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Volume III of IV
The Corporate Law Authority Training

**PAKISTAN INVESTMENT EXPANSION PROGRAM
(PIEP)**

Project Number 391-0514

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PAKISTAN

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The International Science and Technology Institute, Inc.
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ISTI — TEAM MEMBERS

Project Manager:

Bradford A. Warner, Jr. is Vice President of ISTI's Private Enterprise and Economics Division. Mr. Warner has over 25 years of international corporate finance experience including capital market development, public and private securities offerings, corporate direct investment, real estate and equipment lease financing and venture capital portfolio management.

Corporate Law Authority Training Program:

Robert M. Bishop, former Senior Vice President, Chief Regulatory Officer and Member of the Managing Committee of the New York Stock Exchange, was the longest-termed regulatory officer in the exchange's history. An employee from 1955, and an officer from 1963, he retired in 1986 after heading N.Y.S.E. regulation during years of major crisis, development and change. He has advised 13 foreign stock exchanges.

Anthony D. Loehnis, former Group Executive Director and Vice Chairman of S.G. Warburg in London and Executive Director of Bank of England for Overseas Affairs, has over 25 years of international corporate finance and banking experience. He is a member of the Group of Thirty, Chairman of the Centre for Economic Policy Research, Director of the U.K.—Japan 2000 Group and member of the Council of Management of the Ditchley Foundation.

Debra J. Kertzman is an attorney who is currently the Regulation Specialist for the USAID/Sri Lanka Financial Markets Project which is being managed by ISTI as contractor. She has worked for the U.S. Securities and Exchange Commission, the Hong Kong Securities and Futures Commission and as a securities lawyer in New York City.

Karachi Stock Exchange Training Program and Certification Course:

John R. Buehler has over 30 years of management experience in the capital markets industry including former positions as National Marketing Director, National Training Director and National Sales Manager of three N.Y.S.E. member firms. In addition, he founded the NYSE/NASD Securities Industry Examinations required of all U.S. investment brokers and securities firm branch managers. He is a member of the Examinations Policy Review Committee of the NYSE and a past member of the NASD Qualifications Committee.

Alfred C. Morley has over 40 years' experience in the investment business, dealing primarily with securities research and management of institutional funds and with the training of global investment professionals. He was the first President of the Institute of Chartered Financial Analysts and is the ISTI Program Coordinator for establishing the CFA program in Sri Lanka under the USAID/Sri Lanka Financial Markets Project.

John L. Kinnaman has over 20 years experience in stock exchange and securities firm operations and management in the U.S. and internationally. As ISTI's Advisor to the Colombo Stock Exchange, he was responsible for the development of its Central Depository, and recently he has advised on clearance and settlement, stock exchange rules and custody arrangements in Tanzania, Venezuela, Bulgaria, India and Pakistan. He is a former Vice President of NYSE, Midwest Stock Exchange and the National Securities Clearing Corporation.

Ronald E. Copley is an Associate Professor of Finance at the University of North Carolina and a principal reviewer of examinations for the Institute of Chartered Financial Analysts. He also is engaged in investment management for professionals, retirement plans and foundations. He is an expert court witness on investments and personal and business valuation and advises the State of North Carolina on its \$7 billion pension fund.

Susan S. Martin, as an ISTI consultant, designed and implemented the first Sri Lanka stockbroker licensing program for the Colombo Stock Exchange and the Securities and Exchange Commission, including formulating the syllabus, compiling and writing the training manuals, teaching the curriculum and administering the final examinations. Ms. Martin is a stockbroker by profession.

Expanded Outlines for Courses in

Operations and Regulation of Capital Markets and Stock Exchanges

and

Special Regulatory Considerations

Pakistan Corporate Law Authority Course Outline

Sponsored by USAID/Pakistan, Executed by International Science and Technology Institute of Washington, DC, USA, Instruction by Robert M. Bishop, Deborah Kertzman, and Anthony Loehnis

TRAINING SESSION A: CAPITAL MARKETS AND THEIR REGULATION

TRAINING SESSION B: SPECIAL REGULATORY CONSIDERATIONS

Session hours: 9:30 - 11 am, 11:30 - 1 PM, 2 - 3:30 pm
October 11-23, 1993, except Fridays

MONDAY, OCTOBER 11.

Bishop - Outline of the Course

A1. Loehnis - Features and Functions of Financial Markets

Definitions - The financial sector of a country is its financial market. Money is for short term use, Capital for long term use.

Money as lubricant of economy

Financial sector intermediates between those who have money (savers) and those who need it (investors)

Seamless web of maturities

Financial markets bring together savers and investors

Retail/wholesale distinction

Financial Market Components

Short term money providers - Banking institutions (takers of deposits) - Central, Commercial, Savings, Mortgage; Finance companies - hire purchase, leasing, factors; Commercial paper

Long term money providers - Banking institutions - Development, Mortgage, Permanent overdraft; Institutional Investors - Insurance companies (life and general), Pension funds, Investment companies (open and closed end)

Venture capital companies

Short term money markets / long term capital markets

Securitization

Privatization vouchers.

