities and Its Regulation through Gatekeepers, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 17.

Exchange;

(a)(1) To effect a short sale, or to use or employ any stop loss order in connection with the purchase or sale, of any security other than a government security, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(c) To effect, accept, or facilitate a transaction involving the loan or borrowing of securities in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[81]

Rule 10b-5

"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,

(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."[82]

Explanation

Section 10(b) of the Securities Exchange Act of 1934 in conjunction with Exchange Act Rule 10b-5 is the second famous liability provision of US securities regulation. Unlike section 11 of the Securities Act, section 10(b) Securities Exchange Act and Rule 10b-5 do not define the

[81] US Securities Exchange Act of 1934, s 10.
[82] 17 CFR 240.10b-5 - Employment Of Manipulative And Deceptive Devices.

class of defendants, nor do they specify the elements of the cause of action, in particular the standard of care that the defendant is expected to employ. This is not surprising, as section 10(b) and Rule 10b-5 were not designed as a private cause of action. Rather, they were intended to broaden the powers of the SEC and facilitate public enforcement of the securities laws. The courts, through ingenious interpretation, granted defrauded investors an implied remedy based on Rule 10b-5, a development that was vividly described by Justice (later Chief Justice) Rehnquist: "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn." However, the development of the private cause of action under the auspices of the judiciary has proven to be a mixed blessing for investors. In order to limit the risk of liability the Supreme Court has overruled decisions of the lower federal courts that had allowed claims in cases of negligence. Instead, it requires the plaintiff to prove that the defendant acted with scienter. Furthermore, the question of who can be sued under Rule 10b-5 belongs to the most controversial issues of US securities regulation. The relevant criteria have always been vague and ambiguous, they have changed over time, and courts in different federal circuits have followed different approaches.[83]

Central Bank Case

Leading case is the decision of the Supreme Court in Central Bank. The Court overturned a line of circuit court decisions that had held both primary violators, i.e. persons that committed the fraudulent act themselves, and secondary violators, i.e. persons that aided and abetted the primary violator (possible gatekeepers), responsible. It limited liability to primary violators, thus consolidating a trend to restrict the scope of Rule 10b-5. The main reason for the turnaround of the Court was its fear of vexatious litigation. The unclear principles of aiding and abetting liability made the outcome of lawsuits unpredictable. In addition, the inquiries were highly fact-oriented; a motion for summary judgement was therefore unlikely to be successful. As a result, parties might have found it prudent, "as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial." However, in one of the last paragraphs of the judgement the Court opened the door again to the potential liability of gatekeepers: "The absence of section 10(b) aiding and abetting liability does not mean that

[83] Carsten Gerner-Beuerle: The Market for Securities and Its Regulation through Gatekeepers, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 18.

secondary actors in the securities markets are always free from liability under the Securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met."[84]

The courts were unsure how to implement the standards established by the Supreme Court. Some purported to apply Central Bank literally and required that the defendant actually made the false or misleading statement that gave rise to the claim under Rule 10b-5 (so-called bright line test). However, they somewhat departed from this clear rule by allowing the claim to be brought against a person other than the one who communicated the misleading brought against a person other than the one who communicated the misleading statement to plaintiffs, provided that the secondary actor "controlled the content of the statement" or "knew or should have known that his representation would be communicated to and relied upon by investors". Other courts approached the legal situation before *Central Bank* in a more undisguised manner. They held responsible as primary violator everybody who had "played a significant role", "a central role", who was "intricately involved", who "actively participated" in the making, or who could be seen as "the 'author' or 'co-author' of the statement". Issuers might be liable for misleading statements by analysts if they "entangled" themselves in the fraudulent acts of the analysts. As opposed to the bright line test, the misrepresentation did not have to be attributable to the defendant. Finally, it was sufficient for liability that the defendant "directly or indirectly engaged in a manipulative or deceptive act as part of a scheme to defraud" even if the material statement by another person implemented the scheme and created the nexus with the securities market.[85]

The Supreme Court, in a recent decision, partly agreed with the wider approach, pointing out that a defendant, in order to be liable, did not need to make a specific oral or written statement that was communicated to the plaintiff, but that "conduct itself could be deceptive." However, it then employed a narrow construction of the requirement to show reliance and by this means effectively approached the bright line test. Reliance could only be established, the Court argued, if the defendant's deceptive acts were disclosed to the investing public or if they made it

[84] Ibid, 19.
[85] Ibid, 20.

"necessary or inevitable" for the issuer to publish the misleading information, for example the falsified financial statements. While this holding militates in favour of the restrictive view outlined above, it is unlikely that the Supreme Court has dispelled all ambiguities. First, the decision only dealt with scheme liability pursuant to Rule 10b-5(a) and (c), not with misleading statements within the meaning of Rule 10b-5(b). Thus, questions such as who is the "author or co-author" of the statement, who has played "a central role" in drafting it or "controlled its content", and whether it needs to be attributable to the author, still await conclusive answers. Second, the Court held that the employment of a deceptive device or scheme that necessitated the issuer's incorrect statements gave rise to liability even if the device itself was not disclosed. The indefinite concepts developed by the Supreme Court have already produced inconsistent decisions of the lower courts. The border between primary and secondary violators remains blurred, and legal uncertainty has reached, if not surpassed, pre-*Central Bank* levels.[86]

In light of the ambiguous legal situation it is not surprising that the considerations of the gatekeeper theory are not reflected clearly in the structure of section 10(b). According to the Supreme Court, gatekeepers can only be liable as primary violators. This is not satisfactory, as gatekeepers are precisely in the position of secondary market participants that verify the acts of the primary participant. The lower courts have realised that adequate results cannot be reached by way of a literal application of *Central Bank*. All of the opinions allow for certain exceptions that are intended to bring secondary actors within the reach of section 10(b). However, the courts are hindered in discussing and implementing the principles of gatekeeper liability by the necessity not to contradict the binding holdings of the Supreme Court. Thus, the decisions focus on the question of delineating the boundaries of primary liability rather than trying to identify the intermediaries that are able to monitor the primary actor in the most efficient way. In other words: The criteria that should govern the construction of the liability provision are obscured by the failure of the legislator and the judiciary to acknowledge that the issue at hand is one of gatekeeper liability.[87]

[86] Ibid, 21.
[87] Ibid, 21.

3.4. Section 12(a)(1) Securities Act of 1933

"Any person who offers or sells a security in violation of section 5, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."[88]

Explanation

As opposed to the two provisions that have been discussed above, section 12(a)(1) of the Securities Act does not constitute an antifraud provision; it does not serve the goal of restitution for the benefit of defrauded investors but deterrence. The structure of the provision is simple: All offerors and sellers of securities are liable for damages if they do not comply with the registration or prospectus delivery requirements of the Securities Act.[89] Accordingly, prima facie section 12(a)(1) is not concerned with gatekeeper liability. It intends to punish a violation of the registration and prospectus requirements by holding responsible the addressees of these requirements, i.e. the primary actors. Again, case-law has obfuscated the seemingly clear rule. Initially, the courts were split on the construction of the terms "offeror" and "seller". The narrow view required strict contractual privity between seller and buyer, thus shielding most financial intermediaries from liability. The opposing view considered as seller/offeror not only the owner but also a third party who acted as agent for the owner and actively participated in the solicitation or implementation of the agreement or, more restrictively, who set a direct and proximate cause for the injury to the plaintiff or was sufficiently close to the transaction to be able to obtain information relevant to the buyer.

The Supreme Court overruled the decisions of the lower federal courts and held in the leading case Pinter v. Dahl: "Seller" within the meaning of section 12(a)(1) "is not limited to an owner who passes title, but extends to a broker or other person who successfully solicits a purchase of securities, so long as he is motivated at least in part by a desire to serve his own financial interests or those of the securities owner." The test for third party liability, therefore,

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[88] US Securities Act of 1933, s 12.

[89] The requirements are stated in section 5 of the US Securities Act OF 1933: An offer to sell a security may only be made after the registration statement has been filed, section 5(c). It may not be transmitted unless in the form of a prospectus within the meaning of section 10, cf. section 5(b)(1). Finally, the sale may not be executed before the registration statement has become effective, section 5(a).

consists of two parts: The third party must have solicited the securities transaction, e.g. urged the investor to make a purchase, and expect to receive a financial benefit.[90]

On this basis, some of the potential gatekeepers fall within the scope of section 12(a)(1). The underwriters can be liable if they are in contact with the investors and promote the offering, either by direct personal or telephone contact or by participating in road shows and placing their name on the securities prospectus or other advertising material. The same considerations apply to brokers and dealers. Other parties, however, that might function as gatekeepers, are, in general, not encompassed by the Pinter definition of "seller", at least not by virtue of their position as directors, officers, lawyers, auditors or experts.

Consequently, as in the case of section 10(b) of the Securities Exchange Act, liability under section 12(b) does not depend on the gatekeeper's capability to ensure compliance with the applicable regulatory requirements (here: section 5 of the Securities Act) by the securities owner, but on a restrictive construction of the provision that is intended to compensate for the overly broad elements of the cause of action.

3.5. Section 12(a)(2) Securities Act of 1933

"Any person who offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraphs (2) and (14) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid

[90] Carsten Gerner-Beuerle: The Market for Securities and Its Regulation through Gatekeepers, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 23.

for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."[91]

Explanation

Section 12(a)(2) of the Securities Act provides for liability in case of untrue statements in the securities prospectus. The class of defendants is identical to that of section 12(a)(1): Investors may bring a claim against the offeror or seller of the securities. While the Supreme Court in Pinter did not address liability pursuant to subsection (2) of section 12(a), the vast majority of the lower courts applies the Pinter-principles in an identical way to both subsections. The gatekeeper problem, however, presents itself in a different fashion. As pointed out, section 12(a)(1) holds liable both the owner and some of the financial intermediaries as offerors or sellers. Since all offerors/sellers are addressees of section 5, all of the defendants can, at least in some formal sense of the term, be described as primary market participants, notwithstanding their role as intermediaries that facilitate the sales efforts of the owner. In section 12(a)(2), on the other hand, the offeror/seller is in the position of a genuine gatekeeper. Liability attaches to the offer or sale by means of a prospectus that contains an untrue statement or a material omission. The defendant will often be an underwriter, dealer or broker. Accordingly, the statute uses a third party who is not the author to review the accuracy of the prospectus and protect investors by refraining from effectuating the transaction in case the documents do not conform to legal requirements.[92]

However, the principles that ensure the efficiency of gatekeeper liability as a regulatory instrument are only imperfectly embodied in section 12(a)(2). The provision does not distinguish between different types of defendant and does not establish a sliding scale of responsibility comparable to that of section 11 in order to allow for differences as far as access to the source of the information is concerned. Some modicum of case-by-case adjustment in light of the position of the defendant is achieved by means of the so-called defence of due care in section 12(a)(2): The defendant shall not be liable if he can prove that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. The courts draw a parallel to the due diligence defence of section 11(b)(3). According to the leading decisions, the required standard of care depends on the type of defendant, its relationship to the source of the information (in particular the issuer) and to the investor, the degree of involvement in the

[91] US Securities Act of 1933, s 12.

