THE REGULATION OF DISCLOSURE IN RELATION TO THE PUBLIC ISSUE OF SECURITIES IN THE UNITED KINGDOM AND TAIWAN

by

Wang-Ruu TSENG

Thesis submitted for the degree of Doctor of Philosophy in Law

University of London
SOAS

November 1996

Abstract

Despite the fact that in the United Kingdom (UK) regulators adopt the ideology of "self-regulation within a statutory framework", while the Taiwanese government opts for the American Securities and Exchange Commission (SEC) model, both English and Taiwanese law place heavy reliance nowadays on mandatory disclosure as a tool to regulate the public issue of securities and publicly issuing companies. The objectives of this thesis are to (1) justify the regulation of mandatory disclosure, (2) provide the guidelines for the design of the content of disclosure, and (3) analyse the elements of civil liability for non-disclosure and untrue statements.

Chapter One sets out the reasons for taking up this topic for research, its methodology, and the contribution and limits of the work. Chapter Two is devoted to describing briefly the English and Taiwanese legal frameworks in order to identify the research scope and provide readers with some general background. The impact of the European Community (EC) legislation on UK company law and securities regulation is also examined, as well as its implementation history. Accordingly, these two chapters taken together constitute the background for the thesis.

The core of the thesis is in Chapters Three to Six. Chapters Three and Four examine thoroughly the defects of the general law and the economic debate on mandatory disclosure with a view to establishing the justification of mandatory disclosure. Chapter Five goes further by analysing the guidelines of disclosure content; through the finding of materiality, it is argued that governmental regulation should only deal with material information. The problem of unsatisfactory accountancy in Taiwan is also not forgotten. Chapter Six discusses civil liability for misrepresentation, criticises the current flaws in English and Taiwanese law, and proposes amendments to them. Finally, conclusions are drawn in Chapter Seven.

Acknowledgments

My sincerest thanks must be expressed to my supervisor, Professor A. Dicks, for his continual encouraging support; also his memorable kindness and understanding help in all aspects. In particular, I treasure his open-mindedness, engendering a sense of his constant seeking to identify himself with the student's side. Without his devoted assistance, I admit I could never have progressed confidently along the course.

Nor must I forget Mr. Michael Palmer for all his generous assistance. I am also grateful to my good friend and companion Pinai Nanakorn who discussed matters with me regarding research during my most difficult phase. There are many kind persons who either gave me a hand in a vital time or helped by smoothing the obstacles I encountered, all of which have become rooted in my mind and which I will never forget.

My husband Shui-Town Lin, who has accompanied me for all these years, is my best supporter and listener. I am not used to pouring out my sufferings, even though the worries have sometimes caused me loss of sleep. However, I feel comfortable and safe to confide to Shui-Town all my sentiments because I know that he will not look down on me. In addition, he will try to assist me one way or another.

Finally, my greatest debts have been to my dear parents. In the last three decades they have never failed to share my happiness, my pains and problems, while bringing me up in the best way. My worries have been their worries, my joys theirs. When I saw their white hair brought on by my own anxieties and conflicts, I felt shattered! Yet, somehow, this kind of emotion spurred me to get through the turbulent Ph.D. ordeal as soon and successfully as possible. I am extremely happy that finally, I am nearing the end of this study and am looking forward to returning to my home country to stay with them for good.

The pains I have had in these years resulting from this doctoral study can never be described even by bottles of inks. Therefore, I would like to treat it as a training which God gives me to foster me to grow up. I believe that when I land at Taipei, my motherland will comfort me to forget all the pains I have ever experienced.

Table of Contents

CHAPTER THREE

CHAPTER SIX

Table of Cases

UK

EC

Numerical List

EC

Alphabetical List

Taiwan

US

Canada

Australia

New Zealand

Table of Statutes

UK

Taiwan

Table of Statutory Instruments

UK

Taiwan

List of Abbreviations

A.C.	Appeal Cases
A.C.L.C.	Australian Company Law Cases
A.L.R.	Australian Law Reports
A.S.B.	The Accounting Standards Board
A.S.C.	The Accounting Standards Committee
Accounting Rev.	Accounting Review
All E.R.	All England Law Reports
B.C.C.	British Company Law Cases
B.C.L.C.	Butterworths Company Law Cases
C.A.	Court of Appeal
C.F.R.	Code of Federal Regulations
C.L.J.	Cambridge Law Journal
C.L.R.	Commonwealth Law Reports (Australia)
C.P.D.	Law Reports, Common Pleas Division
CA 1985	Companies Act 1985 (UK)
CAP	Certified Public Account
Ch. App.	Chancery Appeal Cases
Ch.D. (or Ch.)	Chancery Division
CL	Company Law (Taiwan)
Cmnd.	Command Paper
D.L.R.	Dominion Law Reports (Canada)
DTI	Department of Trade and Industry (UK)
E.C.R.	European Court Reports (the official series)
E.F.S.L.	European Financial Services Law
ECMH	Efficient Capital Market Hypothesis
F.2d	Federal Reporter, Second Series (USA)
FRSs	Financial Reporting Standards
FSA 1986	Financial Services Act 1986 (UK)
GAAPs	Generally Accepted Accounting Practices
H.L.	House of Lords
J. of Acct.	Journal of Accoutancy
J. of Bus.	Journal of Business
J. of Bus. Law	Journal of Business Law
J. of Fin.	Journal of Finance
J. of Fin. Econ.	Journal of Financial Economics
J.C.M.S.	Journal of Common Market Studies
K.B.	King's Bench
L.Q.R.	Law Quarterly Review
L.R.	Law Review
L.R. Ex.	Law Reports, Exchequer
Lloyd's Rep.	Lloyd's Law Reports (after 1951)
M.L.R.	Modern Law Review
Macq. H.L.S.C.	Macqueen's Scotch Appeal Cases (House of Lords)
N.Y.S. 2d	New York Supplement Reporter, Second Series
N.Y.U. L.R.	New York University Law Review
N.Z.L.R.	New Zealand Law Reports

O.J.L.S.	Oxford Journal of Legal Studies
OJ	Official Journal of the European Communitites
POS Regulations	The Public Offers of Securities Regulations 1995 (UK)
Q.B.	Queen's Bench
R.	Reivew
RARs	The Rules on the Contents of the Annual Reports of Publicly Issuing Companies
RISEL	The Rules Implementing the Securities and Exchange Law
RPFRSIs	The Rules for Preparing Financial Reports by Securities Issuers
RPOP	The Rules on the Contents of Public Offer Prospectuses
SEC	Securities and Exchange Commission (Taiwan)
SEL	Securities and Exchange Law (Taiwan)
SIB	Securities and Investment Board (UK)
SROs	Self-regulating Organisations
SSAPs	Statements of Standard Accounting Practices
T.L.R.	Times Law Reports
U. of Chicago L.R.	University of Chicago Law Review
U.C.L.A. L.R..	University of California Los Angeles Law Review
U.S.	United States Supreme Court Reports
W.L.R.	Weekley Law Reports
Yale L.J.	Yale Law Journal

Chapter One

Introduction

This thesis deals with the regulation of disclosure on the public distribution of securities. The research covers the regulation of disclosure on both primary distribution of securities and secondary markets where transactions of issued securities take place. The objectives of the thesis are three-fold: (1) to justify the regulation of mandatory disclosure, (2) to provide the guidelines for the design of the content of disclosure, and (3) to analyse the elements of civil liability for non-disclosure and untrue statements.

The crucial nature of capital markets clearly demonstrates the importance of such a subject. As they provide resources for economic development by channelling surplus units (i.e. savings) to demanding units (e.g. industries) and are the "situs" in which public investors earn their return, any turbulence or movement of capital markets and any illegal events happening there brings about a domino effect. The investing public is the first group to suffer damage, and then the effect goes on to harm companies and the national economy. One could never over-emphasise the importance of this type of chain influence. As a result, in the wave of internationalisation and deregulation sweeping main capital markets in free market economy countries, careful attention must be paid to the way in which an efficient and comprehensive control and supervision system is established. Current developments in the main capital markets (e.g. USA and UK) suggest that the key lies in the principle of disclosure. And this is why this subject was chosen for this thesis.

Such a subject is multi-dimensional and highly dynamic. Why so? This is due to the fact that the problem itself is not the "private preserve" of legal academics; instead,

financial economists, corporate financial experts, and accounting professionals all endeavour to look into this topic in-depth from their professional perspectives. It follows that materials relating to this field in these disciplines are overwhelming, sometimes more fruitful than those of legal research. Accordingly, to a limited extent, we expand our work to grapple with some financial economics, corporate finance, and accounting articles provided that they are closely relevant to and echoed by legal thinking.

For English materials, even though securities transactions have a long sustained history in the UK, it is only within the last decade that there has been a comprehensive and systemic statute in operation (the Financial Services Act 1986) and securities regulation has become an independent subject of study attracting increasing contribution from academics. Consequently, although there are quite a few cases covering securities fraud (especially fraudulent prospectuses), the few articles or books bearing intimate analyses of the subject have not been particularly productive in terms of ideas or solutions to the various legal problems. Accordingly, theories developed in other relevant fields (e.g. directors' fiduciary duties, disclosure requirements under the law of contract and tort, materiality in misrepresentation, causation problems, measure of damages, etc.) are all precious to our research and will be examined and fitted into the thesis in order to develop the arguments advanced by the thesis.

Taiwan is not immune from the same problem of insufficient research up to the present stage and the same approach would be adopted. The Taiwanese securities regulation springs from American law and largely imitates the American model. Consequently, domestic scholars whenever publishing articles or delivering talks on this field would quote the American counterpart regulation or theories. This sometimes serves a positive role as a comparative study. But it also can have a stultifying effect: in that the localisation of a set of regulations and the operation of the regulatory machine vary from jurisdiction to jurisdiction, a fact that has not been appreciated and even

been unduly underestimated. Taking the Securities and Exchange Commission (the SEC) as an example (although this will not be dealt with in this thesis), there is an SEC in American federal government and there is one in Taiwan as well. Even if two institutions bear the same name and are backed by similar regulations, they may not play the same role or have the same importance, given their different human resource and executive or semi-judicial power. Therefore, Taiwan's own legal system is the cornerstone of the thesis with a view to analysing and criticising the Taiwanese regulation of disclosure. The habit of constantly referring back to American law is resisted.

Even more, in a country like Taiwan bearing the mark of the civil law system, the close relationship between commercial law and civil law cannot be ignored. It is true that American law is the blueprint of the Taiwanese securities regulation. It is equally true that the consistency and comprehensiveness of the whole legal system deserve preservation. That the securities regulation has been departing from the norm of traditional legal concepts causes us concern. For instance, in the Civil Code and theories, there is found a well-developed system dealing with civil liabilities, such as the elements of liabilities, the causation requirement, and the measure of damages. Nonetheless, the elements of civil liability and measure of damages are different in the securities regulations from the normal type of civil liability but no clear reasoning of such deviation is ever provided. Only when we come across American law we notice where the root of the new rules stems from. It is sensible to cast doubt on this importation, as the background of these two countries regarding civil liabilities is so different (the fundamental difference between American common law and Taiwanese civil law). What we expect is a legal system with consistency; any specific rule could only be developed after a thorough study. That is, new rules are permitted but must result from the specific characteristic of a problem, and we have sufficient reasons to mark a difference. To justify any "evolution" simply based on foreign legislation is not persuasive.

On the other hand, fortunately, the UK, USA, and Taiwan (in principle) are free market economy jurisdictions. Thus, some common theories in respect of certain topics could be applied to all these three jurisdictions. Taking the justification of mandatory disclosure as an example, the theories dealing with the justification of mandatory disclosure are, both pro and con, developed principally by American scholars, which are capable of providing us with a sound argument base and of filling the gap left by current insufficient materials in the jurisdictions of the UK and Taiwan. That is, this thesis analyses some common theories in addition to the comparative study of English and Taiwanese law.

A comparative approach is adopted throughout the whole thesis. Functions of English and Taiwanese law regarding mandatory disclosure requirements in the general law, standards for mandatory disclosure, and the appropriate civil liability are analysed, contrasted, and compared. Different usage of terms, if any, will not cause any serious problems to this study as we focus on the meaning and function of terms rather than on their superficial definitions. During comparison, we find that regarding some issues these two legal systems each have their own way of resolving puzzles and obtaining reasonable outcomes. But sometimes we notice that their individual methodologies suffer from defects. In this situation, this thesis endeavours to provide, after analysing their defects and merits respectively, better answers to certain problems.

After confirming the research direction, we construct a readable and comprehensible thesis structure. Some questions arise from both a theoretical and a practical point of view:

a: from the theoretical aspect: 1. What theories support the principle of mandatory disclosure? 2. If the principle of mandatory disclosure is really sound, what form should it take and how should it be put into practice? 3. What type of civil

liability is appropriate to the breach of mandatory disclosure rules? Are the principles of liability for damages and the measure of damages developed under the traditional category of contract and tort suitable for cases of securities misrepresentation?

b: from the practical aspect: 1. Can disclosure effectively achieve all its goals? 2. In practice, does anything else need to be taken into account? 3. If the answer to 1. is negative, and to 2. is positive, what are the problems? 3. As securities markets always fluctuate, how can the law cope with this phenomenon when measuring damages?

To answer these questions, first, we should clarify that there are three topics calling for examination as mentioned above. Second, in analysing the three topics, a background study (Chapter Two) is necessary. That is, an initial analysis and introduction of the two legal frameworks regarding the regulation of disclosure on the public distribution of securities are discussed. Since the UK is required to fulfil her Community obligations as one of the EC members, the impact of the EC on the UK in terms of company law and securities regulation, i.e. the regulation of disclosure, is addressed simultaneously. Third, the justification of mandatory disclosure is tackled mostly from the legal aspect. In addition to developing the traditional arguments, this thesis shifts the battle to the legal argument based on the insufficiency of the general law, which has not been done before (Chapter Three). And then for the sake of completeness, we add a small chapter introducing and analysing the theories from the discipline of financial economics (Chapter Four). However, this chapter avoids an endless economic debate regarding mandatory disclosure. Afterwards, we apply the theory of materiality to establish the guidelines for the content of mandatory disclosure (Chapter Five). The last main chapter (Chapter Six) then focuses on civil liability for non-compliance. This thesis consequently discovers the defects existing between the theories and their application, and endeavours to find out a practical answer to solve such defects. Finally, conclusions are prompted in Chapter Seven.

Some explanations are warranted regarding the reasons for not dealing with administrative or criminal liability in the context of non-compliance with mandatory disclosure. To begin with, administrative discipline has no direct effect on mandatory disclosure in the light of public issue of securities. Instead, it focuses on regulating market participants (i.e. people who carry on investment business) in order to maintain market integrity and protect investors.

Second, when criminal liabilities are concerned, either they have no theoretical difficulties or they provide a different insight which in a practical sense is not closely related to mandatory disclosure. Many sections in the Companies Act 1985 (the CA 1985) and the Financial Services Act 1986 (the FSA 1986) demonstrate the former situation. For instance, a company, its shareholder, or its director may be punished because of non-disclosure (e.g. ss. 210(3), 211(10), 231(7), 232(4), 314(3), 317(7), 324(7), the CA 1985); if listing particulars or prospectuses are published without a copy of them having been delivered for registration to the Registrar of Companies, any person who is knowingly a party to the publication shall be guilty of an offence (e.g. ss. 149(3), 154A, the FSA 1986). However, all these do not require any further discussion.

On the other hand, insider dealing, the most important occasion for criminal liability, is far from easy to be caught. The insurmountable task regulators and the courts encounter is how to connect the trader with the information resource. It is not argued whether there should be disclosure. Nonetheless, s. 47 of the FSA 1986 does deal with the criminal liability for misleading statements. This will be discussed when materiality is examined in Chapter Five.

In effect, for investors, what concerns them most is the way they can recover their position and this is sought mainly through civil litigation. Even more, the issue of

civil liabilities bears close relevance to mandatory disclosure. As a result, limited by the volume of this thesis, the topic of civil liability undoubtedly is more valuable to our analyses.

This thesis is intended to contribute to research on securities regulation in a number of ways. First, we justify mandatory disclosure regulation from a new perspective, i.e. the inadequacy of the general law. Second, it is suggested that materiality should be the guiding principle of designing the content of mandatory disclosure. Third, this thesis analyses the civil liability for non-compliance with disclosure requirements and proposes: (1) the scope for protection of investors in the aftermarket; (2) the resolution to the issue of reliance; (3) the ideal definition of damage; and (4) the appropriate way of measuring damages.

Chapter Two

A General Description of Mandatory Disclosure on the Public Distribution of Securities and on Publicly Issuing Companies

This chapter features the English and Taiwanese regulatory framework relating to mandatory disclosure. As the UK has to fulfil her obligation in the EC, the impact of the EC legislation on the UK (throughout the whole thesis, the expression UK with reference to a legal system should be taken as referring, unless the context otherwise requires, to England and Wales) in company law and securities regulation has to be considered. This is also addressed below.

2.1 The United Kingdom

Corporate disclosure is controlled mainly by five sets of regulations: the Companies Act 1985, the Financial Services Act 1986 (hereinafter referred to as the FSA 1986), the Public Offers of Securities Regulations 1995 (the POS Regulations), the Yellow Book, and the City Code on Takeovers and Mergers. The first three sets are statutes or statutory instruments, while the Yellow Book[1] which contains the listing rules has legal effects because of the authorisation made by the FSA 1986.[2] The City Code,[3] although it has no formal statutory standing, is in reality markedly persuasive through the operation of the Stock Exchange, the Securities and Investment Board (SIB), the self-regulating organisations (SROs), and the Department of Trade and Industry (DTI).[4]

---

[1] The Stock Exchange's Admission of Securities to Listing. The title of the "Yellow" Book comes from the colour of the cover.

[2] s. 142(6).

[3] The Code is published and administered by the Panel on Takeovers and Mergers which is not a statutory body.

[4] First, the Stock Exchange inserts the City Code into the Yellow Book (even though the Code is not treated as part of the Listing Rules); non-compliance may result in suspension or withdrawal of the listing; second, the SIB and SROs have incorporated into their rulebooks the "cold-shouldering" rules

Each this body of rules has its own specific concern. As a general rule, the Companies Act 1985 covers all kinds of companies, e.g. annual disclosure of all companies, disclosure of interests in shares, and acquisition and merger accounting.[5] Nonetheless, in the process of public distribution of securities, Part IV of the FSA 1986 and the POS Regulations provide a more comprehensive regulatory framework, and thus transcend the Companies Act 1985 when listing particulars and prospectuses are considered. Besides that, once a company becomes listed, in addition to the requirements in the CA 1985, it must comply with the Yellow Book respecting continuous disclosure. Finally, the City Code sets out details of disclosure contents when an offeror initiates a bid, which regulates disclosure in takeovers and mergers.

Therefore, when one considers English law in relation to corporate disclosure, it may be apposite to classify it into three groups: disclosure at the time of public distribution of securities, disclosure after the public issue, and the correlative problem of disclosure when securities transactions are involved. The latter two groups are conceded as continuous disclosure under the mandatory disclosure regime.

2.1.1 Disclosure at the Time of Public Distribution of Securities

Any company which intends to publicly distribute its securities has to prepare a prospectus;[6] if listing on the Stock Exchange is pursued, it has to prepare listing particulars unless the company offers its securities to the public in the UK for the first time, and then it has to publish a prospectus instead of listing particulars.[7]

---

which require their members not to act in connection with transactions regulated by the City Code for persons whom they believe would not comply with the takeovers rules; third, the Panel can report to the DTI any wrongdoing which may cause the latter to investigate the matter. See Graham Stedman, *Takeovers*, 1993, pp. 58-60; Michael Blair, *Financial Services: The New Core Rules*, 1991, p.11.

[5] See ss. 221-262A (Sched. 4), 198-220, and Sched. 4A respectively.

[6] reg. 4(1) of the POS Regulations.

[7] s. 144(2) of the FSA 1986.

The current rules on prospectuses and listing particulars appear in the POS Regulations[8] and Part IV of the FSA 1986. According to the POS Regulations, when securities are offered to the public in the UK for the first time, the offeror shall make a prospectus available to the public from the time he first offers the securities until the end of the period during which the offer remains open.[9] Before a prospectus is published, it should be delivered to the Registrar of Companies for registration.[10]

Here it is worth mentioning briefly the history of disclosure regulation in company law. The Joint Stock Companies Act 1844[11] introduced the requirement for prospectuses and thereby for the first time applied the disclosure as a method to regulate companies.[12] However, the 1844 Act did not compel companies to register prospectuses before their publication; nor did it require companies to issue prospectuses at the time of offering. To prepare prospectuses was only one of the conditions of obtaining the complete certificate (of incorporation). Moreover, the format and contents of prospectuses were not provided.

Not until 1929 were the provisions as regards the exact contents of a prospectus laid down in the Companies Act. It required every prospectus to state the matter specified in Part I of the Fourth Schedule to this Act and set out the reports specified in Part II of that Schedule.[13] The Companies Act 1985 takes this as its model. The

---

[8] S.I. 1995/1537, made on 14 June 1995 by the Treasury under s. 2(2) and Sched. 2 to the European Communities Act 1972, operative from 19 June 1995, repealing Part V of the FSA 1986.
[9] reg. 4(1) of the POS Regulations.
[10] reg. 4(2) of the POS Regulations.
[11] 7 & 8 Vict. c. 110 (1844).
[12] Such legislation could be attributed to the Gladstone report (1844 *B.P.P.*, Vol. VII) and this in turn was triggered by numerous scandalous frauds. See L.C.B. Gower, *Principles of Modern Company Law*, 5th ed., 1992, p. 39. The Report aimed to pursue the declared end of the better security of the public and to improve the legal and equitable remedies at that time available to companies and to their directors and shareholders. (see p. 3 of the Report). The first part of the Report focused on the minutes of evidence as to the case of West Middlesex General Annuity Assurance Company. The statement of the witnesses who were merchants, bankers, lawyers conversant with mercantile transactions, clearly indicated that disclosure would protect investors from fraud. (see pp. 21-3, 36-7, 64-5, 125, 130, 161, 166-7, 193-4 of the Report) The great advantage anticipated from compulsory publication of corporate financial information was its approximation to the facts (p. 65) and that would be in the nature of a check upon fraud.
[13] *Cf.* the repealed s. 56(1) of the CA 1985.

progress of the Companies Act 1929 revealed that the development of prospectuses was very advanced in the era of the 30's in the UK. Now, the job of regulating prospectuses has been shifted from the Companies Act 1985 to the POS Regulations.

As regards listing particulars, the FSA 1986 lays out its general contents and leaves the details with the Stock Exchange. For example, the Act emphasises the necessity of including material information in particulars, i.e. any information that is reasonably expected by investors and their professional advisers for the purpose of making an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer, as well as the rights attaching to those securities.[14] So far as the contents of listing particulars are concerned, the Stock Exchange assumes the task of deciding.

2.1.2 Disclosure following Public Offers

(1) the Companies Act 1985

First, it is noteworthy that disclosure requirements in the Companies Act are based on the type of companies, that is, public or private, and on the size of companies, small, medium or neither. This implies that whether or not a company has publicly issued its securities will not affect its obligation of disclosure. Second, the Companies Act in principle centres on annual accounts and directors' reports. It does not regulate half-yearly or quarterly reports. They are not required under the Companies Act.

In principle, both public and private companies carry the same obligations concerning the preparation of accounts and reports. The only privilege private companies possess is that they can elect to dispense with the laying of these documents

[14] s. 146(1) of the FSA 1986.

before the company at general meeting.[15] Such an elective solution by no means relaxes the obligation of preparing accounts and reports on private companies. This "equal" treatment between public and private companies derives from a long history of evolution which reflects the attitudes of the legislature towards private companies. The reason is that if the size of a private company is not limited, its members should not be deprived of their rights of accessing corporate information only because the company is "private". To re-state, when a private company is possibly larger than a public company, members of the private company are not counted as inferior to those of the public company in the context of information availability, and this justifies the equal treatment.[16]

---

[15] s. 252 of the CA 1985.