Peripheral support by broker/jobbers

jobbers in government securities, bankers acceptances, commercial paper, privatization vouchers, repurchase agreements

brokers in short term loans, federal funds, certificates of deposit

Capital Markets

History and Evolution

dependent on political and socio-economic development in individual countries.

development of banking system is prior requirement and will long remain most important source of capital

function of pace of economic development and growth consequence not cause of economic development, but relationship becomes symbiotic

Role in the Economy

to collect savings and channel them where they are needed

to encourage the savings habit by providing a variety of savings media, with differing levels of risk and rewards, differing

maturities and differing characteristics

to facilitate the development of institutional savings

to lower cost of finance by providing variety of financial instruments and competing sources of finance

to improve allocative efficiency by providing efficient pricing mechanism and information dissemination

to facilitate change of corporate control

to provide stimulus to greater managerial efficiency

to give signals / warnings to government

International Aspects

globalization of markets

positive contribution of foreign investors

standards, investor protection, information, regulatory

add depth and liquidity

provide access to international markets for domestic companies

Regulatory Implications

systemic risk

investor protection

Pakistan capital issue control is unusual - Objects:

Broad base for ownership of all large companies

Prioritization of use of capital

Limit debt/equity ratio

Limit compensation of directors of loss companies

Balance rapid capital formation and economic

development against social justice and consumer

protection - by limiting concentration of economic power, monopoly, and restrictive trade practices.

Influence on issue price not appropriate

Modaraba - for purposes of broker/jobber servicing, viewed same as companies.

A2. Loehnis - Constituents of Securities Markets

Financial Instruments Involved

Various nomenclatures, but essential division is between debt securities (bonds) and equity securities (stocks/shares). Distinction of creditor relationship and ownership.

Basic bond: fixed payments of specified maturity and designated dates for interest payments - medium/long term, secured/unsecured, fixed/floating charges, bondholder protection through covenants and ratios, negative pledges, variable rate and deep discount bonds.
Preference Shares- right to receive fixed income distribution prior to payment of dividend to common shares, cumulative or non-cumulative, redeemable, priority in liquidation to common, defined rights.
Common shares - residual owners of income/assets after all other securities' entitlements settled
Hybrids - convertibles (bonds or preference shares convertible into common), warrants (permit to subscribe for securities at a fixed price and time)
Derivatives - options, futures, swaps, indexes
Securitized obligations - mortgages, receivables
Program trading

The Players

Primary Markets (where issuers of securities meet savers)
issuing company/institution
sponsor/distributor (securities firm/ broker-dealer/ underwriters/
selling group
regulators (stock exchange, government regulator
investors (institutions, individuals)
custodians and registrars.

Secondary Markets (where investors meet investors, securities are priced, liquidity is provided, enhance capital raising in primary markets by providing liquidity to investors)

Stock Exchanges

Over-the-counter markets

Securities firms (brokers, market makers, jobbers, specialists)

Investment managers and advisors

institutional and individual investors.

regulators

custodians and registrars

security analysts and press

Regulators

Promote investor confidence in primary and secondary markets
and widen competition for use of savings

**READINGS - Model Rules for a Stock Exchange, Third Edition, by
Robert M. Bishop, Principal Recommendations, Pgs 3-22**

TUESDAY, OCTOBER 12.

A3. Loehnis & Bishop - The Regulatory Authorities

Securities Firm Management is first line of defense

Compliance delegation

Line supervisors

Follow up

Government Regulator (CLA, SEC, SIB, etc)

- Primary regulator of public issues and disclosure of information by public companies
- Oversight of self-regulators
- Varying functions - corporate registration, insurance industry, investment companies,
- detection and enforcement of criminal level activity.
- Aim for partnership with practitioners, should concentrate on ensuring full disclosure rather than itself judge merits of securities.
- Industry Self Regulators (stock, options and futures exchanges, dealer associations, transfer agents, clearing organizations and depositories, UK post-Big Bang model)
 - Financial responsibility of members
 - Fair sales practices by members
 - Qualification of key personnel
 - Listing standards
 - Trading methods
 - Settlement
 - Discipline
 - Arbitration
- Finding the right balance
 - contrast of US reform after the 1929 stock market crash and UK 1986 reform (Big Bang)
 - retail/wholesale markets merit different levels of supervision
- Role of regulators in capital development
 - spontaneity vs. public interest

A4. Loehnis - Companies and Issuance of their Securities

- From private company to public -
 - reasons for original owners selling share to public
- Initial Public Offerings
 - criteria for listing (LSE yellow book)
 - conditions for listing
 - role of sponsor and advisers
 - methods of bringing securities to market
 - UK, US case
 - Pakistan case
- Prospectus requirements
 - responsibility
 - contents
 - financial information
- Subsequent issues
 - methods of bringing securities to market
 - prospectus requirements
- Ongoing disclosure
- Corporate governance questions
 - non-executive directors
 - audit and remuneration committees
- Government as regulator
 - Disclosure vs. Merit

WEDNESDAY, OCTOBER 13.

A5. Bishop - Secondary Markets

Clarify 69 Ordinance Sec 8 - seems to require all broker/dealers to be exchange members

- Only members may execute trades on an exchange
- Only listed securities may be traded on an exchange,
- Dealing in listed securities off an exchange is prohibited
- Only Exchange members may be brokers or jobbers for unlisted securities

Stock Exchange Structure

- Ownership
- Objects
- Members
- Floor Trading Privilege
- Associate Members
- Settling Trades, Carrying Introduced Customer Accounts, Depository
- Governance
 - General Meetings
 - Board Composition
 - Represent diverse constituencies
 - Board powers
- Management
 - Chief Executive

Multiple Exchanges

- Inconsistent with centralization of all orders
- Justifiable only if communication prevents centralization or if linked
- Increases customer cost by arbitrage

Jobber Associations

- As jobber interest groups, market operators, regulators
- OTC unlisted trading as tier of Exchange preferred
- Complicates regulation
- Duplicates exchange memberships
- Increases communication and processing cost