[92] Carsten Gerner-Beuerle: The Market for Securities and Its Regulation through Gatekeepers, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 25.

transaction, and the reliance on officers, experts, and others that have drawn up parts of the prospectus. But considerable uncertainty remains. Where section 11(b)(3) specifies that the duty to conduct an independent investigation does not apply in respect to expertised portions of the registration statement, section 12(a)(2) is silent. By allowing exceptions from the requirement to register a security, the Securities Act implies that the level of investor protection should be higher in some transactions than in others. Since section 12(a)(2) comprises registered as well as unregistered securities, the standard of care in that provision is, arguably, lower than that under section 11. However, the precise differences in the contours of gatekeeper liability remain undetermined.[93]

3.6. Section 201 of Sarbanes Oxley Act of 2002

"It amended Section 10A of the Securities Exchange Act of 1934 by adding at the end the following:

It shall be unlawful for a registered public accounting firm that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002, the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including-

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible."[94]

[93] Ibid, 26.
[94] Sarbanes-Oxley Act 2002, s 201.

Explanation

This section prohibits an auditor from providing a delineated list of non-audit services contemporaneous with an audit.[95] The prohibited services include financial information systems design, management services, and legal services, but, significantly, do not include tax consulting. Auditors, after pre-approval on the part of the issuer's audit committee, may continue to provide non-audit related tax consulting.[96]

3.7. Section 203 of Sarbanes Oxley Act of 2002

"Section 10A of the Securities Exchange Act of 1934 as amended by this Act, is amended by adding at the end the following:

It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.''[97]

Explanation

To reduce the possibility of individual conflicts of interest, Sarbanes-Oxley requires the lead partner and reviewing partner of the auditor to rotate at least once every five years.[98]

3.8. Section 206 of Sarbanes Oxley Act of 2002

"Section 10A of the Securities Exchange Act of 1934 as amended by this Act, is amended by adding at the end the following:

It shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was

[95] Ibid.

[96] Sarbanes-Oxley follows up on the SEC's earlier efforts in 2000 that, among other things, required companies in their proxy disclosures to report aggregate audit and non-audit related fees. See Final Rule: Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,009 (Dec. 5, 2000).

[97] Sarbanes-Oxley Act 2002, s 203.

[98] Ibid.

employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.''[99]

Explanation

The Act mandates that several top officers of the issuer (including the CEO, Controller, CFO, and Chief Accounting Officer) not be employed by the issuer's auditor within the one year period preceding the audit.[100]

3.9. Section 307 of Sarbanes Oxley Act of 2002

"Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors."[101]

Explanation

When the Senate took up Sarbanes-Oxley Act 2002, Senator Edwards proposed a floor amendment, subsequently enacted as section 307 of the Act.

It gives lawyers a very "simple" obligation: "You report the violation. If the violation isn't addressed properly, then you go to the board."[102]

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[99] Sarbanes-Oxley Act 2002, s 206.
[100] Ibid.
[101] Sarbanes-Oxley Act 2002, s 307.
[102] 148 Cong. Rec. S6552 (2002).

3.10. Section 501 of Sarbanes Oxley Act of 2002

"The Securities Exchange Act of 1934 is amended by inserting after section 15C the following new Section;

Section 15D: Securities Analysts and Research Reports.

(a) Analyst Protections- The Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information, including rules designed-

(1) to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts, by-

(A) restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff;

(B) limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities; and,

(C) requiring that a broker or dealer and persons employed by a broker or dealer who are involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst employed by that broker or dealer or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report that may adversely affect the present or prospective investment banking relationship of the broker or dealer with the issuer that is the subject of the research report, except that such rules may not limit the authority of a broker or dealer to discipline a securities analyst for causes other than such research report in accordance with the policies and procedures of the firm;

(2) to define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities;

(3) to establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision; and

(4) to address such other issues as the Commission, or such association or exchange, determines appropriate.

(B) Disclosure- The Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to require each securities analyst to disclose in public appearances, and each registered broker or dealer to disclose in each research report, as applicable, conflicts of interest that are known or should have been known by the securities analyst or the broker or dealer, to exist at the time of the appearance or the date of distribution of the report, including—

(1) the extent to which the securities analyst has debt or equity investments in the issuer that is the subject of the appearance or research report;

(2) whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the securities analyst, from the issuer that is the subject of the appearance or research report, subject to such exemptions as the Commission may determine appropriate and necessary to prevent disclosure by virtue of this paragraph of material non-public information regarding specific potential future investment banking transactions of such issuer, as is appropriate in the public interest and consistent with the protection of investors;

(3) whether an issuer, the securities of which are recommended in the appearance or research report, currently is, or during the 1-year period preceding the date of the appearance or date of distribution of the report has been, a client of the registered broker or dealer, and if so, stating the types of services provided to the issuer; ''(4) whether the securities analyst received

compensation with respect to a research report, based upon (among any other factors) the investment banking revenues (either generally or specifically earned from the issuer being analyzed) of the registered broker or dealer; and

(5) such other disclosures of conflicts of interest that are material to investors, research analysts, or the broker or dealer as the Commission, or such association or exchange, determines appropriate."[103]

Explanation

Section 501(a) of Sarbanes-Oxley authorizes the SEC and SROs to adopt rules to address conflicts of interest that can arise when securities analysts recommend equity securities.[104] Section 501(a) seeks to protect analysts from undue influences within their respective firms while also ensuring that analysts disclose their own conflicts of interest with their subject companies. To protect analysts, the statute asks the SEC to draft rules intended to "address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances." Further, the rules should be made "in order to improve the objectivity of research and provide investors with more useful and reliable information." Specifically, section 501(a) demands that the SEC promote the objectivity and independence of securities analysts in three ways. First, section 501(a)(1)(A) demands that the SEC limit the ability of investment bankers to approve analyst reports. Second, section 501(a)(1)(B) demands that the SEC limit the ability of the firm's investment banking division to influence the compensation of securities analysts. Third, section 501(a)(1)(C) demands that the analyst's firm prevent internal retaliation by investment bankers against the analysts whose reports could harm investment banking business. The three measures are clearly aimed at diminishing the effect that business interests may have on the truthfulness of the analyst's recommendations.[105]

Despite the willingness of Congress to leave much of the regulation of auditors and corporate financial statements to the new Oversight Board and the SEC, Congress did make a number of targeted substantive interventions dealing with the provision of non-audit related

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[103] Sarbanes-Oxley Act 2002, s 501.

[104] Louis E. Ebinger, *Sarbanes-Oxley Section 501(a): No Implied Private Right of Action, and a Call to Congress for an Express Private Right of Action to Enhance Analyst Disclosure,* (IOWA Law Review 2008), 1930.

[105] Ibid. 1930-31.

consulting services.[106] The Sarbanes- Oxley Act prohibits an auditor from providing a delineated list of non-audit services contemporaneous with an audit.[107] The prohibited services include financial information systems design, management services, and legal services, but, significantly, do not include tax consulting. Auditors, after pre-approval on the part of the issuer's audit committee, may continue to provide non-audit related tax consulting.[108]

To reduce the possibility of individual conflicts of interest, Sarbanes-Oxley requires the lead partner and reviewing partner of the auditor to rotate at least once every five years.[109] Similarly, the Act mandates that several top officers of the issuer (including the CEO, Controller, CFO, and Chief Accounting Officer) not be employed by the issuer's auditor within the one year period preceding the audit.[110]

Sarbanes-Oxley also focuses on the composition of the audit committee of a corporation's board of directors. "The Act requires the SEC to prohibit the securities exchanges and Nasdaq (National Association of Securities Dealers Automated Quotations) from listing companies without a separate audit committee on the board of directors."[111] The Act requires that each member of the audit committee be "independent," defined as "not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof." The Act also makes clear that the audit committee has responsibility for the selection, compensation, and oversight of the public accounting firm for the issuer.[112]

When the Senate took up Sarbanes-Oxley Act 2002, Senator Edwards proposed a floor amendment, subsequently enacted as section 307 of the Act, requiring the SEC to:

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[106]Congress also provided for specific reporting requirements for off-balance sheet transactions in Section 401(a) of the Sarbanes-Oxley Act 2002. The Act also provides for more rapid reporting of corporate filing information. See Sarbanes-Oxley Act 2002, s 409.

[107] Sarbanes-Oxley Act 2002, s 201.

[108] Sarbanes-Oxley follows up on the SEC's earlier efforts in 2000 that, among other things, required companies in their proxy disclosures to report aggregate audit and non-audit related fees. See Final Rule: Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,009 (Dec. 5, 2000).

[109] Sarbanes-Oxley Act 2002, s 203.

[110] Sarbanes-Oxley Act 2002, s 206.

[111] Sarbanes-Oxley Act 2002, s 301.

[112] Stephen J. Choi, A Framework for the Regulation of Securities Market Intermediaries, (UC Berkeley, Boalt Hall Berkeley Business Law Journal, Vol. 1, No. 1, 2004), 17.

"Issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence ... requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed ... by the issuer, or to the board of directors."[113]

It gives lawyers a very "simple" obligation: "You report the violation. If the violation isn't addressed properly, then you go to the board."[114]

In compliance with section 307, the SEC in January 2003 promulgated the "Part 205" attorney conduct regulation.[115] The core of the new rules is a version of the up-the-ladder reporting requirement envisioned by Senator Edwards.[116]

The Part 205 regulations recognize that the attorney "represents the issuer as an entity rather than the officers."[117] As originally proposed, Part 205.3 further provided that an attorney "shall act in the best interest of the issuer and its shareholders."[118] As finally adopted, however, the relevant rule provides only that "an attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization."[119]

Former ABA Model Rule 1.13 acknowledged the potential need for an attorney to report on suspected wrongdoing within the organization, but it also limited the ability of an attorney to

[113] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 775 (2002).
[114] 148 Cong. Rec. S6552 (2002).
[115] Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185 (Jan. 29, 2003), available at http://www.sec.gov/rules/final/33-8185.htm.
[116] 17 C.F.R. section 205.3(d)(2). In promulgating the Part 205 regulations, the SEC postponed action with regard to mandatory noisy withdrawals. The original proposal obligated an attorney whose internal complaints did not receive an adequate mitigating response by the issuer to resign from the corporation and to file a notification with the SEC explaining the basis for such resignation. This noisy withdrawal rule met with substantial criticism from the bar. As adopted, Part 205 permits, but does not require, an attorney to disclose confidential client information to the SEC under specified conditions, most notably where necessary to prevent "injury to the financial interest or property of the issuer or investors."
[117] Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185 (Jan. 29, 2003), available at http://www.sec.gov/rules/final/33-8185.htm.
[118] Ibid.
[119] 17 C.F.R. section 205.3(a).

do so effectively. The language of the Rule was discretionary rather than prescriptive, allowing an attorney to use his judgment about whether or not to proceed with reporting evidence of misconduct to the board of directors or even to high-level corporate officers. In contrast, Part 205 uses the prescriptive word "shall" to describe an attorney's duty. In pertinent part, the rule provides:

If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith.[120]

As a result, an attorney will not have the luxury of using his own judgment about whether or not to report wrongdoing once the statutory level of evidence is triggered. As Senator Edwards anticipated, counsel must report up within the chain of command.[121]

The initial obligation of a lawyer who "becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer" is to report such evidence to the issuer's chief legal or executive officer.[122] Subject to a slew of exceptions and alternatives, unless the lawyer "reasonably believes that, that officer has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to" the audit committee of the board of directors.[123]

3.11. Synopsis

Section 11 of the US Securities Act can be seen as the paradigm of a provision that embodies the principles of gatekeeper liability. While case law has put a considerable gloss on statutory terms such as "reasonable investigation" and "reasonable ground to believe", the

[120] 17 C.F.R. section 205.3(b)(1).

[121] Part 205 facially preempts inconsistent state rules of legal ethics. Such radical reforms also would have conflicted with legal ethics rules of many states. The Part 205 regulations facially preempt state rules of professional conduct, however. 17 C.F.R. sections 205.6(b)-(c). Accordingly, where there is conflict between a state's rules and Part 205, the latter prevails, unless the state imposes a more stringent obligation upon its attorneys that is consistent with Part 205. Attorneys who comply with the Regulation's procedures in good faith will be immune from liability for violating state ethics rules that conflict. As a result, the organized bar likely would be pressured to square its rules with those promulgated by the SEC.

[122] 17 C.F.R. section 205.3(b)(1).

[123] 17 C.F.R. section 205.3(b)(3).

provision reaches a high degree of legal certainty by outlining the main parameters of the gradual scale of responsibility in the statute itself. Section 12(a)(2) goes in the same direction but falls short of giving precise criteria that could guide market participants and legal practitioners. The effectiveness of section 12(a)(1) as an instrument of gatekeeper regulation is hampered by the desire to restrict the broad elements of the cause of action, which obscures the criteria that are of importance for gatekeeper liability. Finally, section 10(b) of the Securities Exchange Act is symptomatic for a provision that was not intended to grant a private cause of action but has undergone a major transformation through case law. The requirements to bring a claim are not clearly defined, several issues, in particular the class of defendants, are highly controversial, and the outcome of lawsuits involving section 10(b) is correspondingly uncertain. Furthermore, the relationship between the different liability provisions under the Securities Act and the Securities Exchange Act is not conclusively resolved.[124]

Sarbanes-Oxley has a wealth of provisions targeting auditors and financial reporting more generally, the Act says relatively little about securities analysts. Section 501 of the Act simply leaves it to the SEC to adopt conflict of interest rules governing analysts recommending equity securities. The Act, instead, directs more attention toward attorneys, imposing an affirmative duty on attorneys to disclose corporate fraud.[125] In a similar vein, the Act provides more stringent protections for whistleblowers.[126]

Section 307 of the Act warts and all (All defects and imperfections notwithstanding) was necessary to break the organized bar's resistance to legal ethics reforms intended to reduce the managerialist bias of the rules of professional conduct. Corporate counsel work for the board, not management. Only by threatening lawyers who fail to report up the ladder with discipline could the balance of power be shifted in favor of directors relative to managers.

[124] Carsten Gerner-Beuerle: The Market for Securities and Its Regulation through Gatekeepers, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 26

[125] Sarbanes-Oxley Act 2002, s 307 (requiring the SEC to implement rules mandating that attorneys representing issuers "report evidence of a material breach of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof. . . .").

[126] Sarbanes-Oxley Act 2002, s 806.

CHAPTER 4

Provisions of Gatekeeper Liability in United Kingdom

4.1. Introduction

Liability for misstatements and omissions on the primary market is dealt with by section 90 of the FSMA[127] and the implementing legislation.[128] The provision is structurally comparable to section 11 of the Securities Act of 1933, which does not come as a surprise as the Securities Act is based on the English Companies Act of 1929 that contained the predecessor of section 90 FSMA. Section 507 of The Companies Act 2006 provides liability for the act or omission of an auditor whose false or deceptive report misleads the investors during their financial decision making.

4.2. Section 90 of FSMA (Financial Services and Markets Act 2000)

"(1) Any person responsible for listing particulars is liable to pay compensation to a person who has acquired securities to which the particulars apply and suffered loss in respect of them as a result of any untrue or misleading statement in the particulars; or the omission from the particulars of any matter required to be included by section 80 or 81.

(2) Subsection (1) is subject to exemptions provided by Schedule 10.

(3) If listing particulars are required to include information about the absence of a particular matter, the omission from the particulars of that information is to be treated as a statement in the listing particulars that there is no such matter.

(4) Any person who fails to comply with section 81 is liable to pay compensation to any person who has acquired securities of the kind in question; and suffered loss in respect of them as a result of the failure.

(5) Subsection (4) is subject to exemptions provided by Schedule 10.

(6) This section does not affect any liability which may be incurred apart from this section.

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[127] Financial Services And Markets Act 2000.

[128] Schedule 10 Adopted Under Section 90(2) And (5) Of The Fsma; Fsa Prospectus Rules (Pr) 5.5 (For Prospectuses); Fsma 2000 (Official Listing Of Securities) Regulations 2001 (Si 2001/2956), Reg. 6 (For Listing Particulars).

(7) References in this section to the acquisition by a person of securities include references to his contracting to acquire them or any interest in them.

(8) No person shall, by reason of being a promoter of a company or otherwise, incur any liability for failing to disclose information which he would not be required to disclose in listing particulars in respect of a company's securities if he were responsible for those particulars; or if he is responsible for them, which he is entitled to omit by virtue of section 82.

(9) The reference in subsection (8) to a person incurring liability includes a reference to any other person being entitled as against that person to be granted any civil remedy or to rescind or repudiate an agreement.

(10) "Listing particulars", in subsection (1) and Schedule 10, includes supplementary listing particulars."[129]

Explanation

An important feature of the British regulatory system is the employment of "sponsors"[130] or (when listing on AIM[131]) nominated advisers, both of them in general investment banks, that monitor the compliance of the issuer with the regulations promulgated by the FSA[132]. On the primary market, the issuer has to appoint a sponsor if it applies for a listing of its equity securities on a regulated market.[133] The sponsor's role is to provide assurance to the FSA that the issuer's responsibilities under the listing rules have been met and to guide the issuer in understanding and meeting its responsibilities.[134] If a prospectus has to be published, the sponsor is expected to make due and careful enquiry that the prospectus conforms to regulatory requirements.[135] In order to ensure the effectiveness of the sponsor or nominated adviser as a tool of securities regulation, the FSA has set up rules on the independence and qualifications of the

[129] Section 90 Of The Financial Services And Markets Act 2000

[130] The issuing house that handles a new issue for a company. It will supervise the preparation of the prospectus and make sure that the company is aware of the benefits and obligations of being a public company.

[131] Alternative Investment Market (AIM): A sub-market of the London Stock Exchange that permits smaller companies to participate with greater regulatory flexibility than applies to the main market, including no set requirements for capitalization or the number of shares issued. The Alternative Investment Market is the London Stock Exchange's global market for smaller and growing companies.

[132] The Financial Services Authority (FSA) is the regulator of the financial services industry in the UK.

[133] FSA Listing Rules (LR) 8.2.1. An issuer listed on AIM has to retain a nominated adviser at all times, cf. Rule 1 of the AIM Rules for Companies.

[134] LR 8.3.1.

[135] LR 8.4.2, 8.4.8.

intermediary.[136] Furthermore, it supervises the sponsor and may impose sanctions if the sponsor is in breach of the applicable regulations.[137]

Supervision of sponsors by the regulator might not be effective,[138] and secondary market participants other than sponsors may, in certain situations, be in an equally good or better position than investment banks to function as gatekeepers. Consequently, the main avenue for third party enforcement of securities regulation in the UK is, as in the US, through the adoption of incentive creating liability provisions.[139]

Section 90 applies to misstatements in the prospectus or the listing particulars,[140] not to advertisements or the admission document required for an AIM listing.[141] In case of an equity issue, the responsible persons include the issuer, the issuer's directors, each person who accepts responsibility for the prospectus or authorises its contents, and the offeror if not identical with the issuer. The enumeration evidently aims at both primary and secondary market participants. However, it does so in a rather obscure manner. Persons who "accept responsibility for the prospectus" are often the experts, for example the reporting accountants. On the other hand, the prospectus rules stipulate that a person shall not be responsible solely by giving advice in a professional capacity. This is commonly interpreted to exclude the lawyers, although the precise reach of the provision is unclear. The work of the solicitors could be regarded as consisting not only of rendering advice but also arranging the offering;[142] conversely, the exception might be extended to other intermediaries, e.g. investment banks that do not underwrite securities but advise on the transaction.

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[136] Most importantly, an investment bank shall not act as sponsor if it has a significant interest in the equity or debt securities of the issuer or if a director or employee of the sponsor who is involved in the provision of the services has a material interest in the issuer, LR 8.3.6. Criteria for approval as a sponsor are laid down in LR 8.6.

[137] LR 8.7.

[138] John C. Coffee, Jr: Gatekeepers: The Professions and Corporate Governance (Oxford University Press Inc., New York, 2006), 338-40

[139] The FSA has powers to take regulatory action against secondary participants that have been "knowingly concerned" in a contravention of the requirements of the FSMA by a primary addressee of the Act, cf. sections 66(2)(b), 91(2), 97(1)(b), (c), 380(2), (3)(b), 382(1), 384(1) Financial Services and Markets Act 2000. As this essay focuses on private enforcement, the concept of "knowingly concerned" will not be further discussed. For a detailed analysis cf. Eva Z. Lomnicka, Placing Bankers in the Front Line: The Secondary Liability of Bankers for Their Customers' Regulatory Contraventions, J.F.C. 2005, 12(3), 200.