[16] The Companies Act 1908, which was substituted for the Companies Acts of 1898, 1900, and 1907, drew a line between private companies and public companies in relation to the disclosure obligation. Private companies were created by the Companies Act 1907, s. 37, which was replaced by s. 121 of Companies Act 1908. They were defined as companies with no more than fifty members whose right to transfer the shares was restricted and were prohibited from publicly distributing their shares and debentures. A private company enjoyed the privileges and gained exemption from many of the obligations imposed on public companies. In its annual summary, a statement in the form of a balance sheet was not required (s. 26) and it didn't need to file or forward to its members the statutory report (s. 65). As to the requirement of prospectus, it was even not asked to issue any statement in lieu of prospectus. All the privileges enjoyed by the private company were justified on the basis of its "non-public" nature. It was not required to make its information public because it could not invite the public to subscribe to its shares or debentures. Non-disclosure was presumed not harmful to investors in this situation. In addition, the private company would be found extremely useful in the case of partners wishing to have the benefit of the protection of limited liability, and yet not wishing to disclose its information. See L. Worthington Evans and F. Shewell Cooper, *Notes on the Companies Act 1907*, 1907, p. 50. The privileges previously extended to all private companies exempting them from the obligation to include in the annual return a copy of the balance sheet and annexed documents were restricted to a new form of company called the "exempt private company" in the Companies Act 1948. The basic condition for exemption was that no body corporate was the holder of any of its shares or debentures and that no person other than the holder had any interest in any of those shares or debentures (s. 129(4)). Whether this exemption should be repealed was debated. Grounded on the consideration that "publication of the accounts of small companies would give large concerns valuable information about the finances of their smaller rivals while the latter do not gain any corresponding advantage from the publication of accounts of the larger concerns ... the large concern may be able to drive the small out of business, but the latter can do little harm to the former ... Many small private companies are at least as much in competition with partnerships and individuals as with other companies, and this, in our opinion, is a sufficient reason for continuing the exemption while restricting its scope" (see *Report of the Committee on Company Law Amendment (Cohen Report)*, Cmnd. 6659, 1945, p. 27), it was decided that the privileges were limited to the "exempt private company" and the reason for exclusion of those private companies with corporate holders was to prevent public companies from abusing this system by trading through subsidiary private companies. The privileges to the "exempt private company" were finally abolished by the Companies Act 1967. This step was due to the doubt which arose in the course of examining whether the definition of the private company had worked out as intended. It was said that of the 387,000 private companies registered in 1961, some 269,000 that had at the end of 1961 claimed the status of exempt private companies were not very small in membership or in capital or in the extent of their undertakings and

Consequently, the Companies Act 1981 (and continued by the CA 1985) drew a distinction based on the size of companies. As will be discussed in section 2.2.1, small and medium companies enjoy certain exemptions regarding the preparation and delivery of corporate accounts and reports. The new exemption rules make their contribution to small and medium size companies, in that they are less burdensome. The new rules, however, ignore the fact that a small or medium company may publicly distribute its securities if it is a public company. This possibility, although not substantial, cannot be eliminated, and thus, the exemptions are worth reconsideration.

The Companies Act 1985 requires companies to prepare annual accounts and directors' reports. Among these, annual accounts should include the balance sheet and the profit and loss account.[17] In fact, early in the Joint Stock Companies Act 1844, it provided that every registered company had to audit its balance sheet and books of accounts, and these documents provided by directors of the company comprised half-yearly (or other periodical) accounts and the balance sheet.[18] However, the details of the balance sheet were not developed until the Companies act 1856, which increased the items contained in the reports to shareholders.[19] Finally, the formats of the balance sheet and profit and loss account are set out by the CA 1981 and followed by the CA 1985.

---

the very complexity of the definitions not only made its application uncertain but also produced unfairness because some of those private companies were not entitled to it. See S.W. Magnus, and M. Estrin, *The Companies Act 1967*, 1967, p. 19. The *Jenkins Report* (Cmnd. 1749, 1962, p. 21) looked at this argument and recommended the termination of this distinction. The Report argued: "We appreciate the argument that the filing of accounts may cause embarrassment or inconvenience to some exempt private companies ... We think that in general such disadvantage as there may be should be accepted because disclosure is right in principle and necessary to protect those who trade with and extend credit to limited companies."

[17] Part VII and Sched. 4 of the CA 1985.

[18] s. 38 of the Joint Stock Companies Act 1844.

[19] See Table B of the Companies Act 1856, 19 & 20 Vict. c. 47 (1856).

(2) the Yellow Book

The "Listing Rules" regulate only listed companies. As a consequence, any unlisted public companies which publicly issue securities are not required to prepare any extra disclosure documents other than the annual report. This may have effects on deterring companies from applying for listings, and also discriminate against shareholders in those unlisted public companies.

The Yellow Book proceeds in two steps: first, it sets out the contents of listing particulars and prospectuses together with their circulation and publication; second, it requires all listed companies to disclose certain information continuously, which includes half-yearly and immediate disclosure, in addition to annual reports.

In the first place, regarding the duty for immediate reporting, it is established that any information which will affect the price movement should be disclosed to the Stock Exchange without any delay;[20] for the purpose of preventing insider dealing or any unfairness which may have a negative impact on market integrity, such information is not allowed to be given out before disclosure is made to the Stock Exchange.[21] The exceptional case is the communication between the company and its advisers or counterparts in negotiation with respect to the effecting of a transaction or raising capital. The company, however, must advise the recipients of such information that it is confidential and that they should not deal in the company's securities before the information has been made available to the public.[22]

Second, listed companies must prepare half-yearly reports. Only group companies have this obligation.[23] Generally, half-yearly reports should be prepared on

[20] Chapter 9 of the Yellow Book.
[21] 9.7, id.
[22] 9.4 and 9.5, id.
[23] 12.46, id.

a basis consistent with that of the annual accounts; if not, directors have to make a statement to the effect that, according to their opinion, the report enables investors to make an informed assessment of the results of activities of the group companies.[24] The report must be published within four months of the end of the period to which it relates, either by sending it to securities holders and making copies available at the registered office of the company in the UK and at the offices of any paying agents of the company in the UK, or by inserting the report as a paid advertisement in at least one national newspaper.[25]

2.1.3 Disclosure in Connection with other Securities Transactions

(1) disclosure of interests in shares

Early in the Companies Acts 1967[26] and 1976,[27] directors of all companies and substantial shareholders of listed companies were required to disclose their interests in the companies.[28] The Companies Act 1985 continues this requirement[29] and extends its application to all public companies with regard to the disclosure obligation of substantial shareholders.[30] The Companies Act 1989 amended the Companies Act 1985: the threshold of shareholding to notify the company by substantial shareholders is reduced from five per cent to three per cent.[31] The time within which such notification must be given is also reduced from five days to two days.[32]

---

[24] 12.47, id.
[25] 12.49, id.
[26] ss. 27-9, 33, of the Companies Act 1967.
[27] ss. 24-7 of the Companies Act 1976.
[28] See Robert R. Pennington, *The Companies Acts 1980 and 1981*, 1983, p. 1.
[29] Sections 324-8 regulate the disclosure duty imposed on directors.
[30] ss. 198-220 of the Companies Act 1985.
[31] The Companies Act 1989, s. 134(2) amended the CA 1985, s. 199(2); the CA 1985, s. 201 was repealed by the CA 1989, s. 212 and Schedule 24.
[32] the CA 1989, s, 134(3) amended the CA 1985, ss. 202(1), (4) and 206(8).

This disclosure mainly serves two functions: to deter insider dealing, and to detect takeovers at an early stage. A director (including a shadow director) is obliged to notify the company in writing of his interests in corporate securities at the time he becomes a director, which includes the number of shares of each class and the amount of the debenture of each class of the company. He also has to notify the company if his interests in securities are in any other body corporate which is the company's subsidiary or holding company or a subsidiary of the holding company.[33]

Subsequent to that, if he becomes or ceases to be interested in corporate securities, he has to notify the company about this event, as well as about any securities transactions he makes.[34]

The definition of an "interest" is set out in Schedule 13, Part I, where it states that a director has an interest even if he only enters into a contract to obtain securities, or he is entitled to exercise any right conferred by the holding of the securities. For example, if he is only appointed as a proxy to vote or represents a company at any meeting, these will not constitute an interest of his. Directors have to fulfil this requirement within five days following the day they know the existence of the interest.[35]

On the other hand, a substantial shareholder (though, significantly, not debenture holder) is obliged to notify the company when he becomes interested in shares comprised in a public company's relevant share capital, as well as when he ceases to be so or there is any increase or decrease in such interest.[36] Relevant share capital denotes

---

[33] s. 324(1) of the CA 1985.
[34] s. 324(2) of the CA 1985.
[35] Part II of Sched. 13 of the CA 1985, which were amended to implement Directive 88/627/EEC (the Major Shareholding Directive), OJ 1988 L 348/62.
[36] ss. 198-220 of the CA 1985.

that company's issued share capital of a class carrying rights to vote in all circumstances at general meetings of the company.[37]

The difficulty arising is that the calculation of interests is based on the proportion of the total nominal value of shares held by a shareholder to the aggregate nominal value of the issued shares comprised in that class, and it is not easy for a shareholder to know when his shareholding will exceed the percentage provided by law or fall below that percentage. Therefore, this obligation is subject to the knowledge of a substantial shareholder.

Besides that, for detecting takeovers and preventing the evasion of the notification obligation, the Act requires the so-called "concert parties" to notify the company when the conditions mentioned below are met.[38] First, there is an agreement between several parties; the meaning of an agreement is very broad, embracing any undertakings, expectations, and understandings, no matter express or implied, absolute or not. However, the agreement must be legally binding.[39] Second, according to the agreement, any one or more of the parties will be obliged to acquire shares of a particular public company.[40] Third, the agreement must also include provisions imposing obligations or restrictions on any one or more of the parties to it with respect to their use, retention or disposal of their interests in that company's shares acquired in pursuance of the agreement.[41] The term "use" signifies the exercising of any rights or of any control or influence arising from those interests.[42] Fourth, shares have been in fact acquired by any of the concert parties.[43]

---

[37] s. 198(2) of the CA 1985.
[38] ss. 204-5 of the CA 1985.
[39] s. 204(6) of the CA 1985. It provides that "this section does not apply to an agreement which is not legally binding unless it involves mutuality in the undertakings,..." But if there is mutuality, there is supposed to be valuable consideration which makes the agreement legally binding. See L.C.B. Gower, supra note 12, p. 616.
[40] s. 204(1) of the CA 1985.
[41] s. 204(2)(a) of the CA 1985.
[42] s. 204(3), id.
[43] s. 204(2)(b), id.

Therefore, once any acquisition occurs, the concert parties can no longer conceal their agreement. The continuous obligation referred to above is to notify the company when their aggregate interests are over 3 per cent, not individually. In the notification, each party not only has to provide his own information, but also inform the company of the interests of the other parties. Even more, they have to keep each other informed about their interests apart from the agreement. All these obligations depend on the obligors' knowledge.

(2) disclosure in takeovers

The Take-over Panel was formally established in 1968 due to the event of Aberdare Holdings' tender offer for Metal Industries and the City Code was promulgated in the same year by it (before that, the regulation work was left to the Prevention of Fraud Act (1939 & 1958)). The Panel is a designated authority regarding the disclosure of information.[44] Half of the City Code's 10 General Principles relates to disclosure.[45] For example, General Principle 4 lays down the fundamental requirement that shareholders must be given sufficient information and advice to enable them to reach a properly informed decision and must have sufficient time to do so; no relevant information should be withheld from them. General Principle 5 asks for the highest standards of care and accuracy with regards to the preparation of the disclosure documents. General Principle 6 prohibits the creation of a false market and prevents shareholders from being misled. Even more, in Rules 3, 19, 20, 23, 25, 27, and 29, the Code provides a set of rules to help shareholders make an informed judgment.[46]

---

[44] See Financial Services (Disclosure of Information) (Designated Authorities No. 2) Order 1987 (S.I. 1987/859), made under the FSA 1986, s. 180(3), (4).
[45] They are Principles 2, 4, 5, 6, and 9.
[46] See Chapter Three.

Shareholders of a target company are, therefore, assured of obtaining sufficient information before they make decisions as to the offer. Besides that, if the consideration being offered consists of securities for which listing will be sought, listing particulars may be required.[47] By way of contrast, if unlisted securities are offered as consideration, no prospectuses are called for.[48] In addition, the offer itself is an investment advertisement; consequently, it must be issued or approved by an authorised person unless the listing is pursued.[49]

2.2 The Impact of the EC on the UK

The British legislature, in order duly to perform the duties of a Member State of the EC, has obligations *to* or *not to* enact or amend its national law. So far as regulations of the EC are concerned, that the British legislature is prohibited from implementing them in principle was made clear in *Commission v. Italy*.[50] This is due to the characteristic of "direct applicability" of regulations bestowed by the EC Treaty (The Treaty establishing the European Community). The second paragraph of Article 189 of the Treaty provides: "A regulation shall have general application. It shall be binding in its entirety and *directly applicable* in all Member States". Based on this Article, national courts must take cognisance of regulations as legal instruments and the legislative duplication of regulation is impermissible, because this can ensure that regulations will be brought into effect simultaneously in all Member States and will not be distorted by individual national legislation. Only thus can the uniform application of regulations in all Member States be guaranteed.

---

[47] ss. 142-57, the FSA 1986. The Yellow Book, 8.15-8.17, 10.45-10.49 (listing particulars and supplementary listing particulars).
[48] reg. 7(2)(k) of the POS Regulations.
[49] ss. 57(1), 58(1)(d) of the FSA 1986.
[50] Case 39/72 [1973] E.C.R. 101. See also Case 34/73, *Fratelli Variola v. Amministrazione italiana delle Finanze* [1973] E.C.R. 981.

By contrast, given the nature of EC directives, they need implementation by the Member States. Article 189, paragraph three, explicitly states that a directive shall leave to the national authorities the choice of form and methods; the binding effect of a directive on the Member States only concerns "the result to be achieved".

Since the harmonisation of company law and securities regulation among the Member States is carried out mainly through the issue of directives, the major task of the British government is to implement these directives. However, the English courts should be aware that if a directive is not implemented, in certain instances the directive may have "direct effect" and thus give rise to rights in individuals against the "State",[51] and when a directive has been implemented the principle of consistent interpretation should be followed.[52]

The term "direct effect" means that some provisions of directives can give rise to rights in individuals or impose (if allowed)[53] obligations on individuals.[54] In other

---

[51] The European Court of Justice extends the scope of the "State" to "public body" which is not confined to direct emanations of the State and will include a body carrying out a public regulatory function even though it may take the form of a private body. See Case C-188/89, *Foster v. British Gas* [1990] E.C.R. I-3313. See also D.D. Prentice (ed.), *EEC Directives on Company Law and Financial Markets*, 1991, p. 4. For example, Directives 79/279 and 80/390 require the Member States to designate the national authority or authorities to exercise a regulatory function on the events of admissions to listing and listing particulars (Art. 9 and Art. 18 respectively). The UK designates the Securities and Investment Board (SIB) and the London Stock Exchange as the competent authorities. The Secretary of State made an order (The Financial Services Act 1986 (Delegation) Order 1987 (S.I. 1987/942)) to delegate part of its power to the SIB pursuant to s. 114 of the FSA 1986. Based on s. 142 (6), the Stock Exchange becomes the competent authority. See Official Listing of Securities (Change of Competent Authority) Regulations 1991 (S.I. 1991/2000, regs. 1(1) and 3(1)(b)).

[52] *Macarthys Ltd. v. Smith* [1979] 3 All E.R. 325; *Garland* [1983] 2 A.C. 751, p. 771; *Pickstone* [1989] 1 A.C. 66, p. 126; Case 51/76, *Verbond* [1977] E.C.R. 113, p. 128. para. 30; Case 106/77, *Amministrazione delle Finanze dello Stato v. Simmenthal S.p.A.* [1978] E.C.R. 629, p. 644, para. 21; Case 61/81, *Commission v. United Kingdom of Great Britain and Northern Ireland* [1982] E.C.R. 2601, p. 2616, para. 9; Case 270/81, *Felicitas* [1982] E.C.R. 2771, p. 2786, para. 25; Case 14/83, *Von Colson* [1984] E.C.R. 1891, p. 1909, para. 2; Case C-106/89, *Marleasing v. La Comercial* [1990] E.C.R. I-4135, p. 4159, para. 8, etc. See also P.P. Craig, "Sovereignty of the United Kingdom", *Year Book of European Law 1991*, 221-55, 1992, p. 242.

[53] This mainly relates to the problem of horizontal direct effect.

[54] See A. Dashwood, "The Principle of Direct Effect in European Community Law", in 16 *J.C.M.S.*, 229-45, 1978, p. 229; J. Steiner, "Direct Applicability in EC Law — A Chameleon Concept", in 98 *L.Q.R.*, 229-48, 1982, p. 239, it is called "effect utile"; J. Steiner, "Coming to Terms with EC Directives", in 106 *L.Q.R.*, 144-59, 1990, p. 145; Rose M. D'Sa, *European Community Law and Civil Remedies in England and Wales*, 1994, chapter 5.

words, individuals can invoke their rights based on these provisions in certain situations.[55] If the opposite party is the "State", then this is referred to as "vertical direct effect" to denote the relationship between a citizen and the State; if individuals can be sued as defendants, then it is called "horizontal direct effect" to denote the relationship between individuals.

Whether a directive has direct effect is not stated in the EC Treaty. Instead, the applicable principle was mainly developed by the Court during the seventies and early eighties. The criteria which a provision of the directive must satisfy if it is to be directly effective have been re-iterated by the Court on numerous occasions. The Court stated that in order to decide whether a provision has direct effect, it is necessary to examine, in every case, whether *the nature, general scheme and wording of the provision in question are capable of having direct effect* on the relations between Member States and individuals.[56] Analysing and categorising this, the provision concerned should be clear and unambiguous,[57] unconditional, and not dependent on further action.[58]

Up to this point, the vertical direct effect is well accepted by the Court, but not the horizontal direct effect. Article 189, paragraph three, of the EC Treaty provides: "A directive, shall be binding ...upon each Member State to which it is addressed..." It is obvious that, from this, the addressees of directives are the Member States, not individuals. Thus, if directives can give rise to rights in individuals, the obligors will be limited to the "State" only. That is why the vertical direct effect has been well-established by the case law of the Court. Individuals enjoy the right while the Member States bear the burden. Admittedly, before the directive is incorporated into the

---

[55] Case 33/70, *SACE v. Italian Ministry for Finance* [1970] E.C.R. 1213, p. 1223, para. 15; Case 9/70, *Franz Grad v. Finanzamt Traunstein* [1970] E.C.R. 825, p. 837, para. 5; Case 41/74, *van Duyn* [1974] E.C.R. 1337, p. 1349, para. 15; Case 43/75, *Defrenne v. Sabena* [1976] E.C.R. 455, p. 475, paras. 33-4; Case 148/78, *Ratti* [1979] E.C.R. 1629, p. 1641, para. 19; Case 8/81, *Becker* [1982] E.C.R. 53, p. 70, para. 21; Case 152/84, *Marshall* [1986] E.C.R. 723, p. 749, para. 47.

[56] Case 41/74, *van Duyn* [1974] E.C.R. 1337, p. 1348, para. 12.

[57] The Court uses the term "sufficiently precise". See Case 8/81, *Becker* [1982] E.C.R. 53, p. 71, para. 25.

[58] See T.C. Hartley, *The Foundations of European Community Law*, 3rd ed., 1994, pp. 199-206.

national legal system, the Member States traditionally have international obligations under the Treaty to the Commission[59] and other Member States.[60] Since the individual is the beneficiary of those directives which aim to require the Member States to bestow rights on the individual, to extend the traditional view and allow the individual to invoke his own right before the national court is not abnormal. As a result, it is not difficult to admit the existence of the relationship between the State and the individual once the fact mentioned above is appreciated. But the relationship between individuals regarding direct effect of directives, generally called "horizontal direct effect", has not yet been recognised by the case law of the Court. More than that, the *Marshall* case has finally laid all speculation about horizontal direct effect to rest.[61]

In case *R. v. International Stock Exchange, ex p. Else (1982) Ltd.*,[62] with regard to whether the case should be referred to the European Court for preliminary ruling on the construction of Article 15 of Directive 79/279 (Admission Directive),[63] the court of appeal ruled in favour of the Stock Exchange that the case did not need to be referred to the Court, because the national court could interpret Article 15 of Directive 79/279 confidently. In other words, the court believes that this Directive does not give rise to the right of judicial review in shareholders of companies concerning the cancellation of listing of companies' shares.

---

[59] Article 169 of the EC Treaty provides: "If the Commission considers that a Member State has failed to fulfil an obligation under this Treaty, it shall deliver a reasoned opinion on the matter after giving the State concerned the opportunity to submit its observations. If the State concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the Court of Justice."

[60] Article 170 of the EC Treaty provides: "A Member State which considers that another Member State has failed to fulfil an obligation under this Treaty may bring the matter before the Court of Justice."

[61] D. Wyatt and A. Dashwood, *European Community Law*, 3rd ed., 1993, p. 74. See also Case 80/86, *Kolpinghuis Nijmegen* [1987] E.C.R. 3969, p. 3985, para. 9. However, it is worthwhile to mention here that this issue has been reopened in *Dori v. Recreb Srl.* (Case C-91/92 [1994] E.C.R. I-3325). The court insisted on its position taken in *Marshall* and held that no horizontal direct effect could occur (p. I-3355, para. 20). But in the opinion of the Advocate General Jacobs (delivered on 27 January 1994) regarding Case *Nicole Vaneetveld* (Case C-316/93 [1994] E.C.R. I-763), the Advocate General strongly supported the view that directives should have horizontal direct effect. It is impossible to predict at this moment whether the Court will change its attitude or not in the future; this remains to be observed.

[62] [1993] 1 All E.R. 420.

[63] OJ 1979 L 66/21.

This case concerned a company named Titaghur plc. whose shares were listed on the Stock Exchange and were cancelled by the panel of the Quotations Committee of the Stock Exchange. Several shareholders of the company applied for judicial review. One of the central issues on this appeal was: "Are the applicants as shareholders entitled in Community law to challenge the Committee's decision to cancel the company's listing?"

Shareholders under the domestic law are not endowed with this right. The problem is whether they can claim their rights in front of the court based on the Directive. Article 15(1) of this Directive provides:

> "Member States shall ensure decisions of the competent authorities refusing the admission of a security to official listing or discontinuing such a listing shall be subject to the right to apply to the courts."

In this provision, persons entitled to apply to the courts are not identified. The court indicated that this Directive only regulated relations between competent authorities (here the Stock Exchange) and companies or issuers; there was nothing to suggest that competent authorities may have direct relations with investors. It held:

> "Although this Directive expressly recognised the responsibility of competent listing authorities to protect the interests of investors, which was always to be the overriding concern of a competent authority when exercising its powers in dealing with conditions imposed and obligations undertaken by companies whose securities were admitted to listing, the primary purpose of the Directive was to co-ordinate the listing practice of competent authorities in member states with a view to establishing a common market in securities and not in any direct way to provide additional protection for investors."[64]

Following this reasoning, the court declared that only companies and issuers were entitled to claim the right of judicial review.

---

[64] Id., p. 421.

Additionally, no provision in this Directive requires competent authorities to provide investors with information of their decisions; no provision deals with problems arising from the principle that a company is a legal entity separate and distinct from its shareholders and that a shareholder could not as such act on behalf of or enforce the rights of the company; there is also no provision to define "investors". Thus the court has concluded that shareholders did not have this right.