Listing Requirements

- Sufficient distribution to support orderly auction trading
- Company agreement to listing conditions
- Investment merit not a practical standard

Ten Areas of Exchange Rules

Karachi SE has:

- Organization and Governance
 - Negative - Board rejections of applicants without reason or hearing. Only Members on Board.
- Listing of Securities
 - Negative - delisting for failure to pay dividends for 5 years, Positive - no attempt for Merit standard
- Settlement of Contracts

Undue risk - settlement 7-14 days after trade
No clearing fund
Not seen for Karachi
Trading
Questionable decentralized trading
Qualification
Ethical Conduct
Supervision and Control by Members
Financial and Operational control by Members
"Badla" is financing - for members and investors? - sale
of uncleared trades with buy back next day at interest rate
increase, - margin lending during transfer, delivery
suspended - cash collateralized fails - etc.
Discipline
Arbitration

A6. Bishop - Trading in the Secondary Markets

Organization and Operation of Exchange Trading

Call market
Continuous Market
Bid-offer file market
Decentralized floor trading
Broker vs Jobber methods
Auction Manager function
Standardization of units, variations, settlement options (options &
futures as well as equities & bonds)
Openings, Temporary halts
Tiers for Trading
Cross problems
Order priorities, customer, price, time, size
Order and Transaction Records
Locking trades
Floor or computer
No choice of other side
Commissions, fixed or negotiated

Organization and Operation of OTC Trading

All jobber transactions
Decentralized
Best price through communication
Choice of other side
Settlement options
Jobber Mark-ups

Regulatory Monitoring of Trading

Audit Trail, on-line surveillance, reconstruction
Trading Halts
Insider reporting
Insider trades
Market maker, on floor jobber, customer jobber, upstairs member trader
surveillance
Complicated by multiple markets
SRO & Government access differences

READINGS - Model Rules, Pages 3 - 13, 23 - 33
NYSE Listing Requirements - Fact Book copied pages 29 - 30, 45

THURSDAY, OCTOBER 14. (Kertzman arrives)

A7. Bishop - Securities Brokers/Jobbers

Individuals, Partnerships, Limited Liability Companies (Corporations)
Prohibit clearing, carrying of customer accounts by individual members (death risk)
Qualification of directors, officers, controlling parties
Documentation
Supervision capability
 Written supervisory manuals
 Overall responsibility by Chief Executive
 Formal delegation to qualified subordinates
 Follow up system on proper exercise
 Approval of new accounts and credit extension (now not permitted, should be)
 Periodic review of customer accounts, communications, written records of such reviews
 Know your customer compliance
 Review of employee accounts
 Approval of all public communications
 Compliance with research report standards
Capital related to business size and risk
 Minimum for servicing or carrying customer accounts
 Liquid capital regulatory base
 Excludes assets not readily converted to cash
 Capital withdrawable within 6 months
 Business size and historical risk adjustments
 Percent of firm positions
 Undermargined customer accounts
 Aged suspense accounts, transfers
Custody of Customer Property
 Commingling in bank collateral
 Hypothecation limited to lien multiple
 Loans of Customer securities
 Prompt possession and control of customer securities
 Identification of customer property
 Use of customer credits to finance other customer debits
 Segregation of customer surplus credits
 Cushion factor as a capital requirement
Adequate operations capability
 Written delegation of responsibility
 Confirmations and Statements to Customers
 Monthly supervisory review of bookkeeping accounts
 Uniform books and records, standard retention compliance
 Quarterly securities counts
 Required fidelity insurance
Monthly and Quarterly reports to regulators

For firms carrying customer accounts and clearing, monthly
For introducing firms, quarterly
Financial and Operational data
Immediate reports of low capital
Triggers of business restriction
Audits by Independent Public Accountants
Annual
Material Inadequacy Reporting
Regulatory Monitoring discussion in Enforcement Session

B1. Bishop - Compensation Funds

British Law type bankruptcy acts and stockbrokers
Court appoints a trustee of the bankrupt estate
Trustee determines the pool of assets in possession and control of the bankrupt
Trustee determines claims of each customer and other creditor of the bankrupt
Priority of return of securities physically identified as property of particular customers
 Securities with stock powers or in transfer excluded.
 Securities collateralizing bank loans usually not identified as those of a particular customer.
Mode 1 - All other money and property held by the bankrupt is converted to money and distributed pro-rata to general creditors.
 General creditors are all claimants (including customers) who are not shareowners or subordinated lenders.
Mode 2 - For each security and for the overall money balance which can be identified as belonging to customers, each customer receives a pro-rata share of his claim for each particular security and his money balance.
American Mode 3 - The total shortage in customer values identified as customer property is distributed to every customer pro-rata to his approved claim account value.
 Result - percentage losses to customers become small with most feasible for restoration by Compensation Fund.
 Practical outcome is that customers of larger firms are more likely to receive total return than customers of smaller firms.

Compensation Funds

American evolution -

1929 Single & separate fund for customers (Mode 2)
1959 NYSE rescue of small firm, insurance purchased
1963 Failure of Ira Haupt, NYSE - Bank rescue
1964 NYSE Special Trust Fund
1971 Federal Act establishes Securities Investor Protection Corporation
1978 SIPC modified by adoption of Mode 3

Sri Lanka plan

Designed to establish American plan by simple Act of Parliament authorizing SEC by rule to establish bankruptcy provisions for stockbrokers.

READINGS - Model Rules Pages 14-17, 21 - 22, 46 - 59
Extension of Credit - NYSE Fact Book copied pages 67 - 69
Model Rules Pages 56, 57

FRIDAY, OCTOBER 15.