[140] Listing particulars have to be published for certain types of securities for which a prospectus is not required under the Prospectus Directive, cf. section 79 FSMA and Schedule 11A, LR 4.

[141] This seems to be the prevailing opinion, cf. Paul L. Davies, Gower & Davies' Principles of Modern Company Law (8th ed. 2008), para. 25-32.

[142] Paul L. Davies, Gower & Davies' Principles of Modern Company Law (8th ed. 2008), para. 25-34 .

Underwriters as one of the most important types of gatekeeper are not expressly mentioned as defendants. In theory, three of the above groups of responsible persons are sufficiently broadly drafted to comprise the underwriters: those who accept responsibility for the prospectus, who authorise its content, and who offer the securities. Responsibility can be accepted by a declaration to that effect in the prospectus. In practice, generally only the issuer and its directors accept responsibility. As far as the second alternative (authorisation) is concerned, the prospectus rules state that the defendant must have authorised the contents of the prospectus. This is a change from the legal situation under the Companies Act 1985, which referred to the issue of the prospectus.[143] Under the old law, signing the prospectus could be qualified as the act of authorisation. Now some relation to the information contained in the prospectus is required. But the extent of the involvement is not defined. According to some commentators, mere participation in the preparation is not sufficient.[144] This must rule out liability of ordinary members of the underwriting syndicate that do not, in general, exercise much control over the content of the prospectus. Even liability of the lead underwriter or the investment bank that is appointed as sponsor (usually a member of the underwriting syndicate) is questionable.[145] The last of the groups of possible defendants poses equally intricate problems. Whether the underwriters fall under the term "offeror" is an "unanswered and generally unasked question".[146] Offeror is the person who makes the offer to the public.[147] This will commonly be the underwriters,[148] unless they do not communicate with investors but use a group of selling agents. The scope of the provision has been restricted through a subsequent amendment,[149] which stipulates that the offeror is not liable if "the issuer is responsible for the prospectus ...; the prospectus was drawn up primarily by the issuer, or by one or more persons acting on behalf

[143] Section 67(2)(d) Companies Act 1985 (c. 6).

[144] Andrew Whittaker & Geoffrey Morse, The Financial Services Act 1986. A Guide to the New Law (1987), para. 15.27.

[145] Alistair Alcock, The Financial Services and Markets Act 2000. A Guide to the New Law para. 12.4.3 (2000).

[146] Simon Gleeson & Harold S. Bloomenthal, The Public Offer of Securities in the United Kingdom, in International Capital Markets and Securities Regulation, (Harold S. Bloomenthal & Samuel Wolff eds., supp. 12/2008), 36, 48.

[147] FSA Handbook Glossary.

[148] It is not clear whether the underwriters would need to purchase the securities in order to be qualified as offerors (as can happen – but does not necessarily need to happen – in a firm commitment underwriting), or whether acting as an agent, as in a best efforts underwriting, is sufficient. Cf. Barry A. K. Rider, Charles Abrams & Michael Ashe, Guide to Financial Services Regulation, 823 (3d ed. 1997).

[149] The original provision stems from the Financial Services Act 1986 and the Public Offers of Securities Regulations 1995 (SI 1995/1537), reg. 13, which were amended in 1999 in a way that corresponds to the prospectus rules in force today.

of the issuer; and the offeror is making the offer in association with the issuer." The amendment fits the underwriters who conduct the offering in collaboration with the issuer. However, the question remains, when is the prospectus "drawn up primarily by the issuer" so as to exclude underwriter liability? In particular the lead underwriter is often extensively involved in the drafting of the offering documents. Guidance on this issue is not available.[150]

The defences available under section 90(2) FSMA and Schedule 10 to the FSMA exhibit further similarities of the English provision and its US-American counterpart. The defendant does not incur liability if he "reasonably believed" that the incorrect statement was true and not misleading and if he "made such enquiries, if any, as were reasonable" to verify the correctness of the prospectus.[151] The standard of care is reduced if the incorrect statement is contained in an expert's opinion:[152] It is sufficient that the defendant "reasonably believed that the other person [the author] was competent to make or authorise the statement, and had consented to its inclusion in the form and context in which it was included."[153] Interestingly, the defendant's belief does not need to relate to the content of the statement, i.e. the provision does not require that the defendant had reasonable ground to believe that the prospectus was accurate, as is the law under section 11 of the Securities Act of 1933. Arguably, belief in the competence of the expert is a less exacting standard than the requirement to reflect on the accuracy of the information itself. The person responsible for the prospectus might have been able to discover the mistake without further enquiries simply by studying the information provided by the expert. Exculpation in such cases is hardly justified. Neither the regulator nor the courts have addressed this inconsistency or have endeavoured to define the terms "reasonable believe" and "reasonable enquiries".

[150] Simon Gleeson & Harold S. Bloomenthal, The Public Offer of Securities in the United Kingdom, in International Capital Markets and Securities Regulation, (Harold S. Bloomenthal & Samuel Wolff eds., supp. 12/2008), 36, 48.

[151] Schedule 10, section 1(2).

[152] Definition of "expert" in Schedule 10, section 8.

[153] Schedule 10, section 2(2).

4.3. Deceit and negligent misrepresentation

Section 90 FSMA does not exclude remedies that exist under common law.[154] For misstatements in publications that fall outside the scope of section 90 (in particular the admission document for AIM and communications with the investing public that are not made in the form of a prospectus or listing particulars, for example promotional material or communications on the secondary market) common law might provide the only remedies. Historically, the tort of deceit and fraudulent misrepresentation was the exclusive remedy available to investors that sought relief against a defendant that was not a party to the contract with the claimant. While such a claim may be brought against the issuer as well as its directors, the underwriters, and experts whose reports are included in the prospectus, investors face high hurdles to recovery. They have to show that the defendant has knowingly made a false representation or has been reckless, i.e. careless as to whether the representation is true or false. Belief in the truth of the statement will exculpate the defendant even if the belief is not based on reasonable grounds. Furthermore, where the incorrect statement has been made to a person other than the plaintiff (for example to the original allottees in a case brought by a purchaser in the aftermarket) the claim will only be successful if the defendant intended the claimant to act on the statement. Finally, the plaintiff needs to show that he relied on the misrepresentation, which the courts hold as meaning that the defendant's conduct was one of the factors inducing the plaintiff to act as he did. The defendant will then be liable for all damage directly flowing from the transaction caused by the deceit, whether or not it was foreseeable.[155]

The restrictive legal situation under the traditional common law has led to two extensions. First, the legislator adopted the Misrepresentation Act 1967 that introduced liability for non-fraudulent misrepresentations, unless the defendant proved "that he had reasonable ground to believe and did believe that the facts represented were true."[156] However, the provision requires that the plaintiff has entered into a contract after the misrepresentation and restricts relief to claims against the other party to the contract. Liability of third parties, such as the contracting party's agents, has been rejected by the courts. Therefore, the Misrepresentation Act 1967 does not facilitate gatekeeper liability.

[154] Section 90(6).

[155] Carsten Gerner-Beuerle: The Market for Securities and Its Regulation through Gatekeepers, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 32.

[156] Section 2(1) Misrepresentation Act 1967 (c. 7).

Second, in 1964 the House of Lords refined Derry v. Peek, holding that liability for misstatements does not only exist in cases of fraud (deceit) but also in cases of negligence. In accordance with general principles of negligence, the claimant needs to establish that the defendant owed him a duty of care and that he breached that duty. For present purposes, two aspects are of particular interest: Which participants in the financial markets owe a duty of care, and to whom do they owe the duty? In the leading case of Caparo Industries Plc v. Dickman, dealing with a claim brought by a takeover bidder against the target's directors and auditors, the House of Lords addressed the latter point. It held that a sufficiently proximate relationship between the author of the inaccurate statement and the recipient typically exists where the author knows that the statement will be communicated to the recipient in order that it should be used for a specific purpose; furthermore, where the author knows that it is likely to be acted upon by the recipient for that purpose; and where the recipient does act on it to his detriment. Two decisions of the Chancery Division of the High Court have applied Caparo Industries in a seemingly contradictory way to offerings of securities. The first, Al Nakib Investments (Jersey) Ltd v Longcroft, relating to a rights issue, rejected the notion of a proximate relationship between the issuer and purchasers on the open market because, as the court argued, the prospectus was addressed to the shareholders solely for the purpose of enabling them to consider the rights issue. The second case, Possfund Custodian Trustee Ltd. v. Diamond, decided a few years later, took a broader view: The purpose of a prospectus might have traditionally been the information and encouragement of the original allottees. However, in light of changed market practices the information was now generally also directed at aftermarket purchasers. Thus, the duty of care recognised by common law assumed contours that are substantially equivalent to those of the duty under section 90 FSMA. The court suggested that the rule in Al Nakib Investments should be reviewed, and parts of the academic literature agree that the law as expressed in Possfund is more in line with current regulatory demands and philosophies. If this view is correct, the tort of negligent misrepresentation provides a comprehensive liability provision for communications on the primary market. On the secondary market, it might be possible to establish liability under this notion as well, albeit the requirement that the defendant expected the plaintiff to rely on the communication will provide a greater obstacle as statements will typically not be as all-inclusive

as primary market disclosures and will often not have been made with the intention to induce investment decisions.[157]

The other issue mentioned above, the class of market participants that owe a duty of care, has not yet been answered conclusively by the courts. The courts have allowed claims against the issuer and the directors of the issuer, brokers, auditors and financial advisers. However, the defendants in these cases have always been crucial in composing and disseminating the incorrect information. Therefore, they have to be characterised as primary violators, and the objective of the common law duty of care is not one of gatekeeper liability. The literature has proposed to draw further similarities to the statutory cause of action and hold those responsible under common law that would be responsible under the Prospectus Rules or the FSMA 2000 (Official Listing of Securities) Regulations 2001. It is unclear whether this suggestion is intended to bring secondary participants, i.e. persons who are not the authors of the contested information, within the ambit of the tort. In any case, an analogy to the statutory instruments would import the problems outlined above and does not, therefore, seem to be apposite.[158]

The relevance of the tort of negligent misrepresentation will remain limited for another reason. As opposed to an action under section 90 FSMA, the plaintiff in a claim under common law must show that he relied on the material representation and believed that the defendant intended him to act upon it. Furthermore, the plaintiff can only claim damages for the loss caused by the misrepresentation and only for such loss as is not too remote. Again, section 90 FSMA constitutes the more advantageous avenue for the investor. The plaintiff has to show loss causation, but according to the prevailing opinion in the literature the measure of damages is analogous to that in an action of deceit.[159]

[157] Pursuant to section 90A(6) FSMA claims based on the tort of negligent misrepresentation against the issuer and other persons are excluded within the scope of section 90A (i.e. if the issuer's securities are traded on a regulated market and if the misrepresentation is contained in one of the periodic disclosures required under articles 4, 5 or 6 of the Transparency Directive: in the annual or half-yearly financial report or an interim management statement). Liability under section 90A FSMA is restricted to fraudulent acts (section 90A(4): the defendant must have known that the statement was untrue or he must have been reckless to that effect) and to claims against the issuer. The issuer does not need to expect the plaintiff to rely on the disclosure, but the plaintiff must have relied on it and reliance must have been reasonable, section 90A(5). For other communications, for example the episodic (ad-hoc) disclosures required pursuant to article 6 Market Abuse Directive, the torts of misrepresentation and deceit can be invoked against all tortfeasors.