However, it is likely that this judgment is based on policy considerations more than the reasons mentioned above. Since the Directive is aimed at partly to protect investors, based on a purposive construction, it is not impossible to construe that shareholders are protected by Article 15. The real problem is that there are thousands of shareholders; if the company itself does not want to challenge the decision, while minority shareholders want to do so, it may be against the will of majority shareholders and the company. It is also true that courts may not wish to interfere with the internal management of a company acting within its powers. In addition to this, the court wants to ensure the administrative expedience and efficiency of the competent authorities, which are also the goals of this Directive.[65]

2.2.1 The Impact of the EC on UK Companies Acts

The harmonisation of the company laws in the Member States began in the 1960s. Early in 1966, a Report entitled "The Development of a European Capital Market" has indicated the importance of disclosing corporate information. It mentions:

> "Certain groups of financial institutions have set up joint research units to guide their own and their associated investment houses' investment policy and

[65] See the preamble to the Directive: "Whereas there should be the possibility of a right to apply to the courts against decisions by the competent national authorities in respect of the application of this Directive, although such right to apply must not be allowed to restrict the discretion of these authorities."

> have placed the information so collected at the disposal of their clients. Similarly, financial analysis companies have been formed, precisely for the purpose of circulating to their subscribers comparative information on securities in various countries. But in spite of these praiseworthy initiatives, the quality of published information unfortunately still *suffers only too often from the inadequacy of the basic data disclosed by companies.*"[66] (emphasis added)

This points out two problems: one is that the inadequacy of information is attributed to the hesitance of providers, namely, companies; the other is that the quality of information is inadequate. This might partly result from the lack of comparability of information.

Some of the following directives concerning company law harmonisation were triggered by these considerations. Directive 68/151[67] (the First Council Directive) adopted in 1968, aiming to mitigate the first problem, created a system of public disclosure applicable to all companies (public and private), and ensured the publication of certain information in an official gazette. This device made the same type of information available to the public in respect of all companies in the Community.[68] Business firms feared that more exhaustive disclosure of their affairs would weaken their competitive position unless their rivals were put under the same situation. Thus, that the First Council Directive mandated all companies to do so in practice mitigated this problem. This caused the UK to implement it by s. 9(3) of the European Communities Act 1972 and subsequently codify in the Companies Act 1976, ss. 1 and 6.[69] Directive 77/91[70] (the Second Council Directive) supplemented the First Council

---

[66] See Report of a Group of Experts appointed by the EEC Commission, *The Development of a European Capital Market,* 1966, p. 227.

[67] Sp Ed 1968(1) p. 41.

[68] The disclosure items being required include the instrument of constitution, statutes and their amendments, the balance sheet, profit and loss account for each financial year, etc. See Article 2(1) of the First Council Directive. Article 3(1) provides: "In each Member State a file shall be opened in a central register, commercial register or companies register, for each of the companies registered therein." And Article 3(4) requires that the disclosure documents shall be effected by publication in the national gazette.

[69] See *Company Accounting and Disclosure, A Consultative Document (Green Paper),* Cmnd. 7654, 1979, p. 10. Section 1(7) of the Companies Act 1976 provides: "...the directors of the company shall

Directive regarding the information which should be disclosed in the statute or the instrument of incorporation of the company, inter alia, the information about shares and capital.[71] It was implemented by the Companies Act 1980 and now in the Companies Act 1985, s. 117(3)(c) and (d).[72]

The principle of the First Council Directive was extended to new categories of documents for information by the subsequent directives. For example, Article 47(1) of Directive 78/660[73] (the Fourth Council Directive) requires that the annual accounts, duly approved, and the annual report, together with the opinion submitted by the person responsible for auditing the accounts, shall be published in accordance with the First Council Directive; Article 38 of Directive 83/349[74] (the Seventh Council Directive) has the same requirement with regard to consolidated accounts and consolidated annual report together with the opinion submitted by the person responsible for auditing.

As regards the second problem, if accounting documents issued by companies in different Member States are comparable and equivalent, the quality of information will be improved. The reasons are considered below. The instruments mainly used by companies to communicate information to existing or potential shareholders and creditors are financial statements which include annual accounts and annual reports. The annual report in the UK is similar to the directors' report. Given the situation in the European Community, investors may engage in cross-border investments. They

---

deliver to the Registrar of Companies a copy of every document required to be comprised in the accounts of the company in respect of that period..." (Eliz. 2, 24 & 25 c. 69).

[70] OJ 1977 L 26/1. The Second Council Directive is principally concerned with the formation of public companies, and the maintenance and alteration of their capital.

[71] Articles 2 and 3 of the Directive.

[72] s. 4 of the Companies Act 1980, and now Companies Act 1985, section 117(3)(c) which states that the statutory declaration must specify the amount, or estimated amount, of the company's preliminary expenses and the persons by whom any of those expenses have been paid or are payable and (3)(d) requires it to specify any amount or benefit paid or given, or intended to be paid or given, to any promoter of the company, and the consideration for the payment or benefit.

[73] OJ 1978 L 222/11.

[74] OJ 1983 L 193/1.

have to assess another country's political, economic and financial situations and prospects, and short-term outlook of particular industries. This is not without difficulty. As regards foreign shares, they have the additional problem of interpreting the facts and figures published by foreign companies.[75] Thus, the harmonisation of accounting standards can help investors understand the information they have been given, because that is similar to their home country's system. Based on this, the necessity of harmonising the preparation of corporate accounts can be easily advocated and this was done by the Fourth Council Directive and the Seventh Council Directive. The former emphasises the harmonisation of accounting preparation and minimum requirements of disclosure, while the latter supplements the former in connection with consolidated accounts.

The Fourth Council Directive had a considerable effect on UK legislation. It not only brought about the enactment of the Companies Act 1981 but also introduced many different ideas new to the UK. It had two main purposes. First, it attempted to harmonise the different regulations co-existing in the Member States, which in turn aimed to enhance the freedom of establishment and to ensure that investors would be protected by access to more comprehensive and standardised information. Second, it was intended to relieve both medium and small companies of accounting and disclosure obligations.[76]

However, the Companies Act 1981 adopted a somewhat different attitude towards medium and small size companies.[77] The Fourth Council Directive permits the Member State to give exemptions both with regard to the drawing up and the

---

[75] See supra note 66.

[76] In its preamble, it reveals its goals as follows: 1. to achieve simultaneous co-ordination because it is necessary in these fields for these forms of companies whose activities frequently extend beyond the frontiers of their national territories; 2. for the protection of members and third parties of the companies; 3. to establish in the Community minimum equivalent legal requirements as regards the extent of the financial information that should be made available to the public by companies.

[77] Before the enactment of the Companies Act 1981, there was a consultative document, i.e., *Company Accounting and Disclosure*, Cmnd. 7654, 1979.

publication of the accounts to small and medium size companies.[78] According to ss. 5 and 6 of the Companies Act 1981, these companies were only entitled to the benefit of the exemption with respect to the delivery to the Registrar of Companies under section 1(7)(a) of the Companies Act 1976 of accounts and other documents in respect of the accounting reference period by reference to which that financial year was determined.[79] In other words, they were subject to the same obligation of drawing up the accounts circulated to the shareholders as large companies.[80]

Even so, this Act is important because of its embodiment of some provisions for the first time. It also marks a radical departure in respect of the whole area of company financial statements in the UK.[81] For example, for the first time, English law prescribes precise formats for the presentation of company accounts and lays down rules for calculating the amounts at which items are to be stated in those accounts,[82] and one of the most significant changes brought about by the Act is the requirement for company accounts to follow the standard format.[83]

The idea of a standard presentation of the principal accounting statements was new to the UK for companies.[84] It was unprecedented that UK company law regulated the publication of a company's accounts in circumstances other than where a company delivers its accounts to the Registrar of Companies.[85] This Act also inserted some accounting rules and this helped to strengthen the accountants' position.[86] Britain

[78] Articles 11, 27, and 47. The reason why the Community wants to simplify the administrative procedures imposed on small and medium-sized undertakings is to improve the business environment and to promote the development of enterprises.
[79] ss. 6 (2) and (7) deal with small and medium size companies respectively.
[80] This has been changed. The Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Publication of Accounts in ECUs) Regulations 1992 (S.I. 1992/2452) give small-size companies concessions on drafting the balance sheet, the notes to the accounts, and the directors' report. See regs. 1 and 4(3) of the Regulations; s. 246(1A) and (1B) of the CA 1985.
[81] See George W. Eccles and Jenny Cox (eds.), *Tolley's Companies Act 1981*, 1982, p. 9.
[82] See Alan Hardcastle and Michael Renshall (eds.), *The Companies Act 1981 Handbook*, 1985, p. 2.
[83] See the Companies Act 1981, Sched. 1, Part I.
[84] See Peter N. McMonniew, *The Companies Act 1981, a practical guide*, 1982, p. 5.
[85] s. 11 of the Companies Act 1981. See also Alan Hardcastle and M. Renshall (eds), supra note 82, pp. 80-3
[86] The Companies Act 1981, Sched. 1, Part II.

traditionally adopts the "permissive" approach, but after this Directive, the British legislation has to adjust itself to the continental "prescriptive" approach.[87]

The Seventh Council Directive harmonises the issue regarding consolidated accounts by specifying the way and the circumstances in which consolidated accounts must be prepared. As in group companies, the way to provide investors with accounts fulfilling the requirement of having a true and fair view is to prepare a consolidated account, it can be said that the aim of co-ordinating the legislation governing consolidated accounts is to protect the interests subsisting in companies with share capital.

This Directive resulted in the Companies Act 1989 which has no single objective but a number of principal themes in addition to the above mentioned one.[88] It entirely replaced Part VII of the Companies Act 1985 by its Part I with regard to accounts and audit.[89] To improve the provisions concerning the consolidated accounts, aimed at by the Directive, the law has a new definition of so-called subsidiary "undertakings". Since they are named as undertakings, they are no longer necessarily limited to include only companies, instead they can be partnerships, limited partnerships and so on. This

---

[87] The permissive approach means that the law only asks the accounts to give a true and fair view of a company's financial performance and financial status instead of providing comprehensive definition of form and content, while the prescriptive approach asks for not only form and content of accounts but also permitted concepts and methods of accounting measurement being defined. When the Companies Act 1981 was passed, the then Minister for Trade Mr. Cecil Parkinson said: "The technical accounting provisions... represent a much more detailed and prescriptive statutory approach than we are familiar with in this country. The Government has, however, been at pains to impose the minimum change necessary in actual accounting practice and, so far as is consistent with the directive, to leave more flexibility and freedom as possible for the development of that accounting practice..."(Hansard: Sixth Series, Vol. 5 (1980-81), p. 647). See Stephen Barc and Nicholas Bowen (eds.), *Tolley's Company Law*, 1993, A1503.

[88] See Christopher Swinson, *A Guide to the Companies Act 1989*, 1990, p.1. These are (1) to extend deregulation and to simplify administrative requirements for smaller companies such as s. 379A of CA 1985 (s. 116 of CA 1989) and 366A of CA 1985; (2) to improve existing regulatory powers by the extension of existing powers of investigation such as s. 434 of CA 1985, and the introduction of procedural reforms for merger control (s. 152 of CA 1989); (3) to improve market efficiency through the clarification of the law relating to insolvency and financial markets and amendment of the Financial Services Act 1986, for example, 47(A) of the FSA 1986.

[89] The Companies Act 1989 amended the Companies Act 1985 by inserting provisions in ss. 221-262 and changing Scheds. 4 to 10 of the Companies Act 1985.

demonstrates that the control relationship has been decided, based not only on legal control but also on factual control. Thus this creates a comprehensive scope to regulate the drawing up and publication of the consolidated accounts of group companies.

The Companies Act 1989 also has some important extensions to disclosure requirements regarding directors' emoluments and other benefits.[90] Additionally, the new law requires public companies and large private companies to disclose in notes to the accounts whether the accounts have been prepared in accordance with applicable accounting standards.[91]

Turning to Directive 84/253[92] (the Eighth Council Directive) which also constitutes a part of the Companies Act 1989, the first point that needs to be mentioned here is that the purpose of this Directive is to help the Member States establish a legal framework for the qualifying requirements and supervision of auditors. Second, the Act removed the prohibition on bodies corporate acting as auditors.[93] Auditors are required to be independent and the Act permitted the Secretary of State to make regulations defining "independence".[94] Third, auditors' rights to information are increased.[95]

---

[90] See Nigel Furey, *The Companies of 1989, A Practitioners' Guide*, 1990, p. 12. It is enacted in s. 6(3) of the CA 1989. And in s. 232, and Sched. 6, Part I-III, CA 1985. The definition of emoluments is in Sched. 6, Part I, para. 1(4) which defines the term as including: (a) fees and percentages; (b) sums paid by way of expenses allowance; (c) contribution paid in respect of him under any pension scheme; and (d) the estimated money value of any other benefits received by him otherwise than in cash. Moreover, emoluments in respect of a person's accepting office as a director ('golden hellos') must now be included in a director's overall emoluments.

[91] s. 19 of the CA 1989; s. 256(2) CA 1985. This is recommended by the *Making of Accounting Standards Report (Dealing Report)*, para. 10.3 (a).

[92] OJ 1984 L 126/20.

[93] ss. 25(2) and 53(1) of the CA 1989.

[94] s. 27(1)(2) of the CA 1989.

[95] s. 120 of CA 1989 and s. 389A of CA 1985. See Slaughter and May, "The Companies Act 1989", in *Corporate Brief*, 4(2), 32-5, 1990.

Although the Fourth and Seventh Directives are company-law-oriented Directives, they do greatly help the later Directives regarding the public distribution of securities because they deal with the most fundamental problem, that is, the assessment of information. Without this, any further requirement on disclosure is useless as information provided by companies in different Member States is not comparable.

2.2.2 The Impact of the EC on the FSA 1986, Parts IV, and the Public Offers of Securities Regulations 1995

(1) Background

The importance of the free circulation of financial products lies in its great contribution to the integration of the capital market. In turn, the integration of the capital market has been employed as one of the methods for the achievement of an internal market, which is the paramount goal of the Community at the present stage of its development.[96] The White Paper of 1985 (Completing the Internal Market)[97] proves this by clearly stating that the Commission's principal objective in relation to capital markets is to liberalise financial services. This integrating process of the capital market is not just about improving internal infrastructures within the Community but also about propelling "Europe onto the blustery world stage of the 1990s."[98]

In fact, the concept of free circulation was first emphasised in the field of free movement of goods. For example, the Court in *Cassis De Dijon*[99] and its following case *Gilli & Andres*[100] gave a general definition of the barriers to free trade which were prohibited by the provisions of Article 30 et seq. of the EC Treaty. That is, non-discriminatory national rules may themselves amount to measures having equivalent effect to quantitative restrictions on imports prohibited by the Treaty unless they can

---

[96] See Commission, *A Business Guide to the Single Financial Market*, 1992.
[97] Dated June 14, 1985, COM (85)310.
[98] See Financial Times Conferences, *European Securities Markets in the 90s*, 1991, p. 1.1.
[99] Case 120/78, *Rewe-Zentral v. Bundesmonopolverwertung für Branntwein* [1979] E.C.R. 649.
[100] Case 788/79 [1980] E.C.R. 2071.

be justified under certain circumstances.[101] This caused the Commission to declare that goods lawfully manufactured in one Member State are to be admitted to the markets of other Member States.[102] Using a more familiar term to describe this development, it is the "mutual recognition" by the Member States of other Member States' standards. More recently, the free circulation of "financial products" has been increasingly emphasised.[103]

Although the precondition for the free movement of financial services is the freedom of capital movement, the latter can only grant investors the right to purchase any financial product circulating on Community markets and to approach any supplier of financial services or products for that purpose.[104] This does not automatically give the same right to suppliers of financial products, because they may be hindered by the three most serious obstacles within capital market: (1) Full access to markets can therefore involve fifteen different authorisation requirements with their associated rules of supervision and conduct of business; (2) There are significant differences in national rules as to the types of business which different forms of enterprises can carry on in different markets; and (3) There are restrictions in some member states relating to the types of financial products which may circulate.[105] For instance, an issuer of securities may want to apply for listing in one or more Member States; if listing rules in each Member State are different, the issuer will have to spend much time and money in fulfilling the requirements of those countries; meanwhile, securities which are allowed to circulate in some Member States may not have access to other Member States' markets due to different regulations. These obstacles need to be abolished.

---

[101] Such as public morality, public health, fiscal supervision, the fairness of commercial transactions, the defence of the consumer, etc. See Article 36 of the Treaty and the case *Cassis de Dijon*. That discrimination is not an essential characteristic of national measures contrary of Article 30 is made clear in Case 61/84, *Cinéthèque* ([1985] E.C.R. 2605).

[102] See *Commission Notice*, OJ C 256/2, 1980.

[103] See the *White Paper of 1985*, supra note 97, paras. 102, 109; Eva Lomnicka, "The Internal Financial Market and Investment Services", in *EC Financial Market Regulation and Company Law*, S. Kenyon-Slade and M. Andenas (eds), 1993, p. 85.

[104] See R. M. Buxbaum, Marina Hertig, Alain Hirsch, and Klaus J. Hopt (eds.), *European Business Law*, 1991, p. 8.

[105] Id.

One possibility is put forward by some scholars. Their opinion is that the Community eventually should have a "European securities market", where "Eurolist" shares would be traded simultaneously on each of the fifteen EC Member States markets, and a "European index" based on "Eurolist" could be set up to provide a basis for arbitrage and hedging.[106] To achieve this idea is not impossible provided that the conditions indispensable for this goal are fulfilled. In other words, when procedures and conditions of listing applications in the Member States are more and more harmonised, the techniques of mutual recognition and EC passport are widely employed,[107] and other regulations regarding financial intermediaries are co-ordinated to some extent, then, the time for a "European securities market" may be mature.

(2) The Directives

Four Directives constitute the cornerstone of disclosure of the public distribution of securities. Such a concept of disclosure could be traced back to the Report in 1966.[108] It points out that in all Member States, an essential factor in the expansion of the capital market is that the public be given better information on securities and familiarised with the machinery of the stock exchange. This shows the necessity of harmonising the conditions required for official listings and the information needed to be disclosed if the Community attempts to enhance its capital markets.

The first directive passed in 1979 is the Admission Directive.[109] It establishes the minimum conditions for the admission of securities to official listing on stock

---

[106] See supra note 98, p. 2.2. This idea was first mooted by Regis Roussells in April 1989. "Eurolist" would comprise major corporations whose shares are listed on EC bourses.

[107] See I. Fraser and P. Mortimer-Lee, "The EC Single Market in Financial Services", in 33 *Bank of England Quarterly Bulletin*, 92-7, 1993, pp. 92-6; J.A. Usher, "The Implications of the Single European Market for Banking and Finance: an Overview", in *The Single Market and the Law of Banking,* R. Cranston (ed.), 2nd ed., 1995. The term EC passport denotes a situation in which once a business has been authorised by one Member State, it should be free to operate in another Member States as if a natural person who holds a passport of any Member State is free to travel within the Community.

[108] See supra note 66.

[109] Directive 79/279, OJ 1979 L 66/21.

exchanges situated or operating in the Member States. It is applied to those securities which are admitted to official listing or are the subject of an application for admission to official listing on a stock exchange situated or operating within a Member State.[110] However, Member States may exclude units issued by collective investment undertakings other than the closed-up type; they may also exclude governmental securities[111] from the scope of the Directive. There are four Schedules in this Directive. Schedule A regulates the conditions for the admission of shares to official listing on a stock exchange; Schedule C regulates the obligations of issuing companies once their shares are listed. Schedules B and D are concerned with the equivalent forms of regulation for debt securities. The Member States are allowed to make more stringent or additional conditions provided these are applied generally for all issuers or for individual classes of issuers.[112] The Directive provides that the Member States shall designate the national authority or authorities competent to regulate the issues mentioned in the Directive and ensure that the competent authorities have such powers as may be necessary for the exercise of their duties.[113] Additionally, it has numerous provisions dealing with the information to be provided by the issuers.[114]

Directive 80/390[115] (the Listing Particulars Directive) was adopted in 1980. Its preamble shows that listing on the stock exchange has become an important means of access to capital markets, and that the operations of what the Directive refers to as "undertakings" have been enlarged to embrace the whole Community. Thus, corresponding to this development and for the protection of the interests of actual and potential investors, undertakings which offer their securities to the public are required to provide information which is sufficient and as objective as possible explaining the financial circumstances of issuers and particulars of the securities either at the time of

[110] Article 1(1).
[111] Article 1(2).
[112] Article 5(1) and (2).
[113] Article 9.
[114] Scheds. C, D.
[115] OJ 1980 L 100/1.

their offer or of their admission to official stock exchange listing. The Directive then prescribes the information to be provided in the listing particulars.

Directive 82/121[116] (the Interim Reports Directive), concerning information to be published on a regular basis by companies, further enhances the protection of shareholders. Since it only applies to shares[117] and just covers the half-yearly report,[118] it affords no additional protection to the holders of other securities.

These three Directives were implemented by the Stock Exchange (Listing) Regulations 1984 (coming into effect on 1 January 1985).[119] The Regulations were made by the Secretary of State, being a minister designated for the purposes of s. 2(2) of the European Communities Act 1972. It designated the Council of the Stock Exchange as the competent authority for all purposes under the directives and the Council should have all the powers required to be conferred on.[120] The FSA 1986 as amended by the Companies Act 1989 substituted the Stock Exchange for the Council of the Stock Exchange as the competent authority.[121] When the FSA 1986 was enacted, the legislature repealed the Stock Exchange (Listing) Regulations 1984 by passing Part IV of the FSA 1986, s. 142(6) of which authorises the Stock Exchange to promulgate "Listing Rules" with regard to the official listing of securities. Thus, these three Directives are now implemented by Part IV of the FSA 1986 and the Listing Rules of the Stock Exchange, ordinarily called the "Yellow Book".[122]

Before turning to Directive 89/298[123] (the Public Offers Directive), one directive is shortly mentioned here. Directive 88/627 [124] on the information to be published when a major holding in a listed company is acquired or disposed of is not a new idea

---

[116] OJ 1982 L 48/26.
[117] Article 1.
[118] Article 2.
[119] S.I. 1984/716.
[120] reg. 4(1).
[121] s. 142(6) of the FSA 1986.
[122] The Stock Exchange's Admission of Securities to Listing.
[123] OJ 1989 L 124/8.
[124] OJ 1988 L 348/62.

to English company law. The Companies Act 1985 requires a shareholder to notify the company of his interest when his shareholding has been over 3 per cent.[125] This Directive requires that shareholders who, directly or indirectly, own shares in listed European Community companies must disclose their holdings when they reach any of five thresholds (10%, 20%, 33 1/3%, 50%, 66 2/3%).[126] The UK has promulgated two regulations to implement this Directive.[127]

The Public Offers Directive did considerably affect the then existing legal framework in the UK. This Directive requires a prospectus containing specified information about the relevant issuer and securities to be published when securities are first offered to the public.[128] In the UK, such prospectuses originally were regulated by Part III of the Companies Act 1985; but this principle did not survive the enactment of the FSA 1986. In the first place Part IV of the FSA 1986 has appropriated the whole subject of prospectuses in relation to official listing (known as listing particulars in the FSA 1986) away from the Companies Act 1985. Secondly, it was originally intended that Part V of the FSA 1986 should take the place of Part III of the Companies Act 1985. Part V never came into force, and this intention was only finally achieved by the enactment of the POS Regulations which repealed Part V of the FSA 1986 and thus replaced Part III of the Companies Act 1985. As it turned out when the Directive appeared, it became clear that Part V of the FSA 1986 would never have satisfied the requirements of the Community in any event.

First, the concept of "public offer" in the Directive and Part V of the FSA 1986 was not identical. The Directive does not define the term "public offer" and leaves this to the Member States. What it does state is that for securities "offered to the public for the first time" this Directive shall apply.[129] The problem was that Part V of the FSA

---

[125] s. 198 et seq.
[126] Article 4.
[127] The Disclosure of Interests in Shares (Amendment) Regulations 1993 (S.I. 1993/1819) and the Disclosure of Interests in Shares (Amendment)(No 2) Regulations 1993 (S.I. 1993/2689).
[128] Article 1.
[129] Article 1.