Session canceled by USAID, CLA for observance of religious holiday by attendees. Subjects moved to October 16 and 18.

SATURDAY, OCTOBER 16.

B2. Loehnis & Kertzman - Roles of Public Accountants, Securities Analysts and Attorneys

Disclosure vital for investor protection and for market pricing of securities
Accurate, full and audited financial information is key part of disclosure

Public Accountant role is central in preparing financial statements in prospectuses and annual accounts

- Accounts remain management responsibility
- Checking profit forecasts in company documents
- Responsibility Statements
- Liability incentive

Lack of consensus, nationally and internationally, on accounting principles - lack of comparability
Conflict of profit minimization for tax purposes, maximization for stock market performance
Securities analysts can rework published accounts to provide comparability

Problem areas:

- Restating accounts from profit to loss (Trafalgar House)
- Terry Smith's exposure of 12 ways to manage profit and gearing
- Lawsuits brought by regulators against public accountants

What can regulators do about accounting problem?

- Ensure consistent standards
- Ensure improving standards, converging toward best international norms. Regulator as setter of accounting standards
- Ensure accounting profession is up to mark
 - Training
 - Monitoring accounts against company performance
- Need for cooperative relationship between regulators and accountants
 - changing attitudes toward where auditors responsibilities lie
 - UK statutory requirement for reports (FSA and Banking Act)
 - Group of 30 review of US situation
 - Regulators can help auditors by making conformity to accounting standards a condition of listing

The Role of Security Analysts

- Need for training and professional standards

Allegiance owed to securities firm aiming to persuade clients to transact
Important part of reputation of securities firm: league tables
Should have say in financial reporting and accounting standards
Review and analysis of financial statements and other disclosure, depth research
Communication to line customer brokers

The Role of Lawyers/Attorneys

To make directors constantly aware of their legal responsibilities in running a company
To ensure legal and regulatory requirements met in issuance of securities, contents of prospectus, etc.
Good lawyers / Bad lawyers
Advice to issuing companies and to underwriters/sponsors
Legal liability for negligence incentive
Agency relationship
Who is client? Issuer, Underwriter
Preparation and Review of Registration Statements for compliance with regulations
Follow-up after an IPO/ Post effective amendments/ Periodic Reporting
Liability - due diligence defense

B3. Kertzman & Lehnis - Insider Trading

In both US and UK has only recently become top enforcement priority, but very difficult area to define and prosecute successfully

Non-statutory restraints

In UK general principles covering director's fiduciary duty to shareholders should be an effective restraint
Reinforced by LSE listing requirement to adopt model code of Directors' and employees' dealing

Statutory restraints

Disclosure requirements imposed on "insiders"

In UK 1985 Companies Act requires details of directors' dealings to be reported to LSE and disclosure of acquisition by anyone of 3% or more of share holding
Provides power to discover beneficial ownership behind nominee names

US 1934 securities act Section 16

- directors and officers and anyone owning 10% or more to report to SEC on attaining that status and report subsequent purchases and sales
- profits on sale of such securities within 6 months goes to company
- short selling by insiders prohibited
- determination of damages

Prohibition of insider dealing

In UK, successive attempts to tighten definitions of insider, inside information and offense of insider dealing
1985 Insider Dealing Act

1986 Financial Services Act

1993 Criminal Justice Act

In US, insider dealing regulated under anti-fraud provisions

Disclose or abstain rule

Prohibition of tipping or acting on tips

Problems of definition of insiders, outsiders with special relationships, tipper, tippee, insider information, intent

Enforcement - detection, investigation, bounties, proceedings,

Additional Problems

burden of proof for criminal prosecutions high

derivatives make detection even harder

cross parties insider dealings

READINGS - UK 1993 Criminal Justice Act, Part V; How to read a Financial Report, Merrill Lynch

B4. Kertzman & Loehnis - Takeovers and Mergers

Macroeconomic considerations

Part of "creative obstruction" of economic change

Competition policy and efficiency - monopolies, restrictive trade practices

Mergers and acquisitions - short termism vs. long termism; differing concepts of corporate governance; a spur to management efficiency

Microeconomic considerations - UK practice

Takeover by transfer of shares more common than through transfer of assets

1968 City Code on Takeovers and Mergers in response to spate of takeovers: non-statutory

Operated and enforced by Panel with executive, full committee of representatives of City organizations and appeal tribunal. Panel rulings subject to judicial review.

Code principals

Anyone acquiring 30% of a company's shares must make a cash offer for the rest

Equality of treatment for all shareowners

Full information to shareowners to assess merits of an offer

No action to be taken to frustrate an offer before shareholders can vote on it

Offer price must be adjusted to match price of market purchases of shares during offer period if higher than original offer

Rules governing conduct of offerer, offeree and their advisors during offer period

Takeover regulation is not concerned with financial or commercial merits of offer or of public interest considerations

Offer suspended if reference to Monopolies and Mergers Commission

Microeconomic considerations - US practice

Takeovers regulated by SEC under Securities Act of 1934
Takeover not defined, but involves public offer to substantially all
shareholders for substantial percentage of their stock
Offerer must disclose his plans toward offeree at early stage
Withdrawal period available to tenderors of shares
No special deals to selected shareholders
No purchases by offeror outside tender offer
Target company must make recommendation to its shareholders
Disclosure of interests over 5% to avoid "creeping" takeover

Tactics for opposing/preventing unwanted takeovers
Management persuasion in defense document
Soliciting higher offer from more acceptable offeror
Litigation (very difficult in UK)
Poison pills
Purchase of own shares to increase price

SUNDAY, OCTOBER 17.