[158] Carsten Gerner-Beuerle: The Market for Securities and Its Regulation through Gatekeepers, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 35.

[159] Ibid, 35.

4.4. Section 507 of the UK Companies Act 2006

"Offences in connection with auditor's report

(1) A person to whom this section applies commits an offence if he knowingly or recklessly causes a report under section 495 (auditor's report on company's annual accounts) to include any matter that is misleading, false or deceptive in a material particular.

(2) A person to whom this section applies commits an offence if he knowingly or recklessly causes such a report to omit a statement required by-

(a) section 498(2)(b) (statement that company's accounts do not agree with accounting records and returns),

(b) section 498(3) (statement that necessary information and explanations not obtained), or

(c) section 498(5) (statement that directors wrongly took advantage of exemption from obligation to prepare group accounts).

(3) This section applies to-

(a) where the auditor is an individual, that individual and any employee or agent of his who is eligible for appointment as auditor of the company;

(b) where the auditor is a firm, any director, member, employee or agent of the firm who is eligible for appointment as auditor of the company.

(4) A person guilty of an offence under this section is liable-

(a) on conviction on indictment, to a fine;

(b) on summary conviction, to a fine not exceeding the statutory maximum."[160]

Explanation

Section 507 of the CA 2006 creates a new criminal offence in relation to inaccurate auditors' reports. The offence consists of knowingly or recklessly causing a report to include anything that is misleading, false or deceptive; or omitting a required statement of a problem with the accounts or audit.

Section 507(1) of the CA 2006 sets out the offence of commission, and s 507(2) of the CA 2006 that of omission. The items whose omission can be an offence are listed in paras (a)–(c)

[160] Section 507 Of Uk The Companies Act 2006,

of s 507(2) of the CA 2006: statements about inadequate accounting records not being properly reflected in the accounts, and about the auditor having been unable to obtain all necessary information and explanations, and about the directors wrongly claiming the company is exempt from the requirement of group accounts.

Section 507(3) of the CA 2006 defines the individuals potentially caught by the offence as the auditor, if a sole practitioner, or his employees or agents; or the directors, members, employees and agents of an audit firm. But the offence only applies to such an individual if he is an accountant who would be qualified to act as an auditor of the company in his own right. Section 507(4) of the CA 2006 sets out the maximum penalty as an unlimited fine.[161]

4.5. Synopsis

Section 90 FSMA incorporates some considerations of the gatekeeper theory by including secondary market participants – most notably the underwriters and experts – as potential defendants. However, the provision is characterised by a great degree of legal uncertainty. It is vague in respect to the parameters of gatekeeper liability, and almost every aspect of the prospectus rules defining the class of responsible persons is highly ambiguous. As has been shown, the torts of deceit and negligent misrepresentation do not constitute genuine gatekeeper provisions. They are addressed to the tortfeasor only, i.e. to the primary actor. A general rule of secondary liability is alien to English tort law. Accordingly, the situation is comparable to that under section 10(b) of the Securities Exchange Act 1934 after Central Bank, albeit without the attempts of the courts to extend the class of defendants to secondary participants. As a result, there is little authority on the question of when an intermediary can be considered as the author or originator of the incorrect statement, an issue that has created considerable confusion in US law.[162] Section 507 of The Companies Act 2006 provides liability for the act or omission of an auditor whose false or deceptive report misleads the investors during their financial decision making.

[161] Sheikh, Saleem. *A Guide to the Companies Act 2006.* (United Kingdom: Routledge-Cavendish Publishing, 2008), 962.

[162] Carsten Gerner-Beuerle: *The Market for Securities and Its Regulation through Gatekeepers,* (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 36.

CHAPTER 5

Comparison of Regulatory Provisions of United States, United Kingdom and Pakistan

5.1. Objectives of financial market regulation

Any system of financial market regulation has to balance two antagonistic objectives: comprehensive investor protection on the one hand and the provision of a regulatory environment that is conducive to economic activity i.e. that keeps the cost of capital at a low level, on the other hand. Comprehensive investor protection requires that investors have remedies at their disposal if professional market participants sell deficient products or harm the interests of the investing public in another way. The most important case of such harmful activity is the dissemination of incorrect information that affects the investment decisions of the public in a way that causes financial loss.[163] The publication of misleading or inaccurate information can occur in the primary and the secondary market. Accordingly, remedies should be available in both markets. Furthermore, investor protection is not effective if the hurdles to recovery are too high, in particular if the investor bears the burden of proof for factors that he can only verify with great difficulty. This can be the case if he has to show that he relied on an incorrect piece of information that is possibly phrased in highly technical terms and has been circulated by a party that stands in no legal relationship with the investor, but that has nevertheless influenced the value of the investor's interest through market operations, or if he has to determine negligence or scienter on the part of a market participant with whose operations he is not familiar. Finally, the investor needs to be protected against a judgment proof defendant. Major financial scandals often leave a bankrupt issuer behind; if the issuer is the only addressee of liability provisions, investors will frequently not be able to recover their losses.[164]

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[163] Other important instances of harmful behaviour are insider trading and market manipulation. Both types of behaviour are regulated (in the US: inter alia section 10(b) Securities Exchange Act, Rule 10b-5; in the Pakistan section 15A Securities and Exchange Ordinance 1969. They shall not be pursued here.

[164] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers*, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 47.

5.2. Disadvantages of ambiguous legislation on apportionment of proper liability on proper parties

Capital costs are high if the defendant cannot calculate or control the risk of liability. He cannot calculate the liability risk if the respective provisions are drafted in an ambiguous way. The market participant will then have to allocate higher expenses for legal advice and the defence against lawsuits. Additionally, he might be forced to enter into settlements in order to save litigation expenses because the outcome of an action is uncertain in spite of its frivolous nature. He is not able to control the risk of liability if the law establishes a regime of strict liability and he cannot review compliance of the actions that give rise to the claim (e.g. the publication of incorrect information) with the applicable legal rules with absolute certainty. This problem is particularly pronounced if the defendant is responsible for the actions of another party, i.e. in the gatekeeper context. A regime of negligence alleviates the issue to some extent, but the defendant faces the additional difficulty of determining the appropriate standard of care, i.e. the precautionary measures that he has to employ in order to be absolved from liability.[165]

5.3. Liability standards of discussed jurisdictions with reference to primary and secondary markets

The provisions of US, United Kingdom, and Pakistani law explained in previous chapters provide for liability for misrepresentations both in the primary and secondary market. While primary market liability is contained in provisions that have been drafted precisely for this purpose,[166] liability in the secondary market is fragmentary. Some express causes of action exist, but they only encompass specific disclosures.[167] In order to ensure a more comprehensive protection of investors, the courts in US and UK have taken recourse to general antifraud and tort law principles.[168] This approach has produced two problems: First, concepts that were not

[165] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers,* (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 48.

[166] US: section 11 Securities Act 1933; UK: section 90 FSMA 2000; Pakistan: section 18 and 23(2) securities and exchange ordinance 1969.

[167] UK: section 90A FSMA 2000; Section 18 of the Securities Exchange Act 1934, 15 U.S.C. § 78r (2007), applies to most documents that have to be filed with the SEC under the Exchange Act; however, in practice it is of little use since it requires actual reliance, *cf.* Ross v. A.H. Robins Co.,

[168] US: section 10(b) Securities Exchange Act, Exchange Act Rule 10b-5; UK: tort of negligent misrepresentation; Pakistan: section 17 of securities and exchange ordinance 1969.

developed with a view to the regulation of the financial markets or intended to grant a private cause of action needed to be modified and newly construed in order to conform to the particular features of capital market transactions. Second, this modification was not brought about by the legislator but the judiciary. Necessarily, courts cannot fashion an overarching and coherent regulatory system; they are confined to operating within a given legislative framework and to reacting to specific, separate issues. Their decisions rest on the facts of the individual case and may not provide generally applicable solutions.[169]

5.4. Position of Anti-Fraud Provisions in US and Pakistan

In the US, the most important anti-fraud provision is rule 10b-5 and the first decisions discussing it as a private cause of action go back more than sixty years. The first decades after the "discovery" of Rule 10b-5 as a private cause of action were characterised by an increasingly expansive interpretation of the elements of the provision. The section was held to apply to securities registered on a national securities exchange as well as securities not traded in a regulated market and face-to-face transactions. It could be invoked in cases falling within the scope of section 11 Securities Act and any other liability provision of the Securities Act 1933 and the Securities Exchange Act 1934 free of the procedural and other restrictions imposed on the express causes of action. The defendant did not need to have acted with scienter; negligence was sufficient. If he failed to disclose facts that were material "in the sense that a reasonable investor might have considered them important in the making of his investment decision" plaintiffs were not required to establish reliance. Claims could be brought against the perpetrator of the fraud and those aiding and abetting the violation.

In Pakistan the most important anti-fraud provision is section 17 of securities and exchange ordinance 1969. But whenever it is invoked against the perpetrators of manipulative and deceptive practices in securities market, it was very difficult to prove. Mostly lenient view is taken by our regulator and after dropping charges of fraud, a nominal penalty as fine is imposed.[170]

[169] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers*, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 48.
[170] 2006 C L D 1216.