1986 employed the term "advertisement offering securities"; it thus included not only an invitation to subscribe or acquire securities but also any advertisement which contained information calculated to lead directly or indirectly to a subscription or purchase.[130] This concept was, beyond doubt, broader than any kind of interpretation of an offer.[131] At first sight, there was no conflict between UK legislation and the intention of the Directive. The difficulty was that the UK required the issue of prospectuses only when the agreement could be entered into in pursuance of the advertisement,[132] but the Directive requires the preparation of prospectuses whenever there is a public offer. Therefore, if an advertisement in the UK fell into the general concept of public offer but no agreement could be entered into in pursuance of it, the issuer would have been exempted from the obligation of preparing the prospectus under the FSA 1986 (if it had come into force). This clearly conflicted with the Directive.

Second, the meaning of secondary offer in Part V of the FSA 1986 was too narrow to cover those issues regulated by the Directive. Generally, a secondary offer means that securities were already issued by the company to investors and now securities holders want to offer these securities for sale. However, Part V restricted its application to those securities which were first issued to an investor or a predecessor with the intention of offering them to the public and not holding them for investment.[133] This demonstrates that the meaning of the secondary offer of the Directive is wider; it covers all offers whenever they are offered to the public *for the first time*, and the intention of the initial buyers is disregarded. If the UK had not amended these conflicting provisions, there would have been difficulty when Part V came into force. This was the reason why the DTI originally intended to amend Part V

[130] s. 158(4) of the FSA 1986.
[131] The narrow meaning of an offer is to invite the other party's acceptance; the broader sense could include contractual invitation, that is, invite the other party to make an offer.
[132] s. 160(1)(b) (repealed).
[133] s. 160(3) (repealed).

and some provisions of Part IV (listing particulars) as the tool to implement this Directive,[134] but eventually decided to introduce the POS Regulations.

Both these problems have been resolved by the enactment of the POS Regulations. In the Regulations, the term "prospectuses" is re-installed and "for the first time" is clearly employed concerning the public offer and thus the problems raised above are resolved. The Regulations go further by defining the meaning of offers and public offers. A person would be regarded as offering securities if, as principal, he makes an offer which, if accepted, would give rise to a contract for the issue or sale of the securities by him or by another person with whom he has made arrangements for the issue or sale of the securities; or he invites a person to make an offer.[135] And an offer is public if it is made to persons in the UK, i.e. any section of the public, whether selected as members or debenture holders of a body corporate, or as clients of the person making the offer, or in any other manner.[136]

The original proposal of the Directive also attempted to make a pre-vetting system mandatory in respect of all prospectuses even for those securities which were not to be listed. The UK strongly opposed this suggestion on the ground that there was hardly any public issue of non-listed securities and this requirement would be wasteful and unnecessary.[137] However, it was claimed that this argument was unconvincing. On the basis of statistical information, Gower opposed the argument advocated by the UK. He wrote that about 29.6 per cent (from 1978 to 1982) of all registered prospectuses

---

[134] See DTI, *Listing Particulars and Public Offer Prospectuses, Consultative Document*, July 1990. The Public Offers Directive covers all public offers, listed or unlisted. So, when a listing involves a public offer, it is the prospectus rather than the listing particular that should be published. In other words, the DTI has to substitute the term "prospectuses" for the term "listing particulars" in some provisions regarding a listing with public offers.

[135] reg. 5, the POS Regulations.

[136] Id., reg. 6. As regards the details of the Regulations, see Chris Bates, "The New UK Prospectus Rules", in *Butterworths J. of International Banking and Financial Law*, 10(7), 296-303, 1995 (Part I) and 10(9), 426-31, 1995 (Part II); Judith Cseh-Menczer, "The Public Offers of Securities Regulations 1995", in *European Financial Services Law* (E.F.S.L.), 2(6), 174-5, 1995; Charles Abrams, "The Public Offers of Securities Regulations 1995: non-UK issuers", in *E.F.S.L.*, 2(8), 238-40, 1995.

[137] See L.C.B. Gower, *Review of Investor Protection, Report: Part I*, 1984, reprinted 1990, p. 139.

related to securities not listed or admitted to the USM (now the Alternative Investment Market, the AIM)[138] and pointed out that this was certainly not a small figure. However, the final version of the Directive did not ask for mandatory pre-vetting of prospectuses. The Directive was approved in 1990 and was due for implementation by 17 April 1991. Thus in July of 1990, the DTI issued a report entitled "Listing Particulars and Public Offer Prospectuses, A Consultative Document" to deal with the problem of implementation.

Before turning to the proposal of the DTI regarding the pre-vetting system, it is helpful to consider two Directives: 87/345[139] (the Mutual Recognition Directive) and 90/211[140] (the Second Mutual Recognition Directive). Although Article 24 of Listing Particulars Directive requires the competent authorities of Member States to co-operate and endeavour to agree a single text for the listing particulars for use in all the Member States, the Community is not satisfied with this and attempts to simplify the procedure of application for listing on the stock exchange among Member States. Thus, it further employs the concept of mutual recognition after the fundamental work of harmonisation has been done.[141] The first Mutual Recognition Directive provides that listing particulars, subject to any translation and to the addition of purely local information, must be recognised by other Member States in which admission to official listing has been applied for, without its being necessary to obtain the approval of the competent authorities of those States and without their being able to require that additional information be included in the listing particulars.[142] As regards prospectuses,

---

[138] Id., pp. 139-40. The total number of registered prospectuses in these five years (1978-1982) was 245, 249, 321, 368, and 345 respectively; while the number of securities not listed or on USM was 72, 81, 112, 94, and 94 respectively. Even the number of foreign companies' securities was excluded, there was still 41, 48, 58, 46, and 38 British companies' securities concerned in the five years which still counted for 17.7% of the total number of registered prospectuses.

[139] OJ 1987 L 185/81.

[140] OJ 1990 L 112/24.

[141] Mutual recognition cannot be used unless there is a minimum standard existing in the Community which ensures that each Member State has at least a more comprehensive and civilised national legal system. This will make the Member States with higher legal standard less reluctant to recognise other Member States' legislation. See also Benn Steil, Erik Berglöf, et al., *The European Equity Markets: The State of the Union and an Agenda for the Millennium*, 1996, pp. 113-4.

[142] See Article 24a(1).

if drawn up in accordance with the Listing Particulars Directive,[143] they should be recognised as listing particulars[144] and even more be recognised as prospectuses according to the Public Offers Directive.[145] The most important premise for listing particulars and prospectuses to be recognised in other Member States is that they must be approved by the competent authorities within the meaning of whichever the directives are applicable. That is to say, if the UK has no pre-vetting system with regard to prospectuses, issuers will not be able to enjoy the benefits brought about by these Directives. This will impose additional obstacles on UK companies which wish to broaden their European financial base, and may put them at some comparative disadvantage to companies based in other Member States where pre-vetting of prospectuses is carried out.[146]

For these reasons, the opinion of the DTI is that there should be a pre-vetting system for the prospectus and that the Stock Exchange be designated as the competent authority since it has discharged the obligation of pre-vetting with regard to listing particulars, and this can ensure the same standard to be executed in order to make use of the great advantages given by the Directives.

The Public Offers Directive and other ancillary directives forced the UK to change its Companies Act and the FSA 1986, i.e. to prescribe a set of disclosure requirements which is more comprehensive and can protect investors better than before. They also stop the debate on pre-vetting. They eloquently show that if the UK wishes to keep its leading status in the European financial markets, it should consider

---

[143] In Directive 89/298, Article 2 is read as "in accordance with Article 7, 8, or 12."

[144] The condition for mutual recognition of listing particulars as listing particulars is that the applications for admission to official listing on stock exchanges situated or operating in two or more Member States are made simultaneously or within a short interval (Article 24 of Directive 87/345). For prospectuses, the applications are also needed to be made simultaneously or within a short interval and that prospectus must be drawn up and approved by the competent authorities three months preceding the application for admission in that State (Article 24b(1) of Directive 87/345). The latter is extended to the situation where application is only made to one Member State (Article 2 of Directive 90/211).

[145] Article 21.

[146] See supra note 134, p. 9.

the possibility of adopting the pre-vetting system. This does not need to be mandatory; instead, it can be initiated by issuers who want to broaden their scope of business. The government only needs to provide them with the tools. This is the principle that the UK has finally opted for. As amended by the POS Regulations, the new s. 144(2) of the FSA 1986 has substituted "prospectuses" for "listing particulars"; that is, an issuer applying for listing of securities to be offered to the public in the UK for the first time must publish a prospectus rather than listing particulars before admission.[147] Therefore, when pre-vetting of prospectuses is at issue in the context of the above examination, it should be careful not to misconceive the identity of prospectuses. The prospectuses we analysed above only refer to those which are to be published in relation to securities offered to the public in the UK for the first time and in respect of which *no application for admission to listing (in the UK)* has been made, *and* the securities are to be offered to the public or are to be the subject of an application for admission to official listing, *in another member state simultaneously with, or within a short interval of,* the offer in the UK. In this case, the issuer or offeror (with the consent of the issuer) may apply for approval by the Exchange.[148]

2.2.3 The Impact of the EC on other UK Regulations

Finally, Directive 89/592[149] (the Insider Dealing Directive) and the Draft Thirteenth Directive on Take-overs[150] deserve mention. The former Directive aims to ensure that the market operates smoothly and effectively because the importance of the secondary market in transferable securities has been appreciated. In fact, before the enactment of the Insider Dealing Directive, a quite advanced insider dealing regulation has been established in the UK from the EC point of view. According to the Consultative

---

[147] The POS Regulations, regs. 1, 17, and Sched. 2, para. 2(1).
[148] Id., reg. 4(3), s. 156A of the FSA 1986, and the Yellow Book, Rules for approval of prospectuses where no application for listing is made, after chapter 26.
[149] OJ 1989 L 334/30.
[150] COM (95)655 final, 07.02.1996. The new proposal emphasises the principle of subsidiarity and calls itself a "framework Directive".

Document issued by the DTI in 1991, "The Law on Insider Dealing", it seems that with regard to the requirement of disclosure, English law needs minimum change. For example, Article 7 of the Directive extends the provisions of Schedule C, 5(a) of the Annex to Admission Directive to all markets covered by the Insider Dealing Directive, rather than just official listing. Schedule C, 5(a) provides that:

> "The company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares."

This Article regulates official listing securities only. Since Article 7 of this Directive has extended this requirement to all markets wherever they are regulated and supervised by authorities recognised by public bodies, operate regularly and are accessible directly or indirectly to the public. This requires disclosure of information to the public in order to reduce the potential opportunity for insider dealing. The UK has implemented this Directive by means of promulgating the Traded Securities (Disclosure) Regulations 1994[151] and substituting the Criminal Justice Act 1993 for the Companies Securities (Insider Dealing) Act 1985, and at this stage, nothing in the new Act reveals any infringement of the Directive.

Regarding the Draft Take-overs Directive, due to the fact that the City Code has a very complete set of rules regulating the disclosure requirements on take-overs and mergers,[152] the impact which may occur when the Draft becomes a directive would be trivial in the context of disclosure requirements. The more serious debate would lie in the change of the nature of regulation rather than in the substantive rules. That is, the traditional self-regulation on take-overs may be shifted to a statutory control; this will undoubtedly irritate the current UK regulators and they have been resisting its passing strongly. They are concerned seriously with the possibility of losing the flexibility,

[151] S.I. 1994/188.
[152] See infra page 85.

expedience, and efficiency resulting from self-regulation. This problem is not examined in detail here as it is outside the scope of the thesis.[153]

2. 3 Taiwan

Securities legislation in Taiwan, departing from company law, started with the "Regulations for the Administration of Securities Brokers in Taiwan" in 1954.[154] In 1968, the Securities and Exchange Law (SEL) was enacted (amended three times in 1981, 1983 and 1988 respectively), the draft was inspired by the Japanese Securities Exchange Law, American Securities Act 1933 and Securities Exchange Act 1934. As Japan also adopted the American system, Taiwanese securities law is in fact heavily influenced by American legislation. The amendment in 1981 was unimportant because it related to some technical problems only, while the 1983 amendment simply improved the control over "proxies".[155] The current disclosure system of the SEL was mainly introduced by the 1988 amendment.

---

[153] The literature available for those interested in this topic includes: Stephen Kenyon-Slade and Mads Andenas (eds.), *The EC Financial Market Regulation and Company Law*, 1993, Chapters 9 & 10; Trade and Industry Committee, House of Commons, *Take-overs and Mergers, Minutes of Evidence*, 1991, etc. The reason why the statutory structure will decrease the flexibility, expedience, and efficiency is explained by the Report issued by the Panel on Take-overs and Mergers in 1987. It said: "If we had a legislative system, the rules would either have to be less strict, so giving less protection to shareholder, or they would be wide-ranging as at present but without the ability to mitigate their potential harshness in appropriate cases." See Kenyon-Slade, p. 154.

[154] In 1929, the government promulgated the Stock Exchange Law in mainland China; the Law ceased to be applicable in a practical sense after the government retreated from China to Taiwan (no stock exchange existing at that time in Taiwan). On the other hand, the development of the stock market in Taiwan started during the colonial period under Japanese rule. Yet neither of these had any impact on the development of the current securities law and markets which were triggered by the reform of the agriculture policy.

[155] Article 25-1 was inserted. Its first section provides: "The use of proxies in publicly issuing companies for attendance at general meeting shall be regulated by the Competent Authority; the rules governing such matters shall be prescribed by the Competent Authority." Before this new article, proxies had been popularly used by those who aimed to take control of the board of directors. Abuse arose when shareholders "sold" their voting rights in exchange for pecuniary payment without being supplied with any relevant information; the general meeting became formal and no longer represented opinions of shareholders. This eroded the corporate structure, thus impelling the government to intervene in this process. According to the authorisation, the Competent Authority (the Securities and Exchange Commission) issued the "Rules on the Usage of Proxies at General Meeting of Publicly Issuing Companies" (1984), which sets the format of proxies, requires information to be accompanied, and requires those who solicit proxies to notify the SEC.

As regards the problem of disclosure relating to public offers and publicly issuing companies, the Law deals with it from three perspectives: the regulation of prospectuses, the requirements of continuous disclosure, and registration of shareholding. The last amendment in 1988 made great progress on disclosure, especially on the latter two issues.

2.3.1 Prospectuses

Prior to 1984 only a few provisions existed regulating prospectuses. Article 30 of the SEL required an issuer to submit a prospectus when it applied for approval of public offers; the required information therein was to be prescribed by the Competent Authority. The "Competent Authority" is the Securities and Exchange Commission (SEC), which is a governmental institution under the control of the Ministry of Finance. Based on such authorisation, the SEC issued the "Rules on the Contents of Public Offer Prospectuses" in 1968, which only contained three articles: Article 1 described the source of the authorisation of the Rules, Article 2 prescribed the contents of the prospectus in rough outline, and Article 3 set the date the Rules would take effect. The contents of the prospectus were very simple and insufficient concerning the information required by investors. Thus, in 1984, the Rules were refined and have been amended twice since then. The current version has provided investors with more information, which will be discussed in Chapter Five.

2.3.2 Continuous Disclosure

It was not until the 1988 amendment that the importance of protecting investors on the secondary market came to be emphasised.[156] The state of regulatory ignorance which

[156] There are two kinds of markets: one is the primary market and the other is the secondary market. The former is the place where companies or governments for the first time publicly distribute their securities to investors, while the latter is the place where issued securities are traded. Before 1988, the SEL emphasised its regulation of the primary market, such as requiring the issuer to prepare the prospectus for subscribers. Subsequently, however, the legislature and the administrative realised that

preceded this amendment can be contributed to two circumstances: (1) for a developing country, the most important function of the capital market is to help enterprises solicit capital; thus the primary market by nature becomes the major concern of regulators; and (2) in this situation, as a general rule, the secondary market may attract the attention of regulators at a later stage, which is especially possible if the secondary market has a certain degree of fraud and manipulation. However, such market abuse may not happen unless a substantial amount of securities traded, and this in turn, depends on the full development of the primary market. This is why the Taiwanese government and legislature, for a long time, did not shift their focus to the secondary market, because the development of the primary market took several decades.

The most important change was brought about by the amendment of Article 36 of the SEL. Under the original Article 36, publicly issuing companies had to file with the SEC and announce to the public, within fifteen days following the preparation of accounts, financial reports which had been duly audited and certified by a certified public accountant (CPA) and approved by the general meeting. But if an issuer was also a listed company, it had to comply with extra obligations; that is, it was required to file with the SEC and announce to the public, within fifteen days following the close of each half fiscal year, financial reports which had been duly audited and certified by a CPA, then approved by the issuer's board of directors and ratified by its supervisors.[157] Copies of the reports publicly announced and filed with the SEC also had to be sent to the stock exchange(s) and the association of securities dealers for the public's review.

In other words, before the amendment of Article 36, unlisted publicly issuing companies only had the obligation of annual disclosure, while listed companies had

---

the secondary market was no less important than the primary market because it provides investors with a market where they can transfer their securities efficiently. And following this, in the 1988 amendment, the disclosure requirements in the secondary market were strongly emphasised by amending Article 36 of the SEL.

[157] As regards the definition and function of supervisors, see infra Chapter Three, footnote 101.

both annual and half-yearly disclosure obligations. Obviously, the Law distinguished listed companies from unlisted companies and imposed more obligations on the former. This policy, however, contained a serious flaw. It was true that listed companies had a broader trading market and thus concerned more investors, but this did not necessarily mean that investors who purchased shares of unlisted companies publicly were not entitled to enjoy the same protection as their counterparts in listed companies. Moreover, as indicated above, to protect investors is to provide them with information immediately and completely; the annual and the half-yearly reports could hardly meet such a requirement. Hence, Article 36 needed to be amended.

The amended Article 36 abolishes the distinction made by the old law between listed and unlisted companies with regard to the obligations of disclosure. It also imposes additional obligations on both of them. According to the new provision, all companies which have publicly offered their securities, listed or unlisted, must comply with the obligations of annual, half-yearly, quarterly, and monthly disclosure.[158] Among these reports, both annual and half-yearly financial reports need to be approved by the issuer's board of directors and ratified by the issuer's supervisors; the CPA's audit and certification are also indispensable before the issuer files with the SEC. In contrast, the quarterly report does not need to be audited or certified by the CPA — the review of the CPA is enough; the monthly report does not even require approval of the board of directors. The latter two relaxing provisions are aimed at reducing the burden of companies, because it is not easy for them to ensure that such frequent

[158] Article 36(1), SEL, now reads: "An issuer under this law shall announce to the public and file with the Competent Authority, within four months following the close of each fiscal year, financial reports which have been duly audited and certified by a certified public accountant and approved by the issuer's board of directors and ratified by its supervisors. Unless otherwise approved by the Competent Authority, an issuer shall also comply with the following requirements:
1. within two months after the close of each half fiscal year, publicly announce and file with the Competent Authority, financial reports duly audited and certified by a certified public accountant, approved by the board of directors and ratified by the supervisors;
2. publicly announce and file with the Competent Authority financial reports duly reviewed by a certified public accountant within one month after the end of the first and third quarters of each fiscal year;
3. publicly announce and file with the Competent Authority the issuer's business circumstances of the preceding month before the 10th day of each calendar month."

reports (quarterly and monthly) have been duly audited and certified, which costs companies much. The contents of all these reports are to be prescribed by the SEC.

For the sake of rapid provision of information to the public, the obligation of "immediate disclosure" was inserted into Article 36; as a result, publicly issuing companies are obliged to announce publicly and file with the SEC within two days from the date of the occurrence of any of the following events:[159]

1. regarding the annual financial reports approved by the annual meeting of shareholders, if a report approved by shareholders is found to be inconsistent with an earlier version of the annual financial reports announced to the public and filed with the SEC; or

2. any matter, the occurrence of which has had a significant impact on shareholders' equity or the price of the securities.

As indicated above, the annual financial report had to be approved by the general meeting before the issuer filed it with the SEC under the original Article 36(1). This, however, was changed by new Article 36(1). According to the new rule, the issuer has to file the reports with the SEC within four months following the close of each fiscal year, whether it has been approved by the general meeting or not. Should the report have been approved or altered by the general meeting before the issuer files it with the SEC, it is clear that the issuer has to file with the SEC the report so approved or changed. But if such a report is changed by the meeting at a later stage, for example, shareholders discover errors and rectify them by resolution (supposing that they have enough votes),[160] this change, according to Article 36(2), must be filed with the SEC within two days from the date of the resolution being passed and also announced to the public.

---

[159] Article 36(2), SEL.

[160] Article 174 of the Company Law provides: "A resolution at a shareholders' meeting shall, unless otherwise provided for in this law, be adopted by a majority vote of the shareholders present, who represent more than one-half of the total number of issued shares."

The other situation where the issuer has to make a public announcement and an immediate filing with the SEC is concerned with "urgent" cases. If any matter arises, the occurrence of which has a significant impact on shareholders' equity or the price of the securities, the issuer has to inform the SEC and the public as soon as possible. This provision declares two principles of securities regulation: first, insiders should not be given opportunities to use inside information to make profits by concealing information from the public; second, the importance of information is dependent on its impact on shareholders' equity or prices of securities.[161] The former relates to the prohibition of insider dealing, while the latter is related to market efficiency. Both of these topics as justification of disclosure will be discussed in Chapter Three — the equal treatment of investors and the expected efficient market.

2.3.3 Registration of Shareholding

Before the 1988 amendment, the Law required a publicly issuing company to file with the SEC and announce publicly, upon its registration of incorporation, the class, numbers and par value of the shares held by its directors, supervisors, managers, and holders of shares representing an equity in excess of five per cent of the total issued

---

[161] Events which can cause great impact on shareholders' equity or prices of securities and thus a company has to file with the SEC within two days include (Rules Implementing the Securities and Exchange Law): 1. Cheques issued by the company are dishonoured by non-payment by the bank because of insufficient deposit, the company has been rejected for transactions, or other events which cause the company to lose its credibility; 2. There are litigation, administrative decisions, or administrative litigation which has a great impact on corporate finance or business; 3. The production of the company is reduced substantially, the factory or the major production facilities are leased, or all or most of the assets are pledged or mortgaged, with an impact on corporate business; 4. There occurs one of the situations referred to in Article 185 of the Company Law; 5. The court, upon petition by an interested party or *ex officio*, prohibits transfer of the shares of the company during the procedure of corporate reorganisation; 6. The chairman of the board of directors, general manager, or one-third of the directors are removed; 7. The appointed certified public accountant is removed; 8. The company enters into an important contract, makes material changes in its business plan, develops a product, or takes over another enterprise; 9. Any other event likely to have a major effect on corporate operations. Article 185 states: "A company shall not do any of the following acts without a resolution adopted by a majority of shareholders present at a shareholders' meeting which represent two-thirds or more of the total number of issued shares: 1. enter into, amend, or terminate any contract for lease of the company's business in whole, for entrusted business, or for regular joint operation with others; 2. transfer the whole or any essential part of its business or assets; or 3. accept the transfer of another's whole business or assets, which has great bearing on the business operation of the company."

shares of the company, all of whom are defined by the Law for this purpose as insiders.[162] It also required the company to compile reports of shareholdings and file with the SEC a report of the changes in the number of shares held by insiders during the preceding month by the fifteenth day of each month.[163] However, if an issuer failed to comply with these requirements, the SEL lacked any provision for sanctions.[164]

It is submitted that Article 25 served three functions. First, according to Article 197 of the Company Law (1929), a director will *ipso facto* be discharged from his office if he has transferred to others more than half of the shares which the company reported to the Department of Commerce (under the Ministry of Economic Affairs) and the SEC at the time he was elected. Thus Article 25 just repeats what the Company Law provides. Second, it provides a reference for calculating the profits made by insiders when the company claims disgorgement of such profits. Article 157 of the SEL copies the American Securities Exchange Act 1934, §16(b). For the purpose of preventing the unfair use of information which may have been obtained by insiders because of their relationships to the issuer, any profit realised by them from any purchase and sale or any sale and purchase, of any equity securities of such issuer within any period of less than six months, shall inure to and be recoverable by the issuer. Third, the Law sets a special procedure for these persons to transfer their securities. They cannot transfer their shares as they wish at any time; instead, before

---

[162] Article 25(1), SEL.

[163] Article 25(2), SEL.