A8. Bishop - Qualification and Supervision of Persons Servicing Customer Accounts

Exchange traders, OTC traders, Customer brokers, principal executives,
officers, branch and regional managers,

Good business reputation
Bankruptcy not a justifiable uniform exclusion
Felony conviction, or expulsion by a regulator is
Any exclusion should be subject to due process

Relevant education, confirmed by testing
For each product area
Professional testing techniques
Experience for supervisors

Types of Training programs - university, industry schools, correspondence
Reference to NYSE testing outlines for subject matter

Supervision

Methods of Attracting and Retaining clients
Review of prospecting methods and tools
Review of initial client portfolio and security cross-
reference records
Supervision and Control as a Management Function
Formal delegation of management authority to a Chief Executive
and subordinates
Follow up of delegated management responsibility in person or
by compliance and internal audit staffs
Branch Manager & assistant branch manager

Opening new accounts

Learning essential facts
New account form, checking references, deposits, approvals by
branch and firm
Retail and institutional differences
Supervisory reviews of customer accounts

- Daily of transactions
- Monthly of account activity, portfolio and cross-reference records
- Daily of correspondence
- Special situations - discretion, managed accounts, commodities, options, mutual funds, concentrations, large orders, speculative issues, day trades, short sales, employee trades, etc.
- Branch and Main office aspects
- Sales office compliance reviews
- Supervision of sensitive areas
 - Foreign & local securities
 - New issues and secondaries
 - Control securities
 - Outside connections and speaking activities of representatives
 - Flow of securities and funds - extensions and liquidations, prepayments, canceled checks
 - Customer complaints and order errors
- Evidence of reviews
- Supervision of operations and finance
 - Written delegation of responsibility for bookkeeping accounts
 - Monthly review of such accounts
 - Quarterly security counts
 - Internal auditing
 - Independent audits
 - Internal discipline
- Reportable questionable activity

A9. Bishop - Arbitration

- Between members, employees
- Customers
- Arbitration Code
- Arbitration Agreement

READINGS - Model Rules, Pages 39 - 41
NYSE Study Outlines for Test Series 7, 15, and Supervisory Analysts
Patterns of Supervision Booklet copy
Arbitration Procedures booklet
NYSE Arbitration Rules
Model Rules Pages 17, 62-63

MONDAY, OCTOBER 18.

B5. Kertzman and Loehnis - Investment Companies

Significant recent growth in US - \$1 billion a day to date in 1993 related to declining bank deposit rates; \$1.8 trillion currently in mutual funds by 27% of US households

- Benefits and Costs
 - Professionally managed

Cost economies of scale
Diversification of assets, risk
Management fees and expenses
Access to international markets

Background of US regulation - Investment Company Act of 1940

Congressional concerns - Shareholder needs for information; Conflicts of interest; Preference for certain shareholders; Control and Management; Accounting methods; Change in business or management without shareholder approval; Excessive borrowing; Capitalization

Background of UK regulation

Prevention of Fraud (Investments) Act 1958 - very little regulation
EC Undertaking for Collective Investments in Transferable Securities Directive of 1985
Financial Services Act of 1986 - implements 85 Directive and enables SIB activity in regulating collective investment schemes
DTI and SIP 1988 regulations
SIB 1991 regulations for new types of unit trusts
Marketing regulation by SRO's

Definitions

UK - Companies Act relates mainly to distribution powers of investment trusts; Financial Services Act defines collective investment schemes
US - Act of 1940: any issuer which engages primarily in the business of investing in securities with a value exceeding 40% of total assets

US classifications

Unmanaged - face-amount certificate companies; unit investment trust
Managed - any other whether a trust or corporation
Open end mutual funds - redeemability of shares, priced at net asset value
Closed end - traded like shares of other publicly owned companies
Load and No-load
Diversified - with no greater than 5% of assets in any issuer, or 10% of the voting securities of such issuer

UK classifications

Investment Trusts - closed end corporations with fixed capital
Unit Trusts - open end organized as trusts

UK Statutes and Regulations

Financial Services Act implemented by SIB
- Aims of SIB regulations - high standard of investor protection; preserve product distinctiveness; manager and trustee acting solely in interest of unit holders; comparability of charges; produce regular valuations; buy/sell obligation at net asset value; separate trustee and manager; Independent oversight by trustee over manager

- Authorization and Recognition of Schemes - required by the Act; Application by trustee and manager independent of each other; revocation possible; changes reportable to SIB; intervention powers

European Directive on Undertakings for Collective Investments in Transferable Securities

SIB's Unit Trust regulations

Deed to prescribe contents

Manager responsible for administration of trust and contents of particulars

Trustee oversees and supervises Manager

Pricing and Dealing - initial charges vary from 0 to 6.4%;

Annual Management charges from .5 to 2%; Bid/offer spread averages 5.5 to 6.5% depending on stock market

Investment and borrowing powers, wide choice of investment objectives, limited borrowing

Efficient portfolio management

SRO Oversight of unit trust managers

IMRO authorizes most managers and trustees and oversees compliance by members with SIB's regulations

LAUTRO registers most managers for direct marketing of unit trusts

FIMBRA registers most independent intermediaries marketing unit trusts to retail customers

US Regulation

Securities Act of 1933 - regulates public offering of fund shares

Securities Act of 1934 - regulates broker/dealers, proxies, reporting requirements

Investment Advisers Act of 1940 - regulates investment advisers/managers

State Law - regulates public offering of fund shares

Investment Company Act of 1940 - most intensive regulation

Applications for exemptive relief - public interest standard

Registration required with annual updating and amended stickers; no limitation on number of shares of open-end funds