5.4.1 Departure of US Supreme Court from the previous interpretation of rule 10b-5

In 1975, the US Supreme Court began to retreat from this liberal position. The U-turn was prompted by its realisation that a broad construction of Rule 10b-5 opened the door to strike suits, distorted the balance between Rule 10b-5 and the express liability provisions of the Securities Acts, and led to increased litigation expenses and capital costs.[171] Thus, the Supreme Court limited the class of plaintiffs to actual purchasers and sellers, rejected the notion that Rule 10b-5 applied to negligent actions or to breaches of fiduciary duties that did not display any element of manipulation or deception, overruled decisions that had allowed claims against secondary violators, and reinstated the traditional elements of causation and loss. However, most of these clarifications have generated a wealth of new problems, and after sixty years of oscillating case law clearly defined parameters of responsibility under Rule 10b-5 have not emerged.

5.4.2. Effectiveness Comparison of Rule 10b-5 with its UK and Pakistani equivalents

In spite of the "retrenchment" decisions of the US Supreme Court, investor protection under Rule 10b-5 is more extensive than under the torts of deceit and negligent misrepresentation of UK and Section 17 of Securities and Exchange Ordinance 1969 of Pakistan. Rule 10b-5 is no longer governed by traditional principles of tort law. While the concept of "recklessness" applied by the US courts is probably identical to that of Derry v. Peek, investors do not have to show that the defendant intended them to act on the misrepresentation. Thus, as opposed to the tort of deceit, Rule 10b-5 can be relied upon by anonymous investors in the aftermarket. In addition, plaintiffs can take recourse to the fraud-on-the-market theory in order to establish reliance, which is not possible under either the tort of deceit or the tort of negligent misrepresentation. The main disadvantage of the tort of negligent misrepresentation is the requirement that the defendant owes the plaintiff a duty of care. The relevance of this prerequisite for misrepresentations in public offerings is unclear, and recovery in the secondary market is most likely excluded. Rule

[171] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742 (1975) (quoting the decision of the Court of Appeals): "The great ease with which plaintiffs can allege the requirements for [standing under a suggested broad interpretation of Rule 10b-5] and the greater difficulty that plaintiffs are going to have proving the allegations [because standing could be based on hypothetical facts – the plaintiff could allege that he would have purchased the securities but for the misrepresentation] will allow a relatively high proportion of 'bad' cases into court. The risk of strike suits is particularly high in such cases; although they are difficult to prove at trial, they are even more difficult to dispose of before trial."

10b-5 does not suffer from these deficiencies.[172] A comparison with Pakistani law yields similar results. Section 17 of Securities and Exchange Ordinance 1969 is a narrower avenue for investors than Rule 10b-5. Plaintiffs need to prove a violation of public policy and, more importantly, actual reliance.

The express liability provisions come with their own problems. Again, US law is characterised by causes of action that are favourable to plaintiffs. Reliance and loss causation either do not constitute elements of sections 11, 12(a)(1), and 12(a)(2) Securities Act, or they are structured as defences, i.e. the defendant bears the burden of proof. Section 12(a)(1) of the Securities Act does not require the plaintiff to show more than a violation of section 5 Securities Act.[173] English law does not provide the investors with equally broad causes of action, section 90 FSMA, while stipulating shifts in the burden of proof similar to those under US law, are addressed to an obscure class of defendants. Pakistani counterpart to sections 12(a)(1) and (2) is section 18 securities and exchange ordinance 1969 which prohibits furnishing of false statements and its liability is provided in section 23(2) of securities and exchange ordinance 1969. Reliance and loss causation have to be shown by plaintiff and defendant has the defence that he acted in good faith. Section 59 of Pakistani companies ordinance 1984 is also dealing with civil liabilities for mis-statements in prospectus. By perusing these provisions it reveals that they are very close to US legislation but in Pakistan we lack the case law which can further interpret these provisions and define their pararmeters.

Even after the "retrenchment" decisions of the Supreme Court, investors in the US have stronger remedies at their disposal than in Pakistan. This is true for the primary and even more so for the secondary market. Still, data shows that investor protection in the US is by no means complete; investors are in general not able to recover more than 5% of the investment loss. Consolidated data for Pakistan does not exist, but the figure is likely to be lower. Furthermore, the numerous not yet clarified problems of statutory construction that afflict the capital market laws of all three countries are an obstacle to effective regulation. Legal uncertainty and, consequently, transaction costs are high, which entails negative effects for both investors and professional market participants. The legislator is called upon to remedy the ambiguities and

[172] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers*, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 51.
[173] Ibid, 52.

remove the greatest obstacles to recovery for investors, for example the requirement to show reliance.

5.5. Who should be held responsible as gatekeepers

To reduce the cost of capital, only such third parties should be held responsible as gatekeepers that are well positioned to review the acts and disclosures of the primary market actor. The burden that gatekeeper liability imposes on the third party becomes less the more intimately the gatekeeper is familiar with the primary market participant's business and the more easily it can verify the accuracy of the relevant information. Applying these considerations to third party actors in the financial markets (executive and non-executive directors, underwriters, accountants and auditors, lawyers), some general observations can be made about the suitability of the parties as gatekeepers.[174]

Inside directors are intimately involved in the drafting of corporate disclosures. However, they are also subject to the most severe conflicts of interest. They are the actors that can gain most from false statements. Their salary might be tied to a high share price, and their career might depend on a seemingly successful running of the business. Consequently, holding only them responsible for violations of securities regulation by the primary market actor is not sufficient.[175]

The position of outside directors is ambivalent. On the one hand, they often lack the time and expertise to familiarise themselves with all details of the issuer's business operations. On the other hand, they participate in regular board meetings and decide on fundamental corporate changes. They will, therefore, be able to function as gatekeepers for certain transactions, whereas they might not be well equipped to review technical and detailed accounts, for example the financial data in the offering prospectus.[176]

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[174] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers*, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 53.

[175] John C. Coffee Jr. *Gatekeepers: The Professions and Corporate Governance* (New York: Oxford University Press, 2006), 49.

[176] Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, (48 J. Fin, 1993), 864.

Experts, such as accountants, lawyers, appraisers or engineers, are best positioned to ensure the correctness of their opinions. However, they have no influence on the content of the parts of the disclosure not prepared by them.

Underwriters occupy a central position in the process of offering and selling securities. They prepare and structure the offering, conduct a due diligence of the issuer, organise road shows and other marketing activities, draft the offering documents, receive subscriptions for securities, determine the issue price, apply for admission to trading of the securities, and perform stabilisation measures. They possess the necessary expertise to assess even highly technical information. In addition, they are not subject to the same conflicts of interest as issuers or inside directors. Their gain from participation in the offering is smaller i.e. they receive a small percentage (ca. 5-7%) of the proceeds of the offering as underwriting and selling fees. On the other hand, their potential loss from litigation is higher. The success of their business operations generally depends to a high extent on their reputation, which may be tarnished by allegations of fraud and deception.[177] Courts realise this exceptional role of the underwriter in the primary market. They emphasise: "No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter."[178]

Section 11 of Securities Act 1933 implements these aspects in a convincing way. All of the actors identified as suitable gatekeepers are caught by the provision. Furthermore, the section allows for the limited contribution of experts,[179] the limited influence of outside directors, and the different roles of defendants in the offering process. Rule 10b-5 is better suited to fill the gaps in the regulatory system than sections 12(a)(1) or (2) Securities Act. It is more flexible than section 12(a)(1), which requires a violation of section 5 Securities Act, and section 12(a)(2), which does not apply to secondary market transactions and private placements. At the same time, the risk of excessive liability can be contained more easily through elements such as loss

[177] This view was summarised by John Pierpont Morgan as early as 1933 in the following words: "If, in the exercise of his profession, the private banker disregards [code of professional ethics], which could never be expressed in legislation, but has a force far greater than any law, he will sacrifice his credit. This credit is his most valuable possession; it is the result of years of fair and honorable dealing and, while it may be quickly lost, once lost cannot be restored for a long time, if ever." Quote from US v. Morgan, 118 F. Supp. 621, 744 (S.D.N.Y. 1953).

[178] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers*, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 54.

[179] Experts are only liable for misstatements in their opinion, section 11(a)(4).

causation or scienter, which are not part of the causes of action under sections 12(a)(1) and (2).[180]

5.6. Comparison of Prospectus liability

The prospectus liability provisions of English and Pakistani law are unsatisfactory. In spite of a catalogue of defendants in the Prospectus Rules that is similar to section 11(a) Securities Act, it is unclear whether and under which conditions experts and underwriters are responsible pursuant to section 90 FSMA 2000. Section 59 and 60 of Pakistani companies ordinance 1984, do not specifically encompass any gatekeepers, and it is questionable whether all or only some of them are caught. Section 11 Securities Act should serve as a model for the interpretation of the existing provisions or for amendments. In particular, the legislator should acknowledge that effective incentive structures require the expert to be accountable for misstatements in the opinion provided by him, and the underwriters for the whole prospectus.

As regards the underwriters, it is important to note that not all underwriters are involved in the offering process to the same degree. Often only the lead underwriter participates in the preparation of the offering. The other underwriters might, therefore, not be as familiar with the financial condition and the business operations of the issuer. Expecting a full-fledged due diligence from them would disproportionately increase the cost of capital. However, these are questions that are better addressed in the context of the applicable standard of care. At least in some cases the members of the underwriting syndicate will be in a position to review parts or all of the information contained in the prospectus, and a rule that excludes the liability of all underwriters except the book runner will be too undifferentiated. On the other hand, a general rule restricting the class of defendants is useful as far as other banks are concerned that are engaged in the placement of the securities (sub-underwriters, selling agents, brokers). They contract with the underwriters and not the issuer. Information necessary to verify the correctness of the issuer's disclosures is not easily available to them; consequently, the increase in the cost of capital caused by the heightened risk of liability of such secondary actors would in general not be offset by the improvement in investor protection.[181]

[180] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers,* (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 55.

[181] Accordingly, the Securities Act stipulates that the term "underwriter" within the meaning of section 11 shall not include "a person whose interest is limited to a commission from an underwriter or dealer not in excess of the

In the secondary market, investor protection is even less developed. The tort of negligent misrepresentation does not apply to secondary violators. Furthermore, the courts have not shown any inclination to broaden the scope of the provision and hold the financial intermediaries liable. As a consequence, investors were left without a remedy in many instances of accounting fraud and dissemination of incorrect ad-hoc announcements and other statements. The legislator should establish liability of the actual authors of misleading statements, i.e. the issuer's directors, and those secondary actors that have participated in the drafting of the statement or that review it (e.g. the auditors).