[164] One point needs to be dealt with. In the Company Law, an issuer has obligations to file with the Department of Commerce (sub-institution of the Ministry of Economic Affairs) particulars of its managers' (Article 37), directors' (Article 197), and supervisors' (Article 227) shareholdings, but not those of major shareholders. According to Article 403, in case of any change in any of the particulars registered with the Department of Commerce, a company or a foreign company shall, within fifteen days after such change, file an application with the Department for registration of the change. If the shareholder or director designated to represent the company fails to comply with the time limit, such a shareholder or director shall be severally subject to a fine of not less than one thousand yuan but not more than five thousand yuan (Article 403(2)) (one yuan is equal to three NT dollars; the former is a unit solely for the purpose of measuring penalty, while the latter is a currency unit used in daily transactions).

the transaction, they must obtain the approval from or file with the SEC.[165] Thus, registration of their shareholdings will prevent them from evading the requirements.

What the 1988 amendment did was to increase the percentage of shareholders' shareholding from 5 to 10 and impose an obligation on insiders (as defined in Article 25) to report to the company the change of their shareholdings during the preceding month. At the same time a provision of punishment in case of non-compliance was added.

No specific reason was given for the amendment of the percentage from 5 to 10. Three possibilities could be reasonably advanced. First, it is aimed at making this provision compatible with the "Regulations on the Administration of Unit Trusts". Article 15(9) of the Regulations sets the maximum for investment made by such a trust in the listed company as 10 per cent of the total issued shares of that company. In other words, a trust can invest its funds in a listed company's shares provided that it does not exceed 10 per cent of that company's total issued shares. Under the original Article 157 of the SEL, however, as indicated above, any profit realised by directors, supervisors, managers, or major shareholders (those who held 5 per cent or more of the total issued shares) was to accrued to and be recoverable by the company. Thus, it would have to disgorge its profits to the company whenever became a 5 per cent shareholder and transactions on shares happened within six months. This would cause great inconvenience to a unit trust. Therefore, in the 1988 amendment, the legislature changed the definition of major shareholders in Article 157: from holders of 5 per cent issued shares to 10. At the same time, with regard to the obligation to file with the SEC the shareholding of major shareholders, in Article 25, the threshold was increased

[165] Article 22-2 provides that these persons cannot transfer their shares except by one of the following methods: 1. an offering to the public following an approval from or an effective registration with the SEC; 2. transfer three days following the registration with the SEC, on the stock exchange or on the over-the-counter market of the shares that have been possessed over a period specified by the SEC within a daily transfer "ration" prescribed by the SEC. This registration requirement does not apply to the transfer of less than 10,000 shares per exchange day; 3. to transfer, within three days following the registration with the SEC, by means of private placement to specific persons who meet the qualifications prescribed by the SEC.

to 10 per cent in accordance with the change. This amendment, stated otherwise, was aimed at harmonising the definition of major shareholders in law as a whole. It was not really necessary to amend the law in such a way; the legislature could have chosen to make an exception for unit trusts in Article 157 rather than change the definition of substantial shareholders.

The second possible reason for the amendment is that the government intended to reduce the range of substantial shareholders who might fall into the restriction. Thirdly, the amendment may simply have resulted from the fact that the percentage figure set by the American Securities Exchange Act 1934, §16, is 10 per cent; thus, Taiwanese law should follow it.

This small alteration has in reality revealed a problem which has always existed in the regulation of securities in Taiwan: neither the government, nor the legislature, nor even academics had ever reflected seriously on the real needs of the Taiwanese market. The lack of policy consideration and the insufficient legal analysis show that such a law (securities law) does not have its own roots in Taiwan. We are not opposed to quoting American law as reference; our dissatisfaction lies in a lack of a persuasive explanation concerning the importation of such an amendment by Taiwanese legislature and administrators.

Regarding the new obligation imposed on insiders to report to the issuer their shareholdings, this is for the purpose of mitigating a practical difficulty which had arisen before the amendment. The old provisions required the issuer to file with the SEC the changes of insiders' shareholdings monthly; however, the law did not impose the same requirement on insiders to report to the issuer monthly. Thus, it was difficult for an issuer to comply with the requirements if insiders did not give information about it. Under the new law, insiders are obliged to report to the issuer, and violation of this could result in a fine of not less than 20,000 yuan but no more than 100,000 yuan (one

yuan is equal to three NT dollars).[166] One problem remains: if an issuer is not informed by insiders and then does not file with the SEC, will the issuer be fined? According to Article 178, it seems that an issuer which does not file with the SEC will be fined along with those who fail to report to the issuer (e.g. insiders) regardless whether the issuer is informed or not. Nonetheless, theoretically, if the company is unaware of the changes because of absence of report from insiders, the company should not be fined in such a case.

2.3.4 Merit Regulation or Mandatory Disclosure?

After the foregoing analysis of the disclosure requirements, we can turn to the question: does securities legislation in Taiwan adopt merit regulation or mandatory disclosure? Mandatory disclosure in the context of disclosure means a compulsory disclosure obligation imposed by regulators on issuers and certain other persons. However, in the context of granting permission for a public offer, with which the present section of this thesis is concerned, it goes further by meaning that once the required information has been disclosed, no objection should be raised against the public offer of securities concerned. This latter definition is what meant by this section. Before the 1988 amendment, the government believed in merit regulation. The original Article 22(1) provided:

> "With the exception of government bonds and/or other securities exempted by the government, publicly offering and issuing of securities are prohibited without an approval from the Competent Authority (the SEC). Rules regulating the approval shall be prescribed by the Competent Authority."

It was obvious from this Article that the government adopted merit regulation. Merit regulation is a regulatory system that authorises state administrators to deny registration to securities unless: (1) the substantive terms of the offer and the associated transactions can ensure a fair relation between promoters and public investors; and (2) investors are fully informed. The SEC had the right to reject the

[166] Article 178, the SEL.

application even though all documents required had been supplied. The SEC, through promulgating the "Regulations on the Standard of Approval of the Application for Public Offers and Issues of Securities", could inspect and control the quality of securities and issuers.[167] By way of contrast, if a government adopts mandatory disclosure rather than merit regulation, whenever all information required has been fully disclosed by submitting the required documents, the SEC cannot reject the application unless the admission is detrimental to investors.

The amended Article 22(1) made a change to this system. It provides:

> "With the exception of government bonds and/or other securities exempted by the Ministry of Finance, publicly offering and issuing of securities are prohibited without the approval of or *effective registration with the Competent Authority (the SEC)*. Rules regulating the approval and registration procedures shall be prescribed by the Competent Authority." (emphasis added)

The words "effective registration with the Competent Authority" demonstrate that the government has substituted mandatory disclosure for merit regulation in circumstances which the government considers to be appropriate. For the purpose of complying with new Article 22(1), the SEC amended the above mentioned Regulations and altered their title to the "Regulations on the Administration of the Application for Public Offers and Issues of Securities" in 1988. According to the new Regulations, procedurally, if a company has submitted all required documents, the SEC will grant it

[167] For example, it required that if the total amount of issued shares is NT$300 million or less, the shares held by directors as a whole could not be less than 20 per cent of the total issued shares (Article 3); if a previous plan for increasing capital was not carried out according to the schedule and no reason justified this, the SEC may reject the application (Article 6); if the material contents of the plan for increasing capital for this time was not submitted for approval by the board of directors and the general meeting of shareholders, the SEC may reject the application (Article 6); under any of the following circumstances, a company is not allowed to issue corporate bonds: 1. where the company has committed any act in breach of contract, or has been in default of payment of principal and interest, in respect of previously issued corporate bonds or other debts, and such a state of things still exists; or 2. where the company's average annual net profit, after paying tax, of the three most recent years or, in case the company has been in operation for less than three years, of the years the company has been in operation, does not reach one hundred per cent of the total amount of interest payable on corporate bonds intended to be issued, provided, however, that corporate bonds that are issued under bank guarantee shall not be restrained (Article 4); etc.

a notice to the effect that the SEC has no objection to the public issue of the securities. This procedure is somewhat different from its counterpart in the USA. In the USA if, after the "waiting period", the SEC does not issue any "stop order", the application becomes effective automatically, whereas in Taiwan, companies still have to wait for the notice before the permission formally comes into effect.

There were two reasons for this amendment. First, the government appreciated that nowadays an increasing number of individuals engage in investment activities on the stock exchange, a fact which means that the government should no longer adopt a "paternalistic" approach to securities regulation. To use merit regulation to reduce the investment risk is not workable, because investors are more knowledgeable today, then the government has to leave investors to decide their investment portfolio provided that they are fully informed.

Second, many cases show that merit regulation cannot achieve its goal. Far from reducing the investment risk it rather gives investors the wrong impression that the securities being approved by the SEC are risk free. In effect, it is increasing the risk in certain situations. Thus, when a company becomes insolvent, the SEC may be criticised because it is deemed to have guaranteed the quality of the securities. The case of *Wan Yi Co. Ltd.*[168] demonstrated this well. The company applied to the SEC for permission to increase its capital by the public distribution of securities and received approval in 1982. Two months after the distribution of securities, it was revealed that the company's financial situation was precarious, thereby causing a slump in the price of the stocks, which finally resulted in the company's liquidation on ground of insolvency. Many investors suffered loss which they considered was attributable to the negligence of the SEC officers. They petition the Control Yuan to impeach the SEC officers. After this event, the SEC realised that under merit regulation, it may be

[168] See the Supreme Court, *74 nien tu t'ai shang tzu ti 7198 hao*, 27. 12. 1985.

condemned unreasonably by investors and decided to give up this method to some extent.

For the above reasons, the government resolved to shift partly from merit regulation to regulation of disclosure, and as a result mandatory disclosure is now firmly accepted in the Taiwanese legal framework which controls the public distribution of securities.

However, in examining the amended Regulations, companies may be disappointed. First, the Regulations only apply to very limited circumstances. Companies are not entitled to use such a procedure if they have incurred a loss in two consecutive years.[169] In addition, only those companies which have publicly distributed their shares previously and now wish to issue new shares or debentures are eligible to register in accordance with the new Regulations.[170] In the case of secondary distribution of securities, issuers may not be eligible to register in accordance with the new procedure unless the same kind of securities have been listed on the Stock Exchange or traded on the over-the-counter market.[171] Article 7 sets thirteen conditions under which the SEC can reject an application. These conditions, in fact, are the substantive conditions of shares,[172] and cannot be thought of as bearing the normal meaning of regulation of mandatory disclosure, as such an Article reflects the spirit of merit regulation rather than mandatory disclosure.

As a result, Taiwanese legislation so far has not substituted mandatory disclosure for merit regulation in substance. Nonetheless, the amendment has shown that the trend of merit regulation has begun to change; the substitution of mandatory disclosure for merit regulation in certain circumstances is predictable in the near future.

---

[169] Article 11 of the Regulations on the Administration of the Application for Public Offers and Issues of Securities.
[170] Articles 11, 23, id.
[171] Article 3, id.
[172] Article 7 of the Regulations, in fact, is the combination of Articles 4 and 6 of the old Regulations, which dealt with the substantial conditions of issuers and securities.

Chapter Three

The Justification of Disclosure, especially Mandatory Disclosure

The indispensability of disclosure in the context of public distribution of securities and continuous disclosure of publicly issuing companies is demonstrated by legal and economic arguments. However, the reasons which favour disclosure do not necessarily support a system of mandatory disclosure. Thus, this chapter begins with an examination of the rationales favouring disclosure in general. It then analyses the reasons for mandatory disclosure which have been hotly debated for several decades.

3.1 The Justification of Disclosure

3.1.1 Introduction

This section analyses the justification of disclosure[1] both on public offerings of securities and of publicly issuing companies from two points of view: (1) the protection of investors and (2) market efficiency. The justification for protecting investors rests on legal considerations.[2] Among those most frequently advanced are:

---

[1] Disclosure is said to have three functions: enforcement effect, public reaction, and the informative function. First, disclosure is an aid to the enforcement of laws against insider dealing. If insiders have to disclose their shareholding and transaction of securities, the law can deter them from making a profit out of their position; this is the enforcement effect of disclosure. The so-called "public reaction" is to make use of public pressure, which derives from disclosure, to prevent those who are responsible for disclosure from shirking their duties. For example, a company may decide to build a new factory in area B, but once this information leaks out, directors of the company may face pressure from the public to disclose more information about this plan, such as the possible occurrence of noise and pollution. The third function is the informative effect, i.e. the recipient may be able, by acting on his evaluation of disclosed information, to protect his personal interests without the necessity of altering the future conduct of persons responsible for disclosure. See Note, "Disclosure as a Legislative Device", in 76 *Harvard L. R.*, Vol. 2, 1273-93, 1963. What interests us most in this chapter is its informative function.

[2] See Richard C. Breeden, "Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation" (in 17 Fordham International L. J., S77, pp. S88-S90), in Joseph J. Norton, "Foreign Issuer Listings on U.S. Securities Exchanges", in *Z.B.B.*, 366-75, 1995, p. 370.

the prevention of fraud and the equal treatment of investors. Other important considerations are: the change of the nature of the modern company (that is, the separation of ownership and control) and the right of the public to know certain information.

Market efficiency is a general notion under which many different concepts fall. Among these are: informational, allocative, and operational efficiency.[3] For the purpose of allocative efficiency, the efficient operation of the market (or the efficient allocation of resources) depends on the public, as current or potential investors, being well-informed, and this in fact results from informational efficiency. Market efficiency (i.e. allocative efficiency in the context of this thesis) constantly emphasises the importance of disclosure. Such an argument is based on the assumption that people are rational maximisers of their ends in life and thus they are guided by what they conceive to be their self-interest; furthermore, people choose means reasonably designed to promote such ends.[4] Therefore, an *informed* investor (a rational person) will have an optimal investment portfolio, which in turn will definitely enhance efficiency of resources allocation in a capital market. It appears that to make investors informed bears direct connection with informational efficiency: the more efficient the dissemination of information is, the more information investors have and the more informed investors become.

Although the choice among voluntary disclosure, mandatory disclosure, or merit regulation is a matter of policy, a thorough evaluation of these options can be made. If a government appreciates the importance of informational efficiency to the capital

[3] Allocative efficiency means that capital resources are used in the most productive manner. Allocative efficiency results from informational efficiency. Operational efficiency means that the performance of the functions of the capital market is at lowest cost. See Christopher Paul Saari, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry", in 29 *Stanford L. R.*, 1031-76, 1977, p. 1031. Informational efficiency will be discussed at page 102.

[4] Richard A. Posner, *Economic Analysis of Law*, 4th ed., 1992, p.1. The reason for making this assumption is that the rational-behaviour model generally leads to a better ability to predict the behaviour of and describe the industry, the market, and the whole economy. See Merton H. Miller, "Debt and Taxes", in 32 *J. of Finance*, 261-75, 1977, p. 272.

market and believes that it cannot be achieved by voluntary disclosure, the government may opt for the regulation of mandatory disclosure. By way of contrast, a paternalistic government may prefer merit regulation.

The sections which follow start with an examination of the protection of investors and then market efficiency in the context of disclosure. It then continues with an examination of these perspectives in the context of mandatory disclosure.

3.1.2 The Protection of Investors

The Financial Services Act 1986 was built on the principle of the protection of investors. This can be seen from the titles of Gower's reports, the White Paper 1985,[5] and the parliamentary debates.[6] In fact, the protection of investors is a general concept comprising many different but related aspects, such as (1) to protect investors from being cheated and (2) to ensure every investor has equal information. These aspects are now considered.[7] We will then examine the change in the nature of the company and the public's right to know.

---

[5] L.C.B. Gower, *Review of Investor Protection, A Discussion Document*, 1982; Gower, *Review of Investor Protection, Report: Part I,* Cmnd. 9125, 1984; Part: II, 1985; DTI, *Financial Services in the United Kingdom, A new framework for investor protection (generally called the White Paper 1985),* Cmnd. 9432, 1985. At the beginning of these documents, investor protection is emphasised. For example, Gower mentioned that he was commissioned by the Secretary of State for Trade to consider the statutory protection now required by private and business investors in securities and other property. See 1.01 of the *Discussion Document.* He repeated this in his Report later in 1984, p. 1. *The White Paper 1985* reads: "In all developed countries proper regulation to protect the interests of investors is seen as a necessary element in the healthy development of financial services ... Our existing investor protection laws are outdated and incomplete. They need to be made more straightforward, more consistent, more comprehensive, and more suited to the present and future challenges facing the financial services industry." See p. 1.

[6] See *Parliamentary Debates, Commons*, Vol. 89, 1986, p. 939. At page 990, Mr. Anthony Nelson is quoted as saying: "Greater protection for investors is needed urgently".

[7] There is a characteristic common to all these reasons; that is, they justify the necessity of disclosure. "Disclosure of information is an essential part of the working of a free and fair economic system..." (see Company Law Reform, Cmnd 5391, 1973, p. 7, para. 10) In addition, Lord Shaughnessy argued: "I am one of those who believe wholeheartedly that the best protection of all is the requirement for prompt and complete disclosure of all material information in the most readily understandable form to guide the potential investor in his choice." *Parliamentary Debates, Lords*, Vol. 478, 1985-86, p. 628; see also Sir Adrian Cadbury, "Highlights of the Proposals of the Committee on Financial Aspects of Corporate Governance" in *Contemporary Issues in Corporate Governance*, D.D. Prentice and P.R.J. Holland (eds.), 1993, p. 47.

3.1.2.1 The Prevention of Fraud

One of the most important reasons for disclosure is the prevention of fraud. All commentators recognise that with disclosure the potential for deceit is limited; and therefore loss to investors is greatly reduced.[8] The era of the South Sea Bubble was a boom period, when the public distribution of securities was extremely popular; companies offered shares without providing subscribers with any important information, and the subscribers did not seek information from companies either. Thus, when the bubble burst, many investors were left with worthless shares. The concern during the next hundred years over constant occurrence of fraud scandals culminated in the enactment of the Joint Stock Companies Act 1844 which introduced the principle of disclosure as one of its main aims in the UK.[9]

This phenomenon of market scandal was not unique to the UK; it was also a common situation everywhere in the capital market such as in Taiwan and the USA.[10] The prevention of fraud is the goal of legislation in many fields of law, in particular, in legal systems committed to at least a minimum system of formal justice.[11] The reason why this concern is specifically emphasised in securities transactions may be attributed to its notoriously high rate of occurrence.[12] The genesis of law always reflects the expression of what is socially desirable, and the existence of disclosure laws is some

---

[8] See Donald C. Langevoort, "Fraud and Insider Trading in American Securities Regulation: Its Scope and Philosophy in a Global Marketplace", in 16 *Hastings International and Comparative L. R.*, 175-87, Winter, 1993, pp. 175-9.

[9] Before the 1844 legislation, there were several attempts made to bring companies into the regulatory regime; however, all these Acts (e.g. 1825, 1834, 1837) failed to contain adequate safeguards against fraud in the promotion or in the conduct of the business of these companies. See William Holdsworth, *A History of English Law*, Vol. 15, 1965, pp. 45 et seq.

[10] See Louis Loss, *Fundamentals of Securities Regulation*, 1988, chapter 1.

[11] See, e.g., F.A. Hayek, *Law, Legislation, and Liberty*, Vol. II, 1982, pp. 31, 73.

[12] See Colin Chapman, *How the Stock Markets Work*, 5th ed., 1994, pp. 155-60; Robert C. Clark, *Corporate Law*, 1986, pp. 719-20.

evidence that society needs more information:[13] the lack of information being a reason for the occurrence of fraud.[14]

The concept of the prevention of fraud can be observed from two perspectives in the context of provision of information: the passive side and the active side. That is, anti-fraud law, as a general rule, reduces the potential for deceit but does not give rise to an obligation of full disclosure (the passive side). Nonetheless, given the specific characteristic of securities transactions, anti-fraud law should discharge its function by imposing certain obligations of disclosure (the active side).[15]

First, adopting the language of a well-known model for the marketing of products of varying quality, anti-fraud provisions can only passively abolish "lemons"[16] and save costs for those who wish honestly to disclose information.[17] As a general rule, if investors can distinguish the "better" securities from other securities, they will prefer to buy the better ones. To enable investors to make such a judgment, sufficient information about securities is indispensable. In other words, investors may appreciate the value of the better "securities" provided that information is available. When information is not available, lemons will dominate the market. The reason for this is that in the circumstances where every investor feels his way towards investment

---

[13] "I suppose it is fair to say that one or two scandals which affected relatively few people but received much publicity acted as the trigger. Following the rightly praised report of Professor Gower and the stock exchange agreement, to which reference has been made, it became clear that something approaching a revolution in the provision of financial services was on the horizon. Thus, the combination of isolated but serious scandals, a major change in the City's activities and the era of consumer protection has led to the requirement for legislative change, the manifestation of which is before us in the shape of the Bill (the FSA)." See supra note 6, p. 998 speech of Mr. Robert McCrindle. "...there must be greater emphasis on a complete and full disclosure of all the facets of a trade or bargain...", id., p. 1003 (Mr. John Browne). See also Ann Judith Gellis, "Mandatory Disclosure for Municipal Securities: A Reevaluation", in 36 *Buffalo L. R.* 15-73, 1987, p. 40.

[14] See *Parliamentary Debates, Commons,* id. p. 992.

[15] The same point of view is advanced by Milton H. Cohen in his "Regulation Through Disclosure", in *J. of Acct.*, Dec. 1981, 52-62, at p. 52.

[16] Lemons are something unsatisfactory or worthless; for the sake of convenience here, "lemons" directly refer to sellers of unsatisfactory products who cheat by means of providing incorrect information rather than to the products themselves.

[17] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law*, 1991, p. 280.

judgments, better securities can be sold only at the same prices as those of inferior securities lacking the availability of any information.[18] Put another way, if better securities are unable to persuade investors of their superior quality, they cannot be sold at higher prices than those of inferior securities. Finally the bad drives the good out of the market.

In this case, providers of "better" securities will try to provide investors with more information to prove the quality of those securities. Consequently, more costs are incurred. However, lemons can still mimic them and disclose wrong information to deceive investors; therefore, either the good ends up spending even more money to show the quality of the security, or the good cannot survive in the competition. In such a situation, anti-fraud provisions, with the help of the deterrent force of penalties, can deter lemons from fraudulent disclosure and then save the costs of good providers.

Second, the concept of anti-fraud can actively support the importance of disclosure. The present prohibition of fraud by law can only passively prevent some people from cheating others; it does not require providers of information to disclose material information needed by investors. Besides that, looking into the substantive meaning of "fraud" shows that people are "cheated" to some extent when they cannot make an informed judgment of investments. This results from an important characteristic of securities transactions, namely, the evaluation of securities is extremely dependent on the provision of information. Clearly, one obvious function of disclosure is to help investors to assess the merits of securities, which, in turn, prevents them from being deceived.

---

[18] See George A. Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism", in 84 *Quarterly J. of Economics*, 488-500, 1970, p. 489.

3.1.2.2 Equally Informing the Investors

The previous section is concerned with the relationship between issuers of securities and investors, while the focus here lies on the relationship among investors. That is, investors should be treated equally.

Here it is appropriate to borrow from American experience to explain the relationship between disclosure and provision for equal information to investors. The SEC has implicitly based its regulations on a model of the informed layman making investment decisions in a market populated by equally informed investors. Thus, the SEC assumes that each investor should have equal information in promulgating regulations which protect them. Disclosure of information and the regulation of insider trading are relied upon by the SEC as two vehicles in pursuit of this goal.[19]

Hence, the SEC attempts to protect investors by providing them all with the same information; this is known as market egalitarianism.[20] According to such a premise, only adequate and immediate disclosure of information can reduce the premium, which would be made by those who are the first to know information. Of course, the prohibition on insider dealing is indispensable for eliminating the remaining opportunity of unfair gain.

Equal treatment of investors is not unfamiliar to the UK. The most important principle of the City Code on Takeovers and Mergers is to ensure fair and equal treatment of all shareholders in relation to take-overs.[21] This shows that equal

[19] See Saari, supra note 3, pp. 1032-3. This is supported by the legislative history of the 1933 Securities Act: "The purpose ... is to place the buyer [of securities] on the same plane so far as available information is concerned, with the seller." 77 *Cong. Rec.* 2918 (1933).