Bans persons with securities fraud records

Prohibits pyramiding and cross ownership,

Requires shareholder approval for changes of business or investment policies, Management contracts and amendments

Public offers permissible only by companies with net worth of \$100,000 or more

Sets conditions limiting company distributing its own shares

Requires written code of ethics, SEC approval of insider transactions, annual and semi-annual reports to SEC and

shareholders, filing of sales literature with SEC; purchase and redemption of open-end shares at net asset value; sets conditions for issuance of senior securities

Regulates solicitation of proxies, custody of fund assets outside US
Prescribes accounts and records, and inspection by SEC; selection of auditors by Directors and ratification by shareholders
Tax laws require 90% of dividends to be distributed to shareholders
Compliance and enforcement

A10. Loehnis and Kertzman - Investment Advisers and Managers

Regulatory goals - as between adviser and clients
Protect fiduciary relationship
Eliminate or expose all conflicts of interest

UK Regulatory Systems - a complex maze

Financial Services Act
SIP regulations pertinent to investment managers
Integrity, skill, care, diligence, conflicts of interest, independence
Market practices, Dealing for customers
Information for and about customers, customer accounts, customer relations
Administration, Financial resources, Organization
Advertising and Marketing

SROs and third tier rules

IMRO regulates investment management companies, managers of unit trust operations including trustees, investment trust managers, in-house pension fund managers, pension fund trustees, investment advisers at wholesale level; by special advertising code, terms of customer agreements, rules for dealing with pension fund assets, enforcement and disciplinary procedures

FIMBRA regulates independent financial advisers engaged in marketing and advising retail clients on investments, including unit trusts

LAUTRO regulates tied agents marketing unit trusts and life insurance products

BOTH regulate Fact Finds or financial circumstances and investment objectives of customers, customer files to be kept by salesmen, advice given recorded with reasons, information that must be given qua polarization, cooling off period for cold call sales, enforcement and disciplinary procedures.

Polarization issue - Salesman can be either an independent adviser on wide range of products of many companies, or tied representative selling products of only one company

US - investment managers are regulated as investment advisers under the Investment Advisers Act of 1940, modeled on broker/dealer regulation with policy of full disclosure.

Defined as meeting 3 elements -
for compensation
engages in the business
of advising others on value of securities, or advisability of
investing, or issues or promulgates analyses or reports
concerning securities

Issues arise as to
Compensation
Business Standard

**READINGS - SIB Principles and rules for the Conduct of Investment
Business**

TUESDAY, OCTOBER 19,

A11. Loehnis & Bishop - Ethics

Good business practice

Manipulation

successive transactions

pools

wash sales

misleading activity

inducing activity by alleging market operations

inducing activity by false or misleading statements

fictitious bids or offers

Fraudulent Acts

Customers first (agency)

Customer order priorities

Exposure of orders to market

Conflict of interest in other employment

Disclosure of conflicting interest

firm or personal positions

agency or dealer status

market making

Commercial bribery or influence by excessive gratuities

Reports of questionable conduct

Guarantees of or sharing in customer accounts

Misleading names

Discretion without written authority

Rumor circulation

Privacy of Regulatory information

Truth and good taste in advertising and promotion

Reasonable basis for recommendations

Performance records

balanced

confined to specific universe

date and price of recommendations

relevant costs, material assumptions for annualization

general market conditions in period covered

- irrelevance to future performance
- retention of working papers for inspection by SRO
- Basis for projections and predictions
- Comparison with other brokers factually supportable
- Dating of research reports
- Testimonial limitation
- Promptness of account delivery at customer request
- Fair commissions and mark-ups
- Fair corporate financing
- Free riding and withholding
 - Bona-fide distribution of hot public offers
 - full distribution
 - No favoritism
- Disclosure of conflicting interest
- Inaction on inside information, and reporting to regulators
- Codes of Conduct - UK, US
 - Useful for establishing ethic standards
 - Normally consist of general principles which explain rules
 - UK examples
 - City Code on Takeovers and Mergers
 - SIB principles and code rules for investment business
 - Code for directors and employees share dealings (London Stock Exchange Yellow Book)
 - Cadbury Committee code on corporate governance (responsibility of non-executive directors, audit committees, remuneration committees, etc.)
 - US Approach
 - NYSE and NASD Interpretations
- Codes must be capable of adaptation to changing market circumstances and ethical attitudes

READINGS - SIB Principles and Code Rules for Conduct of Investment Business, LSE Yellow Book Code for Directors and Employee Dealings, Cadbury Committee Code on Corporate Governance, SIB Discussion Paper on Custody Review, 1993

A12. Bishop & Kertzman - Enforcement and Discipline

- Historical development of Exchange enforcement and discipline
 - Early stages - by Exchange Governing Board
 - Delegation of some levels to committee
 - Committees develop staff support for investigation and prosecution, committee judges - Still NASD system (district conduct committees)
 - By 1930's NYSE began to specialize by type of defendant and seriousness of charge.
 - Board retained judgment function for members and allied members in offense with suspension or expulsion potential.
 - Other member and allied offense judged by Board Committee
 - Judgment function for other member personnel delegated to Exchange regulatory officers
 - Staffs were investigators and prosecutors for all levels.

In mid 1960's judgment function in all discipline shifted to panels of two peers of defendants and one Hearing Officer not associated with regulatory staff.

All such discipline appealable to Exchange Board, with any appeal hearings before a Board committee

Further appeal possible to SEC and after that to Federal Courts. Rarely used by NYSE members

Statutory obligation to enforce

Rules and 34 Act, not other laws

Corrective action, other laws

SEC power to approve, amend SRO rules, discipline SROs and their officers

Disciplinary Penalties authorized -

Summary suspension or limitation for financial or operational danger

Self reporting required

Prompt opportunity for hearing

Penalties after formal charges and hearings - censure, fine, suspension, expulsion

Industry-wide application of penalties

Minor offenses on floor handled by floor officials, smoking, running, etc.

Repetitive types of offense

Dishonesty on applications

Exercising discretion without written customer authorization

Failure to supervise

Overtrading - unsuitable recommendations

Violation of capital, customer reserve, or possession and control rules

Failure to maintain an orderly market

Concealed personal trading on floor

Record keeping deficiencies (late reconciliations)

Development of enforcement actions

By self-regulators within their jurisdiction or reference to government otherwise

By government

Scope of investigatory powers

Methods of Detection

Surveillance of Trading

Observation by floor officials and employees

Complaints by Professionals and Customers

Manual review of records, specialist and floor traders

Computerized surveillance of trade flow

Review of or reference by arbitration

Reference of public questionable involvement to SEC, occasionally to US attorneys.

Surveillance of financial, operational and sales compliance

Within firms by compliance and internal auditing personnel

Supervision as in Session A8.

Liability for acts of Agents

by independent Auditors

By self regulatory and government examiners - (explain periodic and for cause NYSE, NASD, Options examiner scope & coordination, SEC follow ups)

By self-regulatory coordinators (supervision of all regulatory functions and examinations for assigned firms), review of advertising and sales literature, excessive extensions, Complaints by Professionals and Customers

Development of Charges

No publicity on investigations or charges

Prosecution of charges

Written charges

Formal hearings

government - hearing officers or courts

self-regulators - panels of peers and officers

Variations in use of counsel

Written published findings

Indexed case findings in libraries, law firms, etc.

Cross reference by individual and firm in NASD computers available on public inquiry

Negotiated Settlements

SEC Inspection Program

routine unannounced

for cause

SEC Investigations

Legal authority

Informal Inquiry (voluntary response, no subpoena, no announcement)

Formal investigation

Commission authorization

Formal order not served

Subpoena available, oral testimony, document production

Follow-up role of attorneys

contact with SEC staff

Wells submission,

Negotiated settlement

Publication of Results

Prosecution

Administrative proceedings

Penalties - censure, limitations, suspension up to one year,

registration revocation

Controlling person liability

Fines

Cease and desist orders

Judicial Review

Civil Actions

Injunctive relief

Monetary damages

Appeals

Referral to Justice Department for criminal prosecution

Assistance to foreign investors

READINGS - Model rules Pages 14, 42 - 45, 60-61

WEDNESDAY, OCTOBER 20, (Kertzman leaves)

A13. Bishop - Settlement of Contracts and Depositories

Required uniform Books and Records (Pg 48)

- Blotters of original entry
- Ledgers
- Itemized ledger accounts
- Securities ledgers
- Stock ownership and location record
- Brokerage order memoranda
- Proprietary trade memoranda
- Copies of contract notes, notices of debits and credits
- Customer accounts
- Trial Balances, including capital computations & other regulatory computations
- Security count differences
- Suspense Accounts

Assignments, substitutions and Signatures, Pg 36

- Delivery against payment, Pg 37
- Closing of Contracts, Pg 37
- Borrowing of Securities for delivery, Pg 38

Retention of records

Purposes of Clearing and Settlement

- Reduce Physical Deliveries of certificates
- Single money payment or receipt
- Financial guarantee of contracts through clearing deposit
- Group self-insurance through clearing fund
- Delayed delivery protection
- Institutional delivery against payment system
- Centralization of custody, transfer, dividend & split distribution, company communication

Organization

- By contract with bank in small financial markets
- By industry subsidiaries in larger financial markets
- Regulatory oversight
- Settlement Fund
- Carrying of Customer Accounts Option
- Central Computer service option
- Required uniform records of participants
- Lost and Stolen securities data bank option

B6. Bishop - Stock Indices

Uses of Indices

- As yardsticks of performance both of companies against their peers and of investment portfolios
- As bench marks for pricing new issues
- As bench marks for index-tracker funds

Requirements

- clear definition of what is being measured
- transparency in rules for inclusion in index

accurate and consistent measurement of prices
periodic, but not too frequent, updating of clarifications and index components
impartiality in computation

NYSE basic study

Indexes - Averages

geometric, arithmetic
mean, median
weighted, unweighted
by activity or capitalization
combinations

Samples, total market

Stock Price profiles (frequency distributions of percentage price changes)

Excessive public attention

Cost limitations before computers

NYSE Indexes - Pg 62

aggregate market value, adjusted to eliminate capitalization changes,
measure average price change per share resulting from market action.

Four industry groups

base - 1965, \$50

KSE Index

1000 base index
of total market capitalization
of 100 security sample
adjusted daily for changes in capitalization or selected securities

UK Indices

Financial Times
Emerging Markets

READINGS - Model rules Pages 14 - 15, 34 - 38, 46 - 59

Article on "Why the New NYSE Common Stock Indexes"

NYSE Fact Book, copied pages 52-66, 78

SIB Discussion Paper on Custody Review

THURSDAY, OCTOBER 21,

B7. Bishop - Education of Investors

Underlying Training for Stockbrokers

Securities are sold, not bought
Customer - Stockbroker face to face

"Own Your Share of American Business" Campaign

Largest securities public education campaign in history, 1951-66

70 staff members, advertising agency

Preliminary campaign to upgrade member self-esteem

emphasis on ethics of members

comparison with standards of other ethical professions

focus on public service of securities industry to nation

a college president leading Wall Street

Monthly Investment Plan

Paid advertising nationally in newspapers & magazines - institutional, educational display by NYSE, supporting small space by local member firms, coupons
 Books and pamphlets, imprinted with member firm names
 Classes, Seminars, Club meetings
 National publicity on availability for schools, clubs, member branches - scripts prepared by NYSE for use by local member personnel.
 Listed company employee journals
 Unpaid publicity placement in newspapers, radio, magazines, TV by assisting media and independent writers by NYSE staff
 Market Information Systems expanded
 Promotion for printing of stock tables by newspapers
 Stock Price Profile and NYSE indexes
 Deliberate policy of encouraging competitive non-exchange distribution methods
 Securities data and research publications encouraged through low cost access to market data, quality standards for those produced or distributed by members
 Discontinued Exchange monopoly on distribution of current quotations
 Visitors Center Expansion, NYSE and Listed Company displays, gift shop, foreign language guides, welcoming tape prints, unobtrusive security measures
 Shareownership Surveys
 Methods
 Growth as promotional tool
 Analytical publication of data for member marketing planning - establishment of branches, promotional emphasis
 Upgrading education of member sales personnel
 Improved qualification examinations
 Eight regional university course centers established
 New York Institute of Finance upgraded through competition and sale to major publishing house
 Member in-house schools encouraged
 Seminars at exchange for branch managers, experienced producers, and trainees
 Tie-in by Member firms
 Distribution of coupons for member personal follow-up
 Tie in advertising
 Public speaking by member personnel
 Posters for member offices
 Imprinted pamphlets
 Organization of member promotional directors
 National awards for best promotional programs and annual reports for several years
 Selecting Target Groups and efficient methods - Marketing vs Public Relations, Public Information
 The Sri Lanka Experience
 Target - upper income individuals
 Media
 Newspaper ads, illustration, substantial text, coupon

- Newspaper features
- Improved market information systems
- Multi-language
- Objectives
 - What shares are
 - Characteristics as investments
 - How to invest in shares
- Methods
 - Persuade brokers to expand to countrywide agents
 - Two advertising phases
 - Newspaper features program
 - Financial press education
 - Initial and follow up research
 - Secondary school program
- Modification to local constraints
 - Limited advertising agency service
 - No public relations agency
 - Loss of SEC public relations officer
 - Did not pursue teledrama, seminars, schools competition
- Measured results
 - Over 17,000 coupons
 - Target audience awareness
 - Of shares up from 77% to 84%
 - Of share characteristics as investments up from 18% to 78%
 - Of how to invest up from 15% to 49%
 - Criteria to consider, 91%
 - Advantages of shares, 85%
 - Shares riskier than bank deposits, 95%

READINGS - Model Rules Pages 18 - 20
Sri Lanka Public/Investor Awareness Program, Final Report
Market Statistics examples - NYSE Fact Book copies pages 9 - 16, 24, 25, 28

FRIDAY, OCTOBER 22, HOLIDAY (Loehnis leaves)

SATURDAY, OCTOBER 23,

Bishop - Windup - Highlights of Seminar

Aims of Regulation

- To preserve stability of financial system
- To protect investors and maintain investor confidence
- To maintain efficient and orderly functioning of markets

Balance between Government Regulation and Self-Regulation

- In developing countries, government may have to take lead in capital market development

But markets are spontaneous organisms which must be given freedom to develop
Pricing of securities should be left to market
Practitioners have powerful self-interest in maintaining high ethical standards to keep investor confidence
Partnership between government regulator and stock exchange authorities to be encouraged to achieve flexible, cost efficient regulation
Regulation of market operations should be left to exchange authorities
Practitioners should be consulted in the formulation of regulations
Government regulator should monitor exchange standards and enforcement of financial, operational, and sales practice rules

Stock Exchange Governance

Centralized Exchange preferable
Board of Exchange should be by mixed board of members, listed companies, investors
Trading methods should be centralized, open, fully competitive
Regulated Member trading adds depth and liquidity to a market
Geographic coverage should be met by member's branches, associate members and agents rather than exchange proliferation
Capital adequacy of member firms, variations for firms solely servicing customer accounts and those carrying customer accounts and clearing
Adequate capital should be liquid and risk-adjusted
Profit monitoring is a key tool
Financial, operational and sales practice standards should be overseen by field examination by regulators
Centralized carrying of customer accounts adds safety in smaller broker communities
Centralization of post-trade processing is economic
In first stages, fixed minimum commissions to insure profitability for investment in infrastructure of personnel and facilities
Unlisted markets to be supervised by SRO, an Exchange self-regulator of unlisted, second tier trading is efficient in growing economies

Investor Protection

Differentiate between degree of protection necessary for retail and professional investors
Customer interest first
Transparency and full disclosure
Segregation and identification of customer accounts and assets from those of firm
Strong legal framework of company and contract law
Directors of public companies must understand and carry out their fiduciary duties to shareholders
Foreign investors can help raise standards by their expectations
Government regulator to encourage consistent accountancy standards converging with best international practice
Government regulator to encourage professional investment research and analysis
Investor Education
Codes of Conduct useful for maintenance of ethical standards - can be given force by being conditions of listing

Shareholder interests dominant in takeovers; equality of treatment; no oppression of minority
Defenses against insider trading

Mutual Funds

Useful vehicle to increase institutional investment base and to provide professional management and risk spread for retail investors.