5.7. Comparison of liability standards

The provisions under observation exhibit a diverse range of liability standards, ranging from strict liability to negligence, gross negligence, and scienter. Pakistani Law shows the most restrictive standard (gross negligence in the case of primary market prospectus liability, scienter in all other cases), US and English rules differ. In the primary market, US and English securities regulation allows claims based on negligence.[182] In the secondary market, English law applies the same standard, but the deficiencies of the tort of negligent representation have been shown. The most important US liability provision for the secondary market, Rule 10b-5, requires scienter, but the high standard in respect to the defendant's state of mind is somewhat compensated for by the flexibility of the rule regarding other elements of the cause of action.

Ideally, an efficient system of liability should fix the standard of care at a level where the cost of one additional unit of care equals exactly the reduction in expected accident costs. The costs for gatekeepers of reviewing the actions of the primary actor depend on the gatekeeper's position. The same considerations that have been employed above are relevant here. In order to induce an optimal supervision of the primary market participant, the liability provisions should hold third parties to a high standard of care if they are close to the source of the information and can investigate the primary market actor at a low cost. Conversely, if verification is associated with significant costs, less should be expected of the gatekeeper. However, transactions in the

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usual and customary distributors' or sellers' commission", section 2(a)(11) Securities Act, 15 U.S.C. § 77b(a)(11) (2007). On the other hand, section 12(a)(2) Securities Act does not reflect these remarks. It is addressed to any seller or offeror, even those that are not in a position to review the prospectus.

[182] Liability of the directors, experts, and underwriters pursuant to section 11(b) Securities Act; liability pursuant to section 12(a)(2) Securities Act; section 90 FSMA 2000. In some instances, US law even imposes strict liability on market participants: Liability of the issuer pursuant to section 11(b) Securities Act; liability pursuant to section 12(a)(1).

capital markets are too complex and multifaceted as that a statutory rule could calculate these different levels and prescribe them for an unlimited number of cases. The legislator necessarily has to operate with flexible and general terms, such as the concept of "reasonableness"[183]. Notwithstanding this quandary, it should be possible to arrive at certain approximations, which could take the form of gradual standards that differentiate between types of defendant and misstatement.

Again, section 11 Securities Act incorporates these principles appropriately and establishes a sliding scale of responsibility that has been further refined by the SEC and the courts. Schedule 10 to the English Financial Services and Markets Act 2000 distinguishes between statements made by experts and other statements. However, as opposed to the Securities Act,[184] it does not ask whether the defendant had reasonable ground to believe that the expertised opinion was true.[185] Therefore, English law does not give an incentive to review the statement even if that would have been possible at low cost. Furthermore, the statute provides for a uniform standard of care for all defendants, notwithstanding their relationship to the issuer. The terms "reasonable belief" and reasonable enquiries"[186] might be sufficiently broad to allow the courts to hold the issuer and its inside directors accountable for a higher degree of care than the outside directors, and the lead underwriters for a higher degree than the other members of the underwriting syndicate.[187] Nevertheless, a more specific statutory differentiation would be desirable and increase legal certainty.

Pakistani prospectus liability law is the least adequate of the three provisions. Neither does it distinguish between the types of defendant nor the character of the statement as being expertised or non-expertised. In addition, by requiring gross negligence it sets the threshold for liability relatively high. Suggestions in the literature that this amounted to a probatio diabolica[188] for the issuer are hardly convincing. Gross negligence is the extreme departure from ordinary

[183] Section 11(b)(3) Securities Act.

[184] Section 11(a)(3)(C).

[185] Schedule 10, section 2(2)(a) merely requires that the defendant reasonably believed that the expert was competent to make the statement,

[186] Schedule 10, section 1(2).

[187] This is the solution under section 11 Securities Act. *Cf. e.g.* Securities Act Rule 176, 17 C.F.R. § 230.176 (2008): Responsibility depends, *inter alia*, on "[t]he type of person" to be held liable (subsection (c)) and, when the person is an underwriter, "the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant" (subsection (g)).

[188] Probatio diabolica (Latin: "devil's proof") is a legal requirement to achieve an impossible proof. Where a legal system would appear to require an impossible proof, the remedies are reversing the burden of proof, or giving additional rights to the individual facing the probatio diabolica.

care and the disregard of standards of conduct that should have been apparent to anyone. This cannot be construed in a way that would approximate strict liability. In respect to the other defendants, the provision does not provide for the necessary flexibility either. The failure to investigate the issuer's statements will generally not amount to an "extreme departure from ordinary care" if the defendant (e.g. the underwriter) studies the documents, discusses them with the issuer's directors and officers, and does not discover any red flags. Thus, the standard is substantially lower than in the US, where section 11(b)(3) requires a "reasonable investigation", i.e. the verification of the information through on-site inspections, interviews with the issuer's employees, customers, and suppliers, an analysis of the respective industry, and comfort letters procured from lawyers or financial analysts. The legislator should increase the standard of care, at least for the issuer, the inside directors, and the lead underwriter.

In conclusion, a sensibly staggered scale of responsibility in the primary market could consist, for example, of strict liability for the issuer, any type of negligence for the inside directors, the lead underwriter and the experts (for incorrect statements in their opinions), and gross negligence for the remaining members of the underwriting syndicate. The same principles should principally guide liability in the secondary market. The author of the incorrect statement should be held to the highest standard (for example the issuer and the inside directors for false periodic disclosures) and secondary parties that were involved in the preparation, dissemination, or verification of the statement to a lesser degree of care depending on their position in relation to the primary violator.[189]

Finally, the duties of the gatekeeper should be less comprehensive if the information exhibits a certain degree of reliability because it stems form an expert opinion. In such a case, requiring a full-fledged second investigation by the gatekeeper would increase the costs of the transaction without generating much benefit for investors, in particular if the gatekeeper lacks the

[189] It is argued that the standard of care for liability in the secondary market should, as a general rule, be lower than that in the primary market in order to prevent over-deterrence and inefficient results. This argument goes back to a famous article by William Bishop, Economic Loss in Tort, 2 Oxford J. Legal Stud. 1 (1982), claiming that in cases of pure economic loss the cost to society may be less than the private economic loss suffered by the victim and that, accordingly, full liability would give an incentive to implement precautionary measures that do not minimise total social cost and that are therefore not efficient (examples id. at 5-6 and passim). This argument may serve as justification to adhere to the requirement of scienter or gross negligence that can be found in secondary market liability provisions in all three countries under survey (Rule 10b-5, section 90A of the English FSMA, sections 17, of Pakistan securiteies and exchange ordinance 1969). However, it cannot serve as justification for the restriction of defendants to primary violators, as is also the case in all three countries. The economic considerations are complex, and a detailed review of the voluminous literature cannot be presented at this point.

technical qualifications to assess the expert opinion. US law has developed reasonable criteria that may be utilised to solve the controversies that exist in Pakistan about the definition of "expert opinion" and the consequences for the defendants' standard of care. A thorough review of the expert opinion by the gatekeeper will not produce significant additional protection for investors if – and only if – the information has been assembled in a way that ensures a high level of accurateness. This is the case if the expert has followed a clearly prescribed procedure (which is known to the gatekeeper) that is structured to produce high quality information. Consequently, statements from experts do not reduce the gatekeeper's duties simply because they originate from a market actor with particular expertise. To take the most important expert in the financial markets, the auditor, as an example, he may either give positive or negative assurances. The positive assurance attests that the financial information is presented fairly in conformity with generally accepted accounting principles (GAAP). It may only be given if the accountant has audited the information in accordance with generally accepted auditing standards (GAAS). The negative assurance confirms that the data has been reviewed pursuant to the rules set out in AICPA Statement on Auditing Standards (SAS) No. 100, which are less exacting than those under GAAS.[190] Depending on the procedures agreed on with the client, the accountant may follow SAS No. 100 when drafting comfort letters. If the procedures fall short of an SAS 100 review the accountant may not give a negative assurance. The SEC has stipulated that only a formal audit shall be considered as an expertised opinion within the meaning of section 11 Securities Act. In Pakistan the financial statements in annual financial reports must be audited, but not those in half-yearly or quarterly financial reports. The standards for the auditors' review or for comfort letters are comparable to those in SAS No. 100. They do not give reasonable assurance that the information does not contain any misstatement and should, therefore, not lead to a reduction in the duties required of the gatekeeper. On the other hand, if the accountant has audited the financial statements, an independent investigation by another market participant is

[190] The procedures are described in § 722.15-24, Appendix A-C. They consist principally of applying analytical procedures (e.g. comparing interim financial information with prior period information and actual interim results with anticipated results) and making inquiries of persons that are responsible for financial and accounting matters. *Cf. also* § 722.25: "A review of interim financial information is not designed to obtain reasonable assurance that the interim financial information is free of material misstatement. However, based on the review procedures performed, the accountant may become aware of likely misstatements." Accordingly, the accountant will generally formulate: "Nothing came to our attention … that caused us to believe that: a. (i) Any material modifications should be made to the unaudited condensed consolidated financial statements … for them to be in conformity with generally accepted accounting principles …", SEC Accounting and Reporting Manual § 14.101, article 5 Sample Comfort Letter.

unnecessary. The gatekeeper may content himself with verifying the consistency and completeness of the disclosure.[191]

5.8. Debate on two different regimes of Gatekeepers

The academic literature has for some time controversially discussed whether a gatekeeper regime based on strict liability or negligence is preferable. Interestingly, the different opinions operate with the same argument: Cost efficiency.

It is argued that negligence imposes higher costs than strict liability because legislators and courts will have difficulties in defining the precise standard of care that applies in a given situation. Thus, gatekeepers cannot judge what is expected from them. They might over- or under-monitor, in both cases increasing social cost. In addition, the litigation risk is high and the outcome of a lawsuit unpredictable if standards of care are vague. Conversely, it is pointed out that gatekeepers will, in general, not be in a position to determine compliance of the primary market actor with applicable rules with absolute certainty. Thus, under a regime of strict liability they can control the liability risk less well than under a regime of negligence. Furthermore, strict liability internalises all damage. All investors who have suffered a loss can recover, whereas negligence restricts the right to recovery to cases where the defendant has acted with fault. As a consequence, strict liability will force gatekeepers to charge higher fees. Depending on the size of the fee increase, issuers may not be able to afford the intermediary's services and might therefore be prevented from entering the market.[192]

The merits of the two opposing views cannot be evaluated in a theoretical way; rather, an extensive empirical analysis is needed to arrive at a quantification of the different factors that influence the efficiency of negligence based and strict liability regimes. Even if such an analysis was conducted it would be questionable whether it was of much sustainable value in an environment where economic and legal parameters (for example the investment climate or the

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[191] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers,* (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 61.