[20] Louis Loss, "The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States", in 33 *M. L. R.*, 34-52, 1970, p. 35.

[21] See the Introduction (a) of the City Code. The City Code on Takeovers and Mergers is issued by the Panel on Takeovers and Mergers. This Panel is not a statutory body and therefore, has the advantage of informality, approachability and lack of bureaucracy, but it has no power to impose punishment. The Code, although not having the force of law, is very persuasive because of several reasons. Among

treatment is one way of protecting investors. The Panel has several methods to achieve such a purpose.[22] Disclosure is one of them: the Code provides that shareholders must be given sufficient information and advice to enable them to reach a properly informed decision. Moreover, information about companies involved in an offer must be made equally available to all shareholders as nearly as possible at the same time and in the same manner.[23] This indicates that the UK also employs disclosure policies to protect investors.

3.1.2.3 The Change of the Nature of the Company

The rise of the modern company resulted in the separation of corporate ownership and control. When the ownership and control rested upon the same group of people, shareholders or members, members naturally gained access to corporate information.

Once this relationship was broken, however, it became necessary to adapt legal regulations to the new corporate structure. This necessity has become important as corporate securities have become popularly dispersed among many investors. If a shareholder is not automatically entitled to take part in running the company; that is, he or she has no direct control over the investment, in what circumstances will the

---

these, some examples are given: (1) Any company listed on the London Stock Exchange which does not comply with the Code can have its listing suspended or withdrawn; (2) The London Stock Exchange may, at the request of the Panel, withdraw temporarily the facilities of the market from an offender; (3) An authorised person under the Financial Services Act 1986 who breaches or fails to comply with the Code in certain respects can be called to account by his SRO (self-regulating organisation) and RPB (recognised professional body) and may, in extreme cases, have his membership withdrawn. See Graham Stedman, *Takeovers*, 1993, pp. 58-9. Moreover, in *Re Chez Nico (Restaurants) Ltd.* ([1992] B.C.L.C. 192), the court held that failure to comply with the Code may lead the court to make an order under the Companies Act 1985, s. 430C, either preventing the offeror from acquiring compulsorily the holdings of non-assenting shareholders under s. 429 of the Act or specifying terms of acquisition different from those of the offer.

[22] For example, the Code provides an orderly framework within which take-overs are conducted, such as setting out the responsibilities of the offeror and offeree company (Rule 2), timing restrictions on acquisition (Rule 30), etc.

[23] See General Principle 4, and Rules 3 (the board of the offeree company must provide shareholders with independent advice on the offer), 19 (the information given must be adequately and fairly presented), 25 (the board of the offeree company must circulate its views on the offer, including any alternative offers), and 20 (deals with the problem of equality of information to shareholders).

shareholder still wish to maintain the investment? The answer may be two-fold: first, when the shareholder knows the corporate financial situation and business operation, and second, when he or she has some way to control those who manage the business. The former part of the answer apparently relates to the problem of disclosure.

Stated otherwise, disclosure in such a case has been almost universally regarded as indispensable to shareholders.[24] The availability of information helps shareholders in two ways: in exercising their voting rights (shareholders need information to back up decisions) and in opting out when necessary (i.e. to sell securities in the open market, information is the basis of appraising securities market value). From the point of view of a company and its directors, disclosure can help the company solicit capital from the public and strengthen the position of directors, because investors will be willing to invest in an enterprise where they know its financial situation and business operations. They will also be inclined to support those directors who honestly and fully report to them. From the shareholders' point of view, since they are deprived of management rights, theoretically they will strongly demand that the company at the very least let them know the corporate situation. Disclosure thus satisfies the desire of the shareholders.

Thus, the evolution of the nature of the company leads the company and its directors to consider the necessity of disclosure to some degree. Of course, there are some other reasons which will hamper directors from disclosure, and this is left to the section below.[25]

---

[24] See Russell B. Stevenson, Jr., *Corporations and Information: Secrecy, Access, and Disclosure,* 1980, p. 92.
[25] See infra Chapter Four.

3.1.2.4 The Right to Know

The right to know essentially relates to the question: why should the public have corporate information?[26] The answer can be approached from two perspectives: the needs of potential public investors and the needs of the general public. First, as regards potential public investors, this right may be deemed to derive from the extension of the reasoning advanced in the above section (the change of the nature of the company). That is, in a modern company in which corporate securities are transferred from one person to another quickly, potential investors' needs to obtain information might be considered by the company and its directors in the sense that to provide the public with information may encourage them to buy the company's securities. Moreover, on a capital market, where hundreds of thousands of securities are traded, investors, even though they are not securities holders of a company, still need that company's information to decide whether or not to acquire its securities. This helps the market to become efficient and also justifies the public having the right to know.

Second, the separation of ownership and control, as indicated earlier, entails a change in the nature of the company. This change is further examined in this section. One of the more recent reforms in the nature of the public company is the separation of ownership and function of capital.[27] In the nineteenth century, all power in the company was to reside with the general meeting of shareholders; the philosophy underlying this was centred around the power/risk relationship. The persons who risked their capital should own the right of control and could possibly guarantee the proper running of the enterprise.[28] However, continental European legislation, starting with the German law of 1937, formally repudiated the nineteenth century principle of

---

[26] For example, the corporate financial situation, the business report, directors' and big shareholders' shareholdings, etc.

[27] See Francisco Galgano, "The Allocation of Power and the Public Company in Europe", *in European Company Laws, A Comparative Approach*, Robert R. Drury and Peter G. Xuereb (eds.), 1991, p. 89.

[28] Id.

general meeting sovereignty and the authority of the general meeting was downgraded.[29]

The outcome of this reform is that in some countries, directors are not obliged to take the shareholders' interests as the only concern when they make a business judgment since the interests of other groups such as employees and the public must also be considered. It is contended that a company has its own social function for which it should be liable to the public as well.[30]

Following this, it may be supposed that the public has the right to have a reasonable awareness of the company, because a decision of a company not only affects the interests of its shareholders, but also affects the public from time to time. For example, if a company declares that it will build a chemical factory in area A, the life of the residents in area A will be changed. They fear that they may suffer air or water pollution, and in some measure, the interests of this group should be part of the interests of the company. Therefore, the public should be allowed to enjoy the right to knowledge of the plan and operations. Disclosure of planning details and other relevant information, through the publication of prospectuses, listing particulars, and interim

---

[29] Id., p. 87. This was triggered both by the dispersal of shareholding and the change of ideology. When a public company's shares are widely spread and no shareholders are the majority in the sense of control, management would become increasingly independent of the dictation of the general meeting. This results in the question of for whose benefit the company was managed. See Adolf A. Berle, Jr. and Gardiner C. Means, *The Modern Corporation and Private Property*, revised ed., 1968, pp. 66 et seq. As regards the change of thinking, see infra notes 30 and 181.

[30] Berle and Means characterised such evolution: "Observable throughout the world, and in varying degrees of intensity, is this insistence that power in economic organization shall be subjected to the same tests of public benefit which have been applied in their turn to power otherwise located. In its extreme aspect this is exhibited in the communist movement, which in its purest form is an insistence that *all* of the powers and privileges of property, shall be used only in the common interest. In less extreme forms of socialist dogma, transfer of economic powers to the state for public service is demanded. In the strictly capitalist countries, and particularly in time of depression, demands are constantly put forward that the men controlling the great economic organisms be made to accept responsibility for the well-being of those who are subject to the organization, whether workers, investors, or consumers." Id., p. 310. Noticeably, the UK still insists that a company is "regarded as the property of its shareholders and the board of directors is under a duty to act in whatever way it considers to be in the best interests of the 'owner' ... Wider interests, such as those of the community in which the company operates or of the country as a whole, may not be taken into account." See *Trade and Industry Committee First Report, Takeovers and Mergers*, House of Commons, Session 1991-92, 27 Nov. 1991, para. 9.

reports by issuing companies, will thus provide the public with certain information that they may need; i.e. the form of corporate disclosure may be extended that it would have a socially desirable result.

3.1.3 The Improvement of Capital Market Efficiency

The history of the successive American securities acts of the 1930's indicates that one purpose of the legislation was to improve the economic functioning of the capital market to achieve better resources allocation.[31] Allocative efficiency is also a concern in the UK[32] and Taiwan. Two elements are emphasised for the achievement of the efficient capital market — (1) public confidence in the capital market and (2) the full flow of information grounded on the efficient capital market hypothesis.

3.1.3.1 Public Confidence in the Securities Market

In the parliamentary debates of January 1986, the Secretary of State for Trade and Industry stated:

> "[I]t is our responsibility to ensure that those people can have confidence in the good practice and honesty of those who do business in the City. That confidence is all the more important with the increasing competition between the financial centres of the world."[33]

Investors will lose confidence in a capital market if there is insufficient protection. The confidence of investors is an important and intangible element (or psychological element) of an efficient market. Investors, especially small and unsophisticated ones,

---

[31] "[S]ignificant ... is the wastage that this irresponsible selling of securities has caused to the industry ... [I]nvestment bankers with no regard for the efficient functioning of industry forced corporations to accept new capital for expansion purposes in order that new securities might be issued for public consumption. ... Whatever may be the full catalogue of the forces that brought to pass the present depression, not least among these has been the wanton misdirection of the capital resources of the Nation." *H. R. Rep. No. 85, 73d Cong., 1st Sess.* 2-3 (1933), *in Saari, supra* note 3, p. 1032.

[32] *Parliamentary Debates, Lords*, Vol. 478, 1985-86, July 7-18, p. 601. Viscount Chandos stated: "The role of the financial markets is to provide a safe and fruitful vehicle for individual savers and all other investors on the one hand, and on the other hand, to be an *efficient and resourceful supplier* of capital to productive enterprises and the Government themselves..." (emphasis added)

[33] *Parliamentary Debates, Commons*, Vol. 89, 1986, p. 938.

will either withdraw their capital to the detriment of the market and the economy as a whole when they fear that they may be exploited by better-informed traders,[34] or react to information unreasonably and inefficiently, because they might doubt the accuracy of the information. Where investors react unreasonably and inefficiently to information, stock prices become distorted. Thus greater market distortion occurs and market efficiency cannot be achieved. The best way to secure investors' confidence is to create a transparent market, where investors obtain information they need and appreciate that no secret profit is made. In other words, prompt and complete disclosure can be of assistance here.

3.1.3.2 The Efficient Capital Market Hypothesis

The importance of information to the operation of efficient markets is fairly well accepted because "informed" investors are essential to the fair and efficient functioning of a free market economy.[35] Thus, the importance of disclosure is further justified from the point of view of the Efficient Capital Market Hypothesis (the ECMH),[36] which was first propounded by economists, also being accepted later by some legal scholars, legislators, and administrators. The tenor of the ECMH is that a market is efficient if prices fully reflect all available information[37] and accordingly, accurate stock prices are formed.[38] Therefore, the quantity of information available to a market affects the

---

[34] See Easterbrook and Fischel, supra note 17, p. 296; see also John M. Fedders and L. Glenn Perry, "Policing Financial Disclosure Fraud: The SEC's Top Priority", in *J. of Acct.*, July 1984, 58-64, p. 63.

[35] See Howard Beales, Richard Craswell, and Steven C. Salop, "The Efficient Regulation of Consumer Information", in 24 *J. of Law and Economics*, 491-539, 1981, p. 492. Here we substitute "investors" for "consumers" which were used in the article cited. The reason for this substitution is that investors are also consumers, consumers of financial services. "Given that investment represents deferred consumption, it is tempting to see investor protection as the other side of the coin from consumer protection." See A.C. Page and R.B. Ferguson, *Investor Protection*, 1992, p. 14.

[36] Benoit Mandelbrot, "Forecasts of Future Prices, Unbiased Markets, and "Martingale" Models", in *39 J. of Bus.*, 242-55, 1966.

[37] See Jonathan R. Macey, *An Introduction to Modern Financial Theory*, 1991, p. 36. The meaning of full reflection is that prices must behave "as if everyone knows". This explanation entails two equilibria: a. the equilibrium that would result if everyone knows the information; b. the equilibrium that is actually observed, and a = b.

[38] Prices adjust rapidly and without bias to new information, and prices move randomly: these are two main characteristics of the ECMH. See Roger J. Dennis, "Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix", in 25 *William and Mary L. R.*, 373-419, 1984, pp. 374-5.

relative efficiency of the market, i.e. a market with more information gives rise to a more efficient operation in the market.

The ECMH derived from the so-called "random walk theory" (which gained its popularity for the first time in 1953 by the paper of Maurice Kendall in the Royal Statistical Society). In fact, fifty-three years earlier, a Frenchman, Louis Bachelier, had proposed this theory in his doctoral thesis.[39] Several more comprehensive statistical studies of the random walk theory were conducted later.[40] According to this theory, the future price movement of a security could not be predicted by analysing its historical price movements (the cycle) and the successive movements of individual security prices were apparently patternless. The reason for this was that random price movements were shown to be consistent with prices that fully reflected information.[41] Accordingly, the random characteristic of stock price movements are predicated on two observations: (1) the movements of stock prices entirely depend on information and (2) the occurrence of such information is unpredictable.

The random walk theory, however, did not deal with the question what **kind** of information is **reflected** in prices. Instead, the further developed theory, the ECMH, especially the classification suggested by Fama, provided an answer to this question. Fama defined three levels of market efficiency: the weak, the semi-strong, and the strong versions. The first is the case where prices reflect all information contained in historical prices, a weak form of efficiency. The second of these is that prices reflect not only past information but also other published information, a semi-strong form of efficiency. The third is the case in which prices reflect not just public information but all the information that can be acquired by painstaking fundamental analysis of the company, the economy and all unpublished information. This is a strong form of

[39] See Richard A Brealey and Stewart C. Myers, *Principles of Corporate Finance*, 5th ed., 1996, p. 326.
[40] Eugene Fama, "The Behavior of Stock-Market Prices", in 38 *J. of Bus.*, 34-105, 1965, see Christopher P. Saari, supra note 3, p. 1042, footnote 50.
[41] Benoit Mandelbrot, supra note 36.

efficiency.[42] As regards the strong form of efficiency, it is very difficult for the market to reach such an efficient level. If all the information, including inside information, is rapidly reflected in stock prices, insiders can hardly make any extra profits out of their superior knowledge and there is thus no necessity for the government to regulate insider dealing.[43]

Therefore, from a practical point of view, for the purpose of examining the justification of disclosure, this thesis takes into account only the weak and semi-strong forms of efficiency. A market may be weak efficient or semi-strong efficient; ideally, the semi-strong form is preferred, because it is a higher level of efficiency and is possible to be achieved. If the semi-strong form of efficiency is aimed at; that is, securities prices fully reflect not only historical prices but also other published information, the more information that is published, the more efficient the market will be. Disclosure of information is thus to be welcomed in this sense.

Finally, to clarify the concept of efficiency will make this argument more comprehensive. Efficiency connotes a spectrum in which there exist different degrees of efficiency. As a result, when efficiency is referred to in this thesis, we do not bear an exact degree of it in mind; rather, it is an improved degree of efficiency, more advanced in the spectrum towards an ideal maximum. Up to this point, the justification of disclosure by analysing the ECMH is affirmed. Since the ultimate purpose of disclosure is to allocate resources efficiently by securing "correct" securities prices in capital markets, information is indispensable in the process of allocating resources and the ECMH demonstrates such a causal relationship. The ECMH assumes that a market

---

[42] Eugene Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work", in 25 *J. of Fin.*, 383-417, 1970. In fact, the same idea had been invoked by Harry Roberts, "Statistical Versus Clinical Prediction of the Stock Market", unpublished paper presented to the Seminar on the Analysis of Security Prices, University of Chicago, May 1967. See Brealey and Myers, supra note 39, pp. 329-31.

[43] In fact, in these days, it is still popularly held that insiders can make more earnings than outsiders on the stock market. That is, a strong form of efficiency has not happened yet. See J.F. Jaffe, "Special Information and Insider Trading", in 47 *J. of Bus.*, 410-28, 1974; Stephen H. Penman, "Insider Trading and the Dissemination of Firms' Forecast Information", in 55 *J. of Bus.* 479-503, 1979.

is efficient if prices fully reflect all available information, or in other words, information fully reflected in securities prices will result in an efficient capital market; by inference, the flow of information is the premise of such a statement which justifies disclosure in the sense that disclosure brings more information to the market.

Some examples may be given which illustrate this causal relationship between information and resource allocation. Investors, who do not have enough information to judge the risk and return of an investment, will seek a premium to balance the unknown risk. By inference, the unknown will increase an investor's feeling of risks. Where investors are risk neutral, then the expected return from a high risk investment will be equal to that on government securities or blue-chip firms which bear very little or even zero risk.[44] On the contrary, the return will have to include the further premium under the assumption of investors being risk-averse. Assuming that people are rational and maximise their benefits, investors should be risk-averse in the light of the risk-premium relationship.[45]

Because individuals are risk-averse, the greater the risk, the higher the premium that can be expected;[46] the greater risk includes the situation where the lack of information prevents a full evaluation of risk. This reasoning suggests that non-disclosure increases the costs of capital solicitation and reduces market efficiency.[47]

---

[44] See Julian Franks and Colin Mayer, *Risk, Regulation, and Investor Protection*: *The Case of Investment Management*, 1989, p. 133. See also Walter A. Morton, "Institutional Aspects of Savings and Investment: The Structure of the Capital Market and the Price of Money", in 44 *American Economic R.*, 440-54, 1954.

[45] Franks and Mayer, id.

[46] Professor Posner argues that all incremental changes in risk result in differentials in interest rates or prices. See "The Legal Rights of Creditors of Affiliated Corporations: An Economic Approach", in 43 *U. of Chicago L. R.*, 499-526, 1976.

[47] First, operational costs are increased and operational efficiency is reduced. Second, the increased costs may distort the allocation of resources. When a company faces the problem of corporate finance, it has to decide its capital structure, that is, by equity or by debt, because the choice of the capital structure is based on the cost problem (in other words, the asymmetric information problem). There is an optimal debt/equity ratio where the company can save most money. The capital structure affects corporate managers' investment decisions to some extent. They may decide not to take a project which is promising in a long term, because they need quick returns to meet the interest payment of the debts. Thus, the choice of investments is not based on the long term maximisation of corporate profits, but

Company law is not expected to minimise the risk; investors' interest lies rather in forming an accurate assessment of the risk, which presents the problem of information. By implication, information is vital.

The other example is that the value of securities will be misjudged because of non-disclosure; this affects the optimal allocation of resources. In a world of risk and perfect information,[48] investors are certain about corporate financial situations (including the risks attached to it). Therefore, the valuation of classes of securities is relatively straightforward. By way of contrast, when information on financial situations is imperfect, the uncertainty attached to the earnings may be greater. In such conditions, investors may undervalue or overvalue certain classes of securities.[49] In an efficient market, this is not expected to occur.

However, whether market efficiency can be attained in fact directly relates to efficiency of an information market because an information market determines the breadth of initial distribution of information to a capital market. If the distribution of information is broad and fast, market efficiency can be easily achieved. Nonetheless, the initial distribution of information is dependent on distributional costs. Therefore, "from the perspective of the capital market, market efficiency is a function of the initial distribution of information among traders; from the perspective of the information market, market efficiency is a function of the costs associated with particular information. The common factor is information costs."[50] The problem of costs of information relates to the problem of institutional choice; that is, the question remains whether the government should leave the market to function by its own regulation or

---

are affected by some other considerations, which partly derive from the corporate structure, and that in turn is partly related to the problem of costs.

[48] Perfect information means that everyone can equally obtain information fully and promptly .

[49] See George G. Triantis, "Secured Debt under Conditions of Imperfect Information", in 21 *J. of Legal Studies*, 225-58, 1992, p. 229.

[50] See Ronald K. Gilson and Reinier H. Kraakman, "The Mechanisms of Market Efficiency", in 70 *Virginia L. R.*, 549-644, 1984, p. 597.

whether the government should intervene in the market. These questions will be dealt with below.

3.1.4 Governmental Policy

In developing countries such as Taiwan, the government faces a choice of policy whether to regulate the market. This problem can be described from two perspectives. First, the state must have appreciated the importance of the capital market.[51] Second, once the importance of the capital market has been recognised, if the state intends to be internationally competitive in the capital market, the adoption of mandatory disclosure as part of a trend of internationalisation and deregulation cannot be ignored. This in itself may require the adoption of disclosure.

3.1.4.1 The Importance of the Capital Market

(1) definition

The financial market is made up of two parts, the money market and the capital market. The crucial difference between them concerns the time span. The money market is the market for short or medium term borrowing. In contrast, the capital market deals with what economists refer to as long-term "credits"; the definition of "long-term" is a time period which lasts over one year.[52] The breadth of the capital market may vary. Typically, it refers to the securities market only, but now-a-days, when the government is concerned with the regulation of the capital market, it always takes into account the financial institutions (e.g. investment banks, brokers, and market makers) which become involved in securities transactions.[53]

---

[51] The Chinese government (mainland China) may in the near future promulgate a Securities Law as it has appreciated that capital is an element of constructing a "socialist market economy". See Central Daily News, 28.11.1995, p. 4.

[52] See U Tun Wai, *Economic Essays on Developing Countries*, 1980, p. 292

[53] See Robert Burgess, *Corporate Finance Law*, 1992, p. 5.

(2) evaluating the social utility of the capital market

The capital market in reality belongs in the category of services based on the above definition. The traditional thinking still maintains the belief that the production of services is less important than the production of tangible goods, such as manufactures "which can be seen, touched and counted".[54] However, statistics help to overturn such traditional belief. In 1960, the proportions of manufacturing and services to gross domestic product (GDP) in developed countries were 40% and 54%, respectively. By 1986, these proportions had changed to 36% and 61%. Developing countries also have experienced similar changes, with services accounting for 48% of GDP in 1986, up 8% on their share in 1960.[55] In Taiwan, the proportion of services to GDP has exceeded 60% since 1995.[56] This situation caused Albert Bressand to predict that the role of financial markets in the early twenty-first century will be significant.[57]

Two phenomena support his view. First, today's markets allow for an unprecedented combination of expertise around integrated packages of goods and services.[58] For instance, buying a car is not only the exchange of a car for payment. It often relates to insurance services, travelling packages, post transaction maintenance provision, and so forth. If the payment is a money order or a mortgage arrangement, then it needs the additional services of financial institutions. Hence, process and product innovation often cut across the traditionally defined "financial/real" border line.[59] Moreover, modern economies are now information-intensive. Because of the

[54] See Robert Sedgwick, *The Changing Structure of the UK Financial System*, 1990, p. 1.
[55] See Phedon Nicolaides, "Globalisation of Services and Developing Countries", in *International Economics and Financial Markets*, Richard O'Brien and Tapan Datta (eds.), 1989, p. 161.
[56] In the last decade, services production has increased dramatically; from 1985 to 1995, it increased 12.3% (from 47.9% to 60.2%). In contrast, the production of industry has dropped from 46.3% to 36.3%. See *Economic Daily News*, 4.4.1996.
[57] See Albert Bressand, "Wealth Creation and the Role of Financial Markets in the Early Twenty-First Century", in *Finance and the International Economy,* John Calverley and Richard O'Brien (eds.), 1987.
[58] Id., p. 36.
[59] Id., p. 37.

advance of technology, the electronic network weighs increasingly in commercial activities. This will result in the creation of a large amount of information which is most easily obtained from financial markets. These developments further demonstrate the increasing importance of financial markets and also of the flow of information.

Narrowing the focus to the stock market, other evidence can be found which supports this view of the financial market. The Taiwanese stock market provides a good illustration. The total stock exchange tax paid by investors when each transaction is executed amounts to nearly 10% of the government income in Taiwan; in particular, in the fiscal year 1990, it came to over 12%.[60] Also, the yearly turnover of stock exchange transactions was so large[61] that it affected a significant percentage of families and indirectly influenced the success rate of the government in political elections. It also caused a great "financial storm" which forced the government to strengthen its control over the so-called "underground investment companies".[62] During the "crazy" period,[63] the stock exchange index of Taiwan rose from around 3,000 points to more than 12,000. All the above aspects clearly demonstrate that financial services are not less important than manufacturing and that they are worth studying in depth.

---

[60] In 1990 (fiscal year), the stock exchange tax income was NT dollar 106,727,238,000 (the foreign exchange rate of sterling pound to NT dollar is 1: 40) and the revenues of taxes for the whole country was NT dollar 847,733,398,000. See Department of Statistics, Ministry of Finance, The Republic of China, *Monthly Statistics of Financial* (Oct. 1991), p. 72.

[61] The trading value in 1989 is NT dollar 25,673,676,333,000, but it fell down to NT dollar 9,682,730,000,000 in 1991. See SEC, Ministry of Finance, R.O.C., *1989 SEC Statistics*, p. 2, and *1991 SEC Statistic*, p. 2.

[62] Running an investment business in Taiwan needs authorisation by the competent authority. Collecting deposits, in principle, can be done only by banks and other special financial institutions. During the period from 1988 to 1990, there was a company called Hon Yuan which illegally attracted a lot of savings and invested them in the stock market to create a bull market. At the beginning, it had a very high return ratio so that it paid its creditors extremely high interests, that is, 20% or ever higher. But after the crash of the market, it was insolvent and most of the creditors could not receive their principal. The reason why this event could cause a great financial storm is that the size of the stock market is very small and is easily manipulated.

[63] From 1988 to 1991, the stock exchange index rose from 2,341.06 (January 5, 1988) to 12,495.34 (February 10, 1991). See *1988-91 SEC Statistics*. In Taiwan it was referred to as "crazy" because the growth of the stock market was out of proportion to the economic growth and earnings of the listing companies.

(3) the function of the capital market

From the point of view of economic development, economic growth depends largely on investments. It is elementary that holders of surplus units wish to earn a return on their property; consequently, individuals with some savings invest, which allows for accumulated savings, and this promotes additional investment, and so the cycle continues. Financial markets play an important role in economic development by facilitating the collection of savings and by channelling funds to companies and other investment institutions. In addition, the benefits earned from investment encourages more savings and thus constitutes this "virtuous circle". The public distribution of securities in the capital market is the best example of this.

The history of the stock market in the UK demonstrates the importance of the capital market in securities transactions[64] and the Taiwan stock market plays the same role as its UK counterpart. In the early 1950's, learning from the experience of losing the whole of mainland China, the KMT (the ruling party) government decided to redistribute agricultural land among landlords and tenants, following the principle that whoever cultivates the land should own it (the Land-to-the-Tiller policy). To compensate former landowners, the government privatised four companies managed and owned by Taiwan Province and issued shares to the landowners.[65] Because of the traditional view that only tangible assets were worth holding many holders of these securities tried to cash them, which resulted in the creation of a trading market. To control these transactions, taking place for the first time in 1954, the government

---

[64] In the UK, not until the beginning of the nineteenth century was there a formal constitution and a stock market building. The end of the eighteenth century was the time that suitable securities were provided, which was attributable to the formation of joint-stock companies and the beginning of the permanent National Debt. In particular, the great amount of national debts strongly demanded a market where these securities could be traded. After that, the preconditions for the birth of the stock market, such as a considerable volume of securities, a widely-distributed ownership, and the ability to conveniently transfer the title of securities, were progressively fulfilled. See E. Victor Morgan and W.A. Thomas, *The Stock Exchange: Its History and Function*, 1969, pp. 11, 18-9.

[65] The securities offered amounted to $NT2.2 billion. See Rowley, Asian Stockmarkets, 100, in Brian Wallace Semkow, *Taiwan's Capital Market Reform*, 1994, p. 155, footnote 4.

promulgated the "Regulations for the Administration of Securities Brokers in Taiwan",[66] which was replaced in 1961 by the "Regulations for the Administration of Securities Brokers". However, there was no "Stock Exchange" at that time.

In 1962, the government established the Taiwan Stock Exchange. As mentioned above, to control the informal over-the-counter trading which was caused by the land redistribution policy, Taiwan had an embryonic regulation for brokers to ensure fair dealing. However, the rapid increase in private savings looking for more opportunities for investments and the take-off of industries which were short of capital urgently called for a "situs" which could fulfil both their demands. To deal with these needs, the government declared that "...to enhance capital formation and accelerate economic development, the second item of the '19 Items of the Financial and Economic Reformation' is to arrange for the establishment of the stock exchange market..."[67]

Statistics published by the UN supply further proof of the importance of the capital market. These statistics show the size and structure of world financial markets in 1982 and 1988.[68] The combined size of world financial markets can be estimated at over $13,000 and $36,000 billion in 1982 and 1988, respectively. In 1982, capital markets only accounted for 35.9% of the total assets, but increased massively later, thus becoming over half of the total assets in 1988.[69] At this point, the importance of the capital market to the economy and the individual company[70] is self-evident.[71]

---

[66] See SEC (Taiwan), *The Introduction to the Securities and Exchange Commission*, 1991, p. 1. The first four privatised companies were Taiwan Cement, Taiwan Paper, Taiwan Industry & Mining, and Taiwan Tea Corp.

[67] See SEC (Taiwan), *The Review and Prospect of the Securities Administration*, 1991, pp. 3-5.

[68] See United Nations, *Trade and Development Report*, 1990, Report by the secretariat of the United Nations Conference on Trade and Development, p. 109.

[69] Id.

[70] The major place where companies solicit their capital is the capital market. If a country has a well developed capital market, it is an advantage from this point of view.

[71] Stock markets accounted for 11.5% and 26.2% of total assets in 1982 and 1988, i.e. in 1988, stock markets contributed to capital markets greatly (over 50%). In 1988, bond markets accounted for 24.1% which was less than that of stock markets. This is why it is said that the 1980s had seen a major shift in international financial intermediaries from banking to security markets. See supra note 68.

The significance of the capital market and its function fully correspond with the earlier section which dealt with the importance of market efficiency. In short, a government which wishes to develop its economy needs to develop its capital market; the way to effect this is to have an efficient market, and to that end, disclosure is indispensable.

3.1.4.2 The Deregulation of the International Capital Market

Both the enactment of the FSA 1986 and the "Big Bang"[72] showed that the UK and the City of London appreciated the importance of the capital market and realised the necessity of improving the old regulations. The UK government also takes into account the ways in which UK regulation will dovetail with international requirements because virtually all the markets in the City operate on an international scale.[73] Likewise, in the last thirteen years (since 1983) the Taiwanese government has endeavoured to develop an internationalisation program for the securities markets. Initially, foreign investors were allowed to invest in the Taiwanese securities market indirectly by purchasing depository receipts or beneficiary certificates from open-ended mutual funds invested in the Taiwan Stock Exchange and issued by securities

---

[72] This well-known expression refers to the implementation of a series of major reforms in the Stock Exchange. The three principal accomplishments of the Big Bang were: 1. it abolished the single-capacity system, under which every stock exchange member or member firm could either be a jobber or a broker, but not both; 2. it gave access to the Stock Exchange to major British and foreign investment banks and commercial banks; 3. it eliminated fixed commissions. See Norman S. Poser, *International Securities Regulation*, 1991, p. 18.

[73] F.W. Neate (ed.), *The Developing Global Securities Market*, 1987, p. 1; Paul Stonham, *Global Stock Market Reforms*, 1987, p. 13; Hamish McRae and Frances Cairncross, *Capital City*, 1991, pp. 2, 135. As regards the internationalisation of securities markets, see Technical Committee of the International Organisation of Securities Commission, *Report on Issues Raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions*, Oct. 1994, introduction; David Folkerts-Landau, Takatoshi Ito, et al., *International Capital Markets Developments, Prospects, and Policy Issues*, Aug. 1995; Andrew Large, *Regulation for a Global Marketplace*, Panel on Globalisation of Risks: Cooperation Between Banking and Market Regulators, 20th Annual Conference of International Organisation of Securities Commissions, Paris, 12 July 1995, para. 4; and Marc I. Steinberg and Daryl L. Lansdale, Jr., "Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market", in 29 *The International Lawyer*, 43-63, Spring, 1995, pp. 43-4.

investment trust enterprises; later on, from 1990 onwards, foreign investors have been permitted to invest in the securities markets directly (with limitations) provided that they are institutional investors which include foreign insurance companies, banks, fund managers, etc. Finally, foreign natural persons can now directly invest in the securities markets from March 1st, 1996. These developments have resulted in a daily report for Taiwan stock index by the Dow Jones world stock index from April 1st, 1996.

Interestingly, not only have the deregulation[74] and liberalisation[75] of the world's financial markets precipitated internationalisation,[76] but internationalisation in turn has accelerated the process of deregulation and liberalisation. Increased internationalisation of the world's domestic markets has this effect because the players in each domestic financial market are unwilling to suffer the consequences of internationalisation. To prevent such loss, government regulations have adopted policies of deregulation and market liberalisation in a regulatory "race to the bottom" deemed to solicit capital. In other words, when internationalisation becomes widespread, old regulations which hamper this development must be lifted, such as prohibiting foreigners from trading on the Stock Exchange directly or indirectly; thus the policies of deregulation and liberalisation become prevalent.

Following these developments, the question of the protection of investors arises. The answer is simple and clear: in respect of the public offerings of securities and the obligation of continuous disclosure,[77] disclosure is the principal regulatory tool now

---

[74] In some academics' view, the term "deregulation" is ambiguous and in truth a misnomer. The correct term is "re-regulation"; in many ways, the regulatory environment is becoming increasingly formal and detailed, while institutions are being given more freedom over the type of business they may conduct. See David T. Llewellyn, "A Competition and the Regulatory Mix", in *National Westminster Bank Quarterly R.*, 4-13, Aug. 1987.

[75] The Big Bang demonstrates that deregulation and liberalisation have become a world wide trend in the financial market. Regarding deregulation of financial markets, see Alan Gart, *Regulation, Deregulation, Reregulation, The Future of the Banking, Insurance, and Securities Industries*, 1994, pp. 16, 17, and chapter 3.

[76] Neate, supra note 73; the necessity of internationalisation has been increasingly appreciated by enterprises, such as Daimler-Benz, see supra note 2, p. 370.

[77] Demands for access to reliable financial information have escalated as international risks have grown, which results from internationalisation of capital markets. See Doreen McBarnet and Christopher Whelan, "International Corporate Finance and the Challenge of Creative Compliance", in

employed by most developed markets, such as the UK, the USA, and even Taiwan (now developing towards more disclosure instead of merit regulation). Thus, to employ disclosure as the vehicle of regulating the market in most developed markets has become the dominant policy; consequently, even if this policy is not the best choice, a state which aims to develop its capital market has to consider seriously whether to adopt disclosure regulation, and by this, disclosure is justified from the empirical and practical point of view.

3.1.5 The Institutional Choice

From the above section, it is clear that disclosure with respect to the public distribution of securities is justified by both policy and economic considerations. The next question is how disclosure can better be achieved — by mandatory or voluntary disclosure. Voluntary disclosure is defined here as disclosure which is either self-motivated or required by non-governmental institutions (e.g. a stock exchange) which do not act on behalf of the government.[78]

If the final goal of disclosure is to have an allocatively efficient market by means of informational efficiency, which is vital to investor protection, the core problem will be how to distribute information. Stated otherwise, the efficiency of the information market is determinative of the efficiency of the securities market.[79] Following this, information costs determine the breadth and speed of such distribution; therefore costless, or at least less costly information, is a necessary condition for the efficient operation of the capital market.[80] The more cheaply the information can be obtained

---

The Internationalisation of Capital Market and the Regulatory Response, John Fingleton (ed.), 1992, p. 129. Noticeably, the regulatory schemes with respect to the regulation of broker-dealers and, particularly, investment companies, still include a large number of substantive requirements. Poser, supra note 72, p. 7.

[78] If the reason is a governmental regulation for a stock exchange requiring disclosure, it is not defined as voluntary disclosure here; instead, it is mandatory disclosure.

[79] See Stephen Breyer, *Regulation and its Reform*, 1982, p. 161.

[80] See Sanford J. Grossman and Joseph E. Stiglitz, "On the Impossibility of Informationally Efficient Markets", in 70 *American Economic R.*, 393-408, 1980, p. 393.

and distributed, the more widely it can be disseminated. Hence, the question can be posed: by which method will the dispersal of information be cheapest? If costs are not easy to measure, what other considerations should be taken into account?

Legal academics commonly advocate the necessity of mandatory disclosure, while some economists, on the other hand, strongly oppose the legislative policy of mandatory disclosure. The opponents of mandatory disclosure believe that the government should not intervene in market operations unless there is market imperfection, and generally the market itself will resolve most problems.[81] They also assume that the purpose of regulation is to improve the "public interest": regulatory agencies employ the positive power of the state to take advantage of economic efficiencies and serve the general welfare.[82] Thus, when the costs of regulation outweigh its benefits, the general welfare is being jeopardised and a regulatory failure takes place.

The main point at issue is whether the market can achieve the ideal level of disclosure without mandatory disclosure. If the answer is negative and mandatory disclosure is necessary, then mandatory disclosure may be justified; the extent (or the scope) of mandatory disclosure is a separate question which will be dealt with in Chapter Five.

3.2 The Justification of Mandatory Disclosure — The Inadequacy of the General Law

3.2.1 Introduction

The above analysis affirms the importance of disclosure in the company and securities

---

[81] Even if the market fails, in some scholars' view, it does not necessarily justify regulation for regulatory intervention may be even worse than market imperfection. As regards the function of regulation, see Manuel F. Cohen and George J. Stigler, *Can Regulatory Agencies Protect Consumers? Rational Debate Seminars*, 1971.

[82] Robert Britt Horwitz, *The Irony of Regulatory Reform*, 1989, p. 26.

fields. The question is how disclosure can be achieved. Without doubt, disclosure now-a-days is often required by legislation and regulation. Nonetheless, its existence *per se* does not automatically imply that it "should" exist. Empirical evidence reveals that such legislation and regulation differ from state to state, from subject-matter to subject-matter; thus reflecting the different views on disclosure among different countries. Deliberation on the basics of mandatory disclosure is therefore the heart of any serious consideration of the law regarding disclosure in different countries. However, for the moment, the discussions of the details of the current legislation of mandatory disclosure are postponed until Chapter Five in order to permit analyses of a preliminary question of fundamental importance, namely, if mandatory disclosure had not been adopted, how far the need for disclosure would be satisfied by the general law. Clearly, if the general law cannot provide investors with sufficient protection, it is arguable that mandatory disclosure is required.

For the UK, "the general law" here refers to English common law in contrast to the FSA 1986, the Yellow Book and all other disclosure regulations, including the provisions of the Companies Acts so far as they are relevant.[83] In Taiwan where there is no precise equivalent of English common law, it includes relevant provisions of both the Civil Code and Company Law in contrast to the Securities and Exchange Law and other administrative regulations promulgated by the SEC.

For the sake of clarity, we would like to emphasise that the term "mandatory disclosure" is used by all commentators in the context of "extra" disclosure

[83] The classification of the Companies Acts in this context involves certain difficulties. The difficulties partly stem from the tradition that British legislators and administrators used to place (in fact, they are still used to it to a certain extent) securities regulations in the Companies Act because there was no "securities legislation" before 1986. Even after the enactment of the FSA 1986, the consequential amendments was first enacted in the Companies Act 1989 and brought about the changes in the FSA 1986. The difficulties are also due to the fact that it is not easy to partition the company law amendments into "the amendment to the general law" or "the new regulation springing from the thinking of mandatory disclosure regime". Therefore, it appears that the Companies Act stands in a grey area in which some provisions could be identified as mandatory disclosure requirements by comparing the enactment of the same or similar rules in the American or Taiwanese mandatory regulations.

requirements imposed by securities legislation and regulations, specifically the US Securities Act of 1933, Securities Exchange Act of 1934, and SEC regulations. Such regulations, in theory, include the Securities and Exchange Law and SEC regulations in Taiwan, and relevant parts of the Companies Act 1985, the FSA 1986, the Code on Takeovers and Mergers, the Yellow Book, and the rules regulating the Unlisted Securities Market (now the Alternative Investment Market) in the UK. Accordingly, even though disclosure requirements imposed by the general law are mandatory, the debate concerning the choice between voluntary and mandatory disclosure does not relate to mandatory disclosure under the general law; the existence of mandatory disclosure in the general law is taken for granted.

The question can first be examined from the point of view of the providers of information (here companies and directors). In the situation where the system of mandatory disclosure does not exist, corporate disclosure either is achieved by voluntary disclosure (of companies and directors) or fails (partly or totally) for the reasons discussed below.[84] What voluntary disclosure does is to make use of market forces fully; that is, the competition among companies forces them to disclose their financial situation and business projects, and this, in turn, helps investors make well-informed investment judgments. However, even if corporate disclosure is achieved by voluntary disclosure,[85] the occasional failure of disclosure will still arise and voluntary disclosure cannot impose any legal liability upon companies and related persons, because it is only an economic instrument, not a legal one. To avoid such occasional failure and to place the company and directors under an obligation to make disclosure, there must be a ultimate possibility of enforcement out of law. The consequences of failing to comply with mandatory disclosure requirements are usually criminal, administrative, or even civil liability. Thus, so far as the incentives for a company or

[84] See infra Chapter Four.
[85] As claimed by some economists referred to in Chapter Four.

the directors to make disclosure is concerned, mandatory disclosure is preferred given the availability of legal enforcement.

Furthermore, this question can be answered from the perspective of recipients of information (here investors). If mandatory disclosure is employed by the government, the recipients' rights mostly come from statutory obligations which are imposed on providers of information. By way of contrast, without the system of mandatory disclosure, duties of companies and directors in relation to provision of information to investors are less certain.

The sections which follow deal with the situation where no mandatory disclosure is imposed on the company or directors. The analysis of the general law shows its inadequacy for the purpose of achieving the goals of disclosure; therefore, mandatory disclosure can be justified. The focus is on two main issues: (1) the relationship between the company and investors; (2) the relationship between directors (or promoters) and investors. The issues raised in the section are approached by comparing the difference between the UK and Taiwan legal systems. It should be borne in mind that Taiwan has a civil law system, judicial decisions do not have the legal significance as their counterparts in the UK.[86]

[86] In a practical sense, the cases specifically chosen by the Supreme Court as "precedents" bind the lower courts for two reasons: (1) if the lower court does not follow a specific precedent, when any party appeals, it would be overruled by the Supreme Court; (2) the result of (1) is the possible effect on the evaluation of judicial performance of the judge in question carried out annually which affects the judge's promotion to a higher court in the future. Since the binding effect is limited to those chosen cases, it is still valid to point out that case law is not very important in Taiwan.

3.2.2 The Relationship between the Company and its Members — Members' Rights deriving from their Status of Members

This section concerns only members or shareholders[87] of companies; creditors or potential investors are ignored. The reason for this exclusion is that if the inadequacy of the general law is proved concerning how to clarify shareholders' rights deriving from their status, then it is not necessary to go further as regards the rights of creditors and potential investors, which derive from their status of being creditors and potential investors. Members' rights hereinafter will be referred to as "members' rights *qua member*". This section demonstrates that under the general law, both in the UK and Taiwan, a member of a company has no clear right qua member to ask for information from the company.

3.2.2.1 The United Kingdom

Unlike the position in Taiwan, where members' rights are examined mainly from their characteristics, in the UK, the rights of a member (or a shareholder) of a company are determined by the contract between the company and its members, specifically, the memorandum and articles of the company.[88] Those are the sources of the rights of the member unless the statute provides the member of the company with some other rights which are not included in the contract. In practice, a member, even of a private company, is not entitled to inspect the books and records of the company except to the extent that the Companies Act specifically provides. In other words, the spirit of

---

[87] Shareholders are members of companies which issue shares (e.g. companies limited by shares). Therefore, the term "shareholders" is employed in the case where companies issue shares while the term "members" is maintained when referring to the other companies. Nonetheless, since shareholders are members, for the sake of simplicity, when members' rights are concerned, we use the term members' rights qua members without specifically mentioning shareholders' rights qua shareholders.

[88] s. 14 of the Companies Act 1985; *Hickman v. Kent or Romney Marsh Sheep-breeders' Association* [1915] 1 Ch. 881. "Much of the difficulty is removed if the company be regarded, ... as being treated in law as a party to its own memorandum and articles." (*per* Astbury J)., p. 896. Approved *Beattie v. Beattie* [1938] Ch. 708. G.B. Parker, M. Buckley, and Sir Raymond Walton, *Buckley on the Companies Acts*, 1981, Vol. 1, pp. 66-7.

company law is to respect freedom of contract of those people who want to form a company; the legislative intervention will arise if, and only if, it is necessary for the purpose of protecting the member of the company. Since corporate constitutions do not always deal with the right to information, such a right will largely depend on statutory intervention, i.e. mandatory disclosure requirements. For example, the Companies Act 1985[89] provides that members (and only members) of the company have the right to inspect director's service contracts without charge; moreover, information, such as registers of the director and secretary, directors' holdings and dealings of the company's securities, and substantial shareholders' shareholdings (above 3%), is open to members (and the public as well). These provisions demonstrate the inadequacy of the general law and the necessity of governmental intervention.

3.2.2.2 Taiwan

The extent to which a member (or a shareholder) qua member may enjoy the right of access to corporate information becomes meaningful when the Taiwan aspect is examined. Under the current Taiwanese Company Law, only the right of receiving the information included in the annual report is recognised for companies of all types, while a general right of inspection at any time is granted to members of unlimited and limited companies and to members with unlimited liability of unlimited companies with members of limited liability. Two questions, however, remain unanswered. First, the legal basis for granting information needs clarification. Second, it is obscure to what extent, if any, members with limited liability of unlimited companies with members of limited liability together with shareholders of companies limited by shares may possess the right of inspection at any time as well as the right to the annual report. It is argued below that since the highly emphasised classification of members' rights by academics could not comprehensively solve such questions, mandatory disclosure is therefore required.

[89] s. 318(7).

Traditionally, academics[90] classify members' rights into different categories and define them as "vested" or "non-vested" rights. Vested rights, theoretically, cannot be altered even by corporate memorandum or articles.[91] Therefore, according to the classification made by academics, it is submitted that "members' right of access to corporate information" can be located in different categories depending on the purpose of exercising such a right.[92] And this helps us to identify whether members should have such rights or not, and if in some situations, the answer turns out to be negative, what are the reasons for this deviation? If the classification turns out to be not meaningful, however, we may have to abandon it.

The relationship between the company and its members regarding the right of access to corporate information can be observed in the Company Law of Taiwan. Comparing the rights of members or shareholders in different types of companies reveals that their rights may vary from type to type. By means of comparison, the reasons underlying such differences can be pointed out; following this, it can be shown that shareholders of companies limited by shares do not have absolute rights of obtaining information unless there are mandatory disclosure requirements on companies. Although academics, as indicated earlier, advocate the classification of members' rights, they have never made this comparison to determine whether the classification is sound; it is intended here to clarify it with the help of this comparison.

To begin with, there are four types of companies in Taiwan: the unlimited company, the limited company, the unlimited company with members of limited liability, and the company limited by shares.[93] It is worth briefly explaining their characteristics.

---

[90] See, e.g., Yung-jung Lin, *The New Annotation of Commercial Law (Shang Shih Fa Hsin Ch'üan)*, 4th ed., 1990, pp. 271-2.
[91] Fang-chih Ko, *The Company Law (Kung Ssu Fa Lun)*, 1987, p. 218.
[92] See infra pages 116-8.
[93] Article 2, CL. See also Yuan Cheng, *Taiwan's Legal Framework for Foreign Investment: What Can the PRC Learn from It*, Working Paper No. 9, SOAS Law Department, University of London, March 1996, pp. 5-7.

The unlimited company is comprised of two or more members who bear unlimited liability for the debts of the company jointly and severally. There is no substantial difference between the unlimited company and the partnership except that the former has a legal personality distinct from its members. Members of the company in principle are also managers of the company.[94]

The limited company is incorporated by more than five but less than twenty-one members. It is a close company, but the control and the ownership have been separated already. As the maximum of the number of directors stipulated by law is three, not every member of the company can be a director.[95] In this type of company there are no shares; a member cannot transfer all or part of his contribution to the capital of the company to non-members without the consent of the majority of all other members.[96] Members' liability is limited to their own particular contributions.

The unlimited company with members of limited liability is organised by one or more members of unlimited liability and one or more members of limited liability. Members with unlimited liability are liable for corporate debts jointly and severally just as those members of the unlimited company, and members bearing limited liability are responsible for company debts being limited to the amounts of capital contributed by them. Unlimited liability members run the business, while the function of members of limited liability is only to provide the company with capital.

The company limited by shares is incorporated by seven or more shareholders with the total capital of the company divided into shares, and each shareholder is liable

---

[94] Article 45, CL, provides: "Each member shall have the right to conduct the business of the company and shall be responsible therefor..."

[95] Article 108(1), CL.

[96] Article 111(1), CL. For directors, it is even more strict. They have to obtain the unanimous consent of all other members before they are allowed to transfer all or part of their contribution to the capital of the company to non-members. See Article 111(3).

to the company in the amount of the shares subscribed for by him. This kind of company is the basis of modern enterprises; the number of shareholders is so large that it is impossible for every shareholder to take part in management.

The Company Law gives members of unlimited companies, limited companies, and also members bearing unlimited liability of unlimited companies with members of limited liability the right to investigate its financial condition at any time. In contrast, the Company Law restricts members bearing limited liability of unlimited companies with members of limited liability and shareholders of companies limited by shares to an annual inspection. The reasons for this distinction are considered below.

First, with regard to the unlimited company, Article 45 of the Company Law provides: "Each member shall have the right to conduct the business of the company and shall be responsible therefor...". Following this, Article 48 provides:

> "Members who do not conduct business may, at any time, require members who conduct business to furnish information on the business condition of the company, and examine the company's assets, documents, books and statements."

From these two articles, it is obvious that members of the unlimited company can gain access to corporate information at any time. However, the reasons underlying this right are three-fold. First, as the management and the ownership are combined, this combination naturally entails such a result (i.e. all members are entitled to gain access to corporate information). Second, this right derives from the heavy burden of "unlimited liability" borne by members of the company. Since all their personal wealth is at stake, they are entitled to enjoy the right to ensure that the company is well-managed. Third, this right is owned by members of the company simply because they are the "members" of the company, in other words, a right qua member.

It is difficult to tell which reason is most sound. They may be all appropriate if only the unlimited company is concerned (because the unlimited company fits every requisite of the three reasons). Nonetheless, a subsequent examination of other kinds of companies may help to answer this question.

Turning to the limited company, Article 109 of the Company Law provides:

> "Members who do not conduct business may, at any time, exercise the right of supervision, and the provision of *Article 48 shall mutatis mutandis apply to such a right*." (emphasis added)

This article empowers members of the limited company to inspect the corporate records without any limitation. In analysing why members of the limited company have unlimited rights to corporate information, two reasons emerge: one based on status, the other on special characteristics. The status argument becomes clear from a comparison between the limited company and unlimited company. The control and the ownership in the limited company are separated as explained above; the liability of members of the company is limited. This, compared with the reasons mentioned above for members of the unlimited company to enjoy the right of information, shows that the most appropriate reason for providing information to members of the limited company may be identical to the third reason ascribed to members of the unlimited company for enjoying unlimited access to information, namely that, a right bestowed by the law simply because they are members (hereinafter referred to as "the member's status").

Accordingly, if the right of access to corporate information is a right deriving from members' status, it may be inferred that members in other kinds of companies, that is, members bearing limited liability of unlimited companies with members of limited liability and shareholders of companies limited by shares, should have the same right as that of members of unlimited companies and limited companies. Surprisingly, the inference is wrong. This is, however, not necessarily a drafting defect. The reasons

for this different treatment among members of different kinds of companies will be developed later.

Article 118 of the Company Law gives the right of only **annual** inspection to limited liability members of unlimited companies with members of limited liability. It provides:

> "A limited liability member may, at the end of every business year, examine the accounts, and the business and financial condition of the company. Whenever necessary *the court* may, upon the application of a limited liability member, grant him or her the permission to examine at any time the company's accounts, and its business and financial condition..." (emphasis added)

It is clear from this Article that the right of "annual inspection" is the principle; the court's approval is only exceptional.

Moreover, Article 229 does not provide shareholders with this court order exception in the case of companies limited by shares. The right they have individually is the right of annual inspection only.[97] Another provision worth mentioning here is Article 210. This Article allows shareholders and creditors to require access to the annual balance sheet and the profit and loss account on submission of a certificate evidencing their interest[98] involved. However, first, this is not a right without limitation because shareholders and creditors need to prove their interest involved; second, the documents available are not the current information; they are only the annual records

---

[97] Article 229 provides: "The statements and records of accounts prepared by the board of directors and the report made by the supervisors shall be made available at the head office for inspection at any time by the shareholders, ten days prior to the annual general meeting of shareholders. The shareholders may bring their lawyers or certified public accountants for such an inspection." Regarding the definition of supervisors, see infra note 101.

[98] According to administrative interpretations issued by the Ministry of Economic Affairs, shareholders and creditors need to show their interest when they exercise such a right under Article 210(2), CL. However, these interpretations did not define the term "interest". The term "interest" can be interpreted as meaning "reasons", reasons for which shareholders and creditors wish to inspect corporate documents. See Ministry of Economic Affairs (Ching Chi Pou) 63.4.4 shang 08576 hao; 72.10.11 shang 41318 hao.

(the balance sheet and the profit and loss account) prepared since the incorporation of the company.

The following question, however, arises: how can the fact that shareholders in companies limited by shares have no right of access to corporate information beyond annual inspection be explained if the reasons developed earlier with regard to the right of members of the unlimited company and the limited company are correct? Does this mean that even if the right is *qua* member, it may be variable because of some special reasons? If it is, then, what are these special reasons?

Second, examining the special characteristics of the limited company helps to identify the reason underpinning this right of members in such a company. As indicated above, the maximum number of members in a limited company is twenty-one. This shows that such a company is generally designed for a family-type company; the limitation on transferring capital contribution to the company by members further supports this view. Therefore, it seems probable that, because in a limited company there is a close relationship among its members, the law decides to give members the right of access to corporate information. The acceptance of this reasoning suggests that, although members of the unlimited company and limited company have the same right of information, the reasons for the right are different. This further suggests that the rights of limited liability members of unlimited companies with members of limited liability and shareholders of companies limited by shares may vary from those of members in other kinds of companies, since companies have different characteristics. Thus, the question raised above regarding the right of limited liability members of unlimited companies with members of limited liability and shareholders of companies limited by shares in the light of members' rights in the unlimited company and limited company will not be relevant here. The answer to this question, instead, should depend on what rights members can enjoy in these two kinds of companies and on the characteristics of both kinds of companies.

Both channels of reasoning suggest that, to see this, it is necessary to delineate the classification of members' rights made by academics.[99] First, the characteristics of members' rights and their types are examined.

(a) the characteristics of membership rights

The membership right itself mixes the characteristics of a property right and a "status" right.[100] To be a member of the company, one has to pay something valuable in exchange for the membership. The ownership of the property is transferred from the member to the company. The payer loses his or her title to that property and the company becomes the new owner. In return, the member obtains the "membership" in the company which allows him or her to enjoy the rights which are generally and commonly owned by other members of the company such as the right to vote and the right to manage the company. These are members' "status" rights.

On the other hand, members are entitled to the distribution of earnings (provided that a dividend is declared) during the life of the company, and the distribution of corporate assets when the company is wound-up (provided there are surplus assets left) after the company discharges its debts. These are members' property rights.

---

[99] See supra note 91.

[100] Rights are generally divided as "property rights" and "non-property rights" in the civil law. The latter includes "the rights of individual personality" and "status rights". The right of individual personality means those rights which come from the person, such as life, body, health, freedom, reputation, name, credit, etc. The status right is a right existing between two persons based on special personal relationship such as the parental rights (parents have rights to take care of or to discipline their children, e.g. Articles 1084 and 1085 of the Civil Code) and the right of the head of the house (Article 1122 provides that a "house" is a body of relatives who live together in a household with the object of sharing a life in common permanently. Article 1123 provides that each house shall have a head. Articles 1126 and 1127 regulate the relationship between the head of the house and the members of the house by stipulating, for example, that the head may order a member of full age or a married minor to be separated from the house, provided that he has good reason to do so.) See Chi-yang Shih, *General Principles of the Civil Code (Min Fa Tsung Tsê)*, 1983, pp. 29-30.

(b) the kinds of membership rights

1. distinction according to the purpose of the right

At a very general level it is useful to distinguish a right which may freely be exercised in its holder's interest from a right which has been conferred so that it is exercised in another's interest. For example, a supervisor[101] of the company has the right to investigate its business and financial condition, acting in the interests of the company, not his own.[102] In contrast, a shareholder has the rights to request access to the company's books and records, acting in his own interest, not the company's.[103]

The same distinction can be made where members' rights are concerned. A right exercised for the purpose of managing the company (in the interests of the company) should be distinguished from a right exercised in members' self-interest only. This distinction echoes the characteristics of the membership right mentioned above. As a general proposition, a membership right bearing the characteristic of a status right is a right to be exercised in the interests of the company, while a membership right with the characteristic of a property right is a right to be exercised in the member's self-interest. For example, the voting right,[104] the right to request the board of directors to convene

[101] In Taiwan, corporate governance of companies limited by shares is a two-tier system: the board of directors and the supervisors. The supervisors are an "organ" of a company independent from the board of directors, exercising the power individually conferred on each of them by the Company Law (CL) (therefore, there is no meeting requirement among the supervisors) (Art. 221, CL). Supervisors must be the company's shareholders and are elected at the general meeting by shareholders; the legal relationship between a company and its supervisors is controlled by a contract of mandate (Art. 216, CL). The power of a supervisor includes: 1. investigating the business and financial condition of the company at any time (Art. 218, CL); 2. checking all statements and records of various kinds prepared and submitted by the board of directors to the general meeting and making a report of his findings in these documents to the general meeting (Art. 219, CL); 3. convening a meeting of shareholders when necessary (Art. 220, CL). Besides that, when a director discovers the possible serious damage that the company may suffer, he should report this to any supervisor immediately (Art. 218-1, CL). Finally, a supervisor shall not be currently a director, manager, or other employee of the company (Art. 222, CL).

[102] See Article 218, CL.

[103] See Article 210, CL.

[104] Article 179, CL. It may seem odd to British lawyers that Taiwanese academics classify the voting right as a right in the company's interest and is a status right. In the UK, the voting right is thought of as a proprietary right and the holder may exercise the right in his own selfish interests even if these

a special meeting of shareholders,[105] the right to apply to the court for reorganisation,[106] and the right to bring derivative suits[107] are rights to be exercised in the interests of the company. The right to the distribution of earnings[108] and the pre-emptive right when new shares are issued[109] are rights in individual shareholder's self-interest.[110]

2. distinction made according to whether the right can be varied or abrogated by corporate memorandum, articles, or resolutions of general meeting

In the UK, vested rights cannot be altered unless by general meeting. However, in Taiwan, academics have interpreted vested rights more restrictively with regard to this classification, namely, such rights are inalienable. If a membership right cannot be varied or abrogated by the memorandum, articles, or resolution of the general meeting, it is a "vested" right of a member. On the other hand, if a right can be varied or abrogated, it is not a "vested" right.[111] This is important because Taiwanese judges pay attention to academic interpretations where statutory language is unclear.

The distinction between vested and non-vested rights is aimed at delimiting the extent of the power of the general meeting in order to protect the interests of shareholders. That is, the extent that the general meeting can deprive members' of their existing rights is limited. It is generally accepted that a right to be exercised in the interests of the company is a "vested" right, while a right for self-interest is not.[112]

---

are opposed to those of the company. *North-West Transportation v. Beatty* (1887) 12 A.C. 589; *Goodfellow v. Nelson Line* [1912] 2 Ch. 324. In Taiwan, the voting right comes with membership, that is, with "persons"; thus, it is a status right. In the UK, on the contrary, the voting right is thought to come with "shares", i.e. the "property", therefore, it is a proprietary right.

[105] Article 173, CL.

[106] Article 282, CL.

[107] Articles 214 and 227, CL.

[108] Articles 157 and 232, CL.

[109] Article 267, CL.

[110] See Fang-chih Ko, supra note 91, p. 216.

[111] Id.

[112] Id.

However, it is now provided by the statute that the constitution of the company can limit the voting right of shareholders of special shares,[113] and not every shareholder can run the company; since running the company and voting are identified as rights to be exercised in the interests of the company, that is, "vested rights", these are good examples of "vested rights" that are no longer inalienable. On the other hand, transfer of shares of the company limited by shares cannot be limited;[114] the right to transfer shares is exercised in the interests of shareholders; it is thus a "non-vested right" which theoretically can be restricted. This demonstrates that the classification is no longer a clear cut distinction. It is difficult to advocate that all "vested" membership rights cannot be varied or abrogated; the distinction provides only a general principle. Exceptions may be made in certain situations.

The problem for the present purpose which arises is as follows: is the right of access to corporate information a right to be exercised in the interests of the company or a right for self-interest? To what extent can it be limited?

The right to information has both characteristics. It is a right to be exercised in the interests of the company when shareholders make decisions at general meeting; they need information to judge which resolution is good for the company. It is also a right in the self-interest of shareholders when they decide to buy or sell shares; they need this information to make a well-informed investment judgment.

If the classification developed above by academics is followed, i.e. the "vested" right cannot be varied or abrogated in principle, and if a right to be exercised in the interests of the company is usually a "vested" right, then, the question raised above can be partly resolved. We can distinguish the different rights owned by members of the

[113] Article 157, CL.
[114] Article 163, CL.

unlimited company and limited company on the one hand, and those owned by members with limited liability of unlimited companies with members of limited liability and shareholders of companies limited by shares on the other hand.

In other words, the right of a member to gain access to corporate information on an annual basis is exercised in the interests of the company and cannot be taken away in any circumstances. But day-to-day supervision, although exercised in the interests of the company, appears, like the voting right, to be a limited right and thus an exceptional case. A possible reason for this exception is that, in a two-tier system like that in Taiwan, a board of directors manages the company while supervisors supervise this board. The Company Law authorises supervisors to check corporate business and financial condition at any time.[115] The supervisor is independent of the board of directors and therefore exercises the right to check the corporate business information on behalf of the company, and in turn, the shareholders as a group. Thus, with the help of supervisors, individual shareholders do not need to be concerned with the day-to-day operation of the company, and this justifies depriving the shareholders as members of companies which have supervisors of the right of day-to-day supervision — no necessity of providing individual shareholders with information.

In contrast, if the right to obtain information at any time from the company is for the shareholder's personal interest (because he wants to make an investment decision), this is a self-interest right, and in turn may not be a "vested" right unless the law explicitly recognises it (as in the case of transfer of shares, Article 163[116]). In this situation, it is not surprising that the statute has not conferred such a right on shareholders.

---

[115] Article 218(1), CL: "A supervisor may at any time investigate the business and financial condition of the company, examine books, records and documents, and request the board of directors to make reports thereon."

[116] Article 163, CL: "The transfer of shares of a company shall not be prohibited or restricted by its memorandum and articles of incorporation, except that no shares shall be transferred prior to the incorporation of the company."

Concerning the problem of disclosure for the individual shareholder's self-interest, the real difficulty is that in practice the constitutions of companies fail to deal with the question whether shareholders should have or have not access to corporate information. The constitutions equally never make provisions for the company's obligations to disclose information to shareholders. Thus, nothing is said and it is very difficult to answer the question as to the extent shareholders have the right to information qua member. Based on this, it is obvious that this right of access to information can be achieved only by judicial or legislative development of the right of shareholders and the obligation of companies.

The answer may vary from situation to situation. For example, it is understandable that shareholders of companies limited by shares have no right to seek corporate information at any time they choose. This is because of the special nature of such companies which are usually incorporated for the purpose of running a large enterprise, where shareholders come and go like flowing water. It is not appropriate to bestow this right on shareholders; it can endanger the company because trade secrets may leak out easily; it also hampers the management, because they waste time satisfying shareholders' inquiries.

To develop this theory, it is submitted that the right to information can be restricted in some situations. Hence, when, to whom, and to what extent information should be available are basically designed by the law. The answer cannot be given by considering the right of members qua member. This is not a natural right like the right to life. If the positive law does not delineate this right clearly, then a grey area arises. The problem is that it is very difficult for a shareholder to claim his or her right to information before the court in the situation where there is no statutory provision explicitly dealing with this right, because a member cannot definitively claim his or her right to information qua member, and the general law has not developed a

comprehensive and exhaustive rule to regulate this issue. Accordingly, if disclosure is deemed indispensable, then the system of mandatory disclosure can resolve this problem to a large extent.

The above discussion reveals that the traditional classification of "vested rights" (which cannot even be altered by the memorandum, articles, or the general meeting) and "non-vested rights", does not help us clarify whether rights of information can be altered or abrogated. The special reasons which cause different treatment among members of different kinds of companies can be developed without the help of such classification. Thus it is suggested that this classification should be abolished. Nonetheless, it is also suggested that the classification of "rights to be exercised in the interests of the company" and "rights exercised in members' self-interest" be retained, because it relates to a more fundamental distinction made by the civil law, namely between non-property rights and property rights.

In summary, this section emphasises that, under the general law, shareholders have no clear rights qua member to ask for information from the company except on an annual basis. The general law can provide certain rules but these not exhaustive. So far, there is no case law in Taiwan concerning this issue, a fact which worries academics because it shows that investors are not conscious of their rights. Even if the case is raised, the decision should take into account such considerations as the nature of the company, the characteristics of investors, and the protection of the company. If we are correctly thinking that disclosure is of great importance, then the best way to achieve this may be by mandatory disclosure rather than by entrusting it to judicial developments or academic interpretations, since the latter cannot ensure legal enforcement and may result in inadequate disclosure.

3.2.3 The Relationship between Directors (or Promoters) and Investors

The major concerns of this section include: (1) whether directors have obligations of disclosure under the general law; (2) whether such disclosure would amount to sufficient protection for investors and enhance market efficiency; and (3) to whom disclosure is to be made. These questions are dealt with from the perspective of recipients of information. Therefore, first, we classify investors into two groups: current investors and future investors. Current investors are those who are currently shareholders or creditors; and future investors are any potential investors, i.e. the public. Current investors, in turn, can be divided into shareholders and creditors.

Second, we examine all these concerns in each category as classified above. Accordingly, the structure of the section is as follows (also see Appendix):

1. current investors:
a. shareholders as a group (the company)
b. individual shareholders
c. creditors
2. future investors

3.2.3.1 Shareholders as a Group (the Company)

Regarding disclosure under the general law, there is a marked difference between English and Taiwanese law. Under the former, where the doctrine of fiduciary duties applied to directors of companies, directors are under strict obligations to fully disclose relevant information to the company. In most cases such information becomes available to shareholders as a group; hence, mandatory disclosure requirements appear unnecessary save in the preparation of corporate accounts. Under Taiwanese law, by

contrast, the obligation of disclosure under the general law is inadequate and unclear. In the context of Taiwanese law, if full disclosure is expected, mandatory disclosure is indispensable, excepting only in regard to the issue of corporate opportunities.

Information that shareholders as a group are entitled to obtain in the UK, as a general proposition, is determined by the scope of directors' fiduciary duties towards the company. We recognise that information disclosed to a company by its directors may not go directly and personally to its individual shareholders; rather, in some situations, such information is "known" to the company (the board of directors only). For example, if there is a specific provision in the articles of association which authorises the board to deal with the company's directors on behalf of the company regarding specified kinds of transactions, the disclosure made by the director in this situation is made to the board of the company, not to the shareholders in general meeting.[117] Yet, despite such clear provisions, what is crucial is not so much the particular body to which disclosure should be made (such as a group of shareholders, even prior to the board)[118] as the directors' obligation of disclosure to the company. If disclosure made to the board of the company is sufficient in the context of protecting investors and improving market efficiency, it is not necessary to disclose such information to the shareholders in general meeting or to the public in a prospectus, for example. Thus, the use of the term "shareholders as a group" to represent the company in the context of disclosure would be sustainable to a certain degree; and, in the situations where information is not disclosed to the general meeting, this usage would be safe because the recipient (the board or the general meeting) of information is not emphasised here.

---

[117] s. 317 of the CA 1985.

[118] For example, in the case of promoters' obligations of disclosure towards the company when self-interest is concerned, the English court originally ruled that disclosure should be made to an independent board of directors (*Erlanger v. New Sombrero Phosphate Co.* (1878) 3 App. Cas. 1218); however, the court relaxed this rule later in *Salomon v. Salomon* ([1897] A.C. 22) and permitted the disclosure to be made to the members.

It is a generally accepted principle of company law that directors owe a fiduciary duty to the company.[119] It has been suggested by one writer that since the company comprises a group of shareholders, directors also owe their fiduciary duty to the shareholders as a group.[120] Such a view seems supported by the case *Re Leeds and Hanley Theatres of Varieties, Ltd.*[121] Here, the promoters purchased property to sell to the company when formed. The prospectus of the company, however, issued with the aim of inducing the public to subscribe for its shares, omitted to disclose the fact that it was the promoters who were the real vendors of the property to the company. The court held that since promoters *per se* stood in a fiduciary position towards *the persons who were invited to take shares* in the company, those promoters must pay the damages to the *company*. It emerges clearly from this case that "the allottees as a group" were regarded as an identical concept to the company. In the law of negligence covering auditors' duty of care, the term "shareholders as a body" has been put forward, possibly applicable to the situation of directors' fiduciary duty whereby directors owe a fiduciary duty to shareholders as a group.[122] On the other hand, such a position would blur the important distinction between a company (with a separate legal personality) and its members. Nonetheless, it seems fair to analyse directors' obligation of disclosure from the perspective of "shareholders as a group" as in reality shareholders do obtain information (to a certain extent as mentioned above) resulting from directors' disclosure to the company.

Under English law, the nature of the director's duties can be stated in this way:

> "[Directors] are persons invested with strictly defined powers of management under the articles of association of a statutory corporation, whose functions

---

[119] See L.C.B. Gower, *Principles of Modern Company Law*, 5th ed., 1992, p. 551. "...the directors stand in a fiduciary relation to the company only...", see G.B. Parker, M. Buckley and Sir Raymond Walton, supra note 88, p. 1009.

[120] See Paul L. Davies, "Directors' Fiduciary Duties and Individual Shareholders", in *Commercial Aspects of Trusts and Fiduciary Obligations*, Ewan Mckendrick (ed.), 1992, p. 84.

[121] [1902] 2 Ch. 809.

[122] see *Caparo Industries Plc. v. Dickman and Others* [1989] 2 W.L.R. 316, by O'Connor L.J. at p. 354; [1990] 1 All E.R. 568 H.L.

> will readily place them in an office of trust or, to express it more widely, in situations of a *fiduciary character*."[123] (emphasis added)

It is not very apposite today to describe directors as the trustees of the company in the strict sense.[124] With regard to their fiduciary duties of loyalty and good faith, which are analogous to the duties of trustees *stricto sensu*, the court has extended the rule of trusts to directors. But, in respect of their duties of care and skill, which are fundamentally different from the duties of normal trustees,[125] it is not appropriate to describe these directors as trustees. Accordingly, the director is at most a quasi-trustee.[126]

The rules of principal and agent apply. Specifically, "whenever an agent is liable those directors will be liable; where the liability would attach to the principal, and the principal only, the liability is the liability of the company."[127]

There are three conceivable situations in which directors would need to disclose either their personal information or corporate information to the company: (1) transactions between a company and its directors, or between a company and a third party of whom a director is the agent; (2) director's use of corporate opportunity or information to make a profit out of his position; and (3) events where the directors have obligations to prepare the accounts for the company, i.e. to disclose corporate information to the company itself, the duty of preparing corporate accounts. In both

---

[123] See A. Kingcome Turner and R. John Sutton, *The Law Relating to Actionable Non-Disclosure and Other Breaches of Duty in Relations of Confidence, Influence and Advantage