[192] Rainier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, (2 J.L. Econ. & Org, 1986), 53.

procedural framework for investor lawsuits) are as volatile as in the financial markets.[193] However, the debate might be of less importance than seems at first sight. Under certain conditions the costs associated with negligence and strict liability will converge. This consideration is based on the fundamental insight developed by Ronald Coase that in the absence of transaction costs all legal allocations of property rights are equally efficient. This rationale applies in the same way to the allocation of liability risks. If parties can freely enter into indemnification agreements, they will allocate the risk in a way that the party that is best positioned to control it bears the burden of liability.[194] Ideally, the market participant that ultimately assumes the risk can control it perfectly well. Thus, the inefficiencies of both strict liability and negligence are eliminated: The additional cost of strict liability and the administrative cost of imprecise standards of care are reduced to zero.

In the real world, some costs will remain. The party that is best positioned to monitor compliance with the regulatory environment is the addressee of the rules (the primary actor, for example the issuer in respect to the disclosure obligations of the securities laws). Even if the issuer contracts to indemnify the gatekeepers, which is common practice, the events that lead to securities litigation might leave the company insolvent. Accordingly, the claim for indemnification might be unenforceable. The gatekeeper, on the other hand, will never act under complete certainty. Furthermore, a system of liability that is based on negligence and that accords investors a claim against, inter alia, the gatekeeper that ultimately has to bear the risk of liability would continue to exhibit the inefficiencies caused by imprecise standards even if it allowed for risk shifting. Finally, administrative costs can arise from litigating the causes of action under the indemnification agreement, which might require a showing that the defendant has acted negligently. Still, risk shifting leads to an allocation that is, if not perfect, more efficient than a system that entrusts the courts or the legislator with determining the standard of care of each market participant. It can serve as an important means to compensate for a standard that has been set at an inefficient level by the legislator. Consequently, liability regimes should

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[193] It is telling that the analyses in the law and economics literature are of an entirely theoretical nature, *cf.* Robert Cooter & Thomas Ulen, Law & Economics 335-64 (5th ed. 2008); Posner, *supra* note 302, at 178-82.

[194] For example, if the auditor can verify the accuracy of the prospectus better than the underwriter, the latter will pay, as consideration for the assumption of the liability risk by the auditor, a fee that is lower than the cost caused by the auditor's exposure to liability but higher than the other party's cost of precautionary measures. Consequently, risk shifting will occur.

not consider risk shifting as against public policy, as is the view in the United States. Deterrence, if necessary, can be achieved without prohibiting contribution and indemnification agreements. The gatekeeper has to bear the insolvency risk of the counterparty, which should motivate him to act.[195]

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[195] Carsten Gerner-Beuerle, *The Market for Securities and Its Regulation through Gatekeepers*, (Temple International & Comparative Law Journal, Vol. 23, No. 2, 2009), 64.

CHAPTER 6

Conclusions and Recommendations

6.1. Conclusions

An analysis that tracks the development of the financial markets in the three jurisdictions over the last one hundred years indicates that significant advances in investor protection were preceded by leaps in stock market activity. The stock market in its modern form developed first in the United States, emerging at the beginning of the 20th century and expanding rapidly until 1929. The Great Crash of October 1929 and the ensuing Great Depression triggered the adoption of the Securities Acts 1933 that provide the basis for today's investor protection regime in US. In the United Kingdom, Big Bang, i.e. the abolition of fixed commission charges and other reforms that were aimed at modernizing the financial markets, precipitated an increase in market activity, which was followed by a replacement of the Financial Services Act 1986 by the Financial Services and Markets Act 2000.

The Pakistan equity market gained momentum in the 1960s and made significant progress in listings and market capitalization. Securities and exchange ordinance 1969 is also the outcome of that golden period. It made compulsory for the stock exchanges to be registered under this ordinance. However, the market lost its momentum in the 1970s due to political turmoil in the country and the nationalization policies adopted by the then government. Though the policy of greater reliance on private enterprise restored the market sentiments in the 1980s, the market actually regained its momentum in early 1990s when it was opened to international investors. In 1997 Securities and exchange act came which replaced the CLA (Corporate Law Authority) with SECP (Securities and Exchange Commission of Pakistan) which proved more dynamic and vibrant regulatory authority for the regulation of capital market. SECP became operational in 1999 and since then it has come up with numerous laws to ensure fairness and transparency in capital markets.

Thus, in all three countries the movement towards a more sophisticated investor protection regime lagged stock market development. In addition, the degree of sophistication of

the regulatory regime mirrors the maturity of the financial markets, implying that the evolvement of an advanced system of capital markets regulation needs time.

US securities law is very detailed and comprehensive and almost cover every aspect of gatekeeper liability whereas Pakistani securities law is very brief and some very important elements of gatekeeper liability are missing. In US securities act of 1933 is applied to primary market and securities and exchange ordinance of 1934 is dealing with secondary market, here in Pakistan the securities and exchange ordinance 1969 is being applied to both markets.

US law is dominated by causes of action that are favourable to plaintiffs. Reliance and loss causation either do not constitute elements of sections 11, 12(a)(1), and 12(a)(2) Securities Act, or they are structured as defences, i.e. the defendant bears the burden of proof. Section 12(a)(1) of the Securities Act does not require the plaintiff to show more than a violation of section 5 Securities Act.[196] Pakistani counterpart to sections 12(a)(1) and (2) is section 18 securities and exchange ordinance 1969 which prohibits furnishing of false statements[197] and its liability is provided in section 23(2) of securities and exchange ordinance 1969.[198] Reliance and loss causation have to be shown by plaintiff and defendant has the defence that he acted in good faith. Section 59 of Pakistani companies ordinance 1984 is also dealing with civil liabilities for mis-statements in prospectus.[199] By perusing these provisions it reveals that they are very close to US legislation but in Pakistan we lack the case law which can further interpret these provisions and define their pararmeters, because our capital markets are in the evolutionary stage hence case law has not yet fully evolved on some of the very important provisions of gatekeeper liability and to some very important provisions e.g. section 59, 60, Companies Ordinance 1984 it is not present at all.

The class of defendants as compare to US is not extensive and does not encompass all responsible actors. There is no sliding scale responsibility criteria as compared to US, is present in Pakistan. There is no defined standard of care in our securities law that takes accounts of the

[196] As discussed previously in chapter 5.4.2. at page 68.
[197] As discussed previously in chapter 2.2. at page 19.
[198] As discussed previously in chapter 2.5. at page 22.
[199] As discussed previously in chapter 2.7. at page 23.

gatekeeper position. Investor protection in the primary and particularly in the secondary market is underdeveloped.

6.2. Recommendations

After concluding research it has become evident that the liability provisions of Pakistani securities laws dealing with financial intermediaries and other market participants who act as gatekeepers are not at par with international standards, hence unable to ensure the transparency of capital market and give confidence to investors. Some of the suggestions to improve our securities regulations are as follows;

(a) A possible system of liability for incorrect information in the primary market in Pakistan could be modeled after section 11 of the US Securities Act 1933 or provide for three layers of liability: strict liability for the issuer, any type of negligence for the parties that are intimately involved in the offering (the inside directors, lead underwriters and experts that prepare or certify parts of the offering documentation), and gross negligence for other participants (e.g. outside directors and the remaining underwriters).[200] Reliance on information provided by third parties reduces the duty of care if the information has been compiled following a procedure that ensures a high level of accuracy. Liability for misstatements in the secondary market should be extended.

(b) Section 17 of securities and exchange ordinance 1969 deals with prohibition of fraudulent acts,[201] but whenever it is invoked against the perpetrators of manipulative and deceptive practices in securities market, it was very difficult to prove.[202] It should be modeled after section 10 and rule 10b-5 of the US securities and exchange act of 1934.[203] This will enhance the securities regulation in secondary market and also expand the powers of SECP as a regulator.

[200] As discussed previously in chapter 5.7. at page 74.
[201] As discussed previously in chapter 2.2. at page 18.
[202] As discussed previously in chapter 2.2. at page 19.
[203] As discussed previously in chapter 3.3. at page 36.

(c) There is need of causes of action in our securities law that are conducive to legal certainty, addressed not only to the primary violator but also to third party actors, i.e. underwriters, auditors, lawyers, and other experts. In Pakistan the preferable solution would be the creation of express causes of action by the legislator to replace the ill-equipped section 17 of securities and exchange ordinance 1969. Express causes of actions against these third party actors can serve as a good tool to force them to keep an eye on primary violators and withheld their cooperation if they smell anything wrong in the financial transaction and immediately report it to the regulator.

(d) In proving a case against third party for any fraud based on negligence or misrepresentation burden of proof should not be so high if it is on the investor to show that he relied on an incorrect piece of information that is possibly phrased in highly technical terms and has been circulated by a party that stands in no legal relationship with the investor, but that has nevertheless influenced the value of the investor's interest through market operations.

(e) Section 59 and 60 of Pakistani companies ordinance 1984, do not specifically encompass any gatekeepers, and it is questionable whether all or only some of them are caught. Section 11 Securities Act should serve as a model for the interpretation of the existing provisions or for amendments. In particular, the legislator should acknowledge that effective incentive structures require the expert to be accountable for misstatements in the opinion provided by him. US law has described that a thorough review of the expert opinion by the gatekeeper can produce significant additional protection for investors if the information has been assembled in a way that ensures a high level of accurateness.[204] Pakistan should follow this criterion to solve the controversies about the definition of expert given in our securities law.

(f) Comprehensive laws targeting primary and secondary markets separately and encompassing each and every aspect of gatekeeper liability should be legislated.

[204] As discussed previously in chapter 5.6. at page 71.

(g) I suggest regime of strict liability for gatekeepers instead of negligence because negligence imposes higher costs than strict liability and legislators and courts will have difficulties in defining the precise standard of care that applies in a given situation.[205] Thus, gatekeepers cannot judge what is expected from them. They might over or under-monitor, in both cases increasing social cost. In addition, the litigation risk is high and the outcome of a lawsuit unpredictable if standards of care are vague.

(h) Penalties and punishments mentioned in securities and exchange ordinance 1969 and Companies ordinance 1984 should be enhanced to deter perpetrators of securities fraud.

To conclude, regulators in Pakistan should come up with new and effective legislation ending uncertainties regarding the efficiency implications of regimes of strict liability and negligence encompassing financial intermediaries which act as gatekeepers to financial market.

[205] As discussed previously in chapter 5.8. at page 76.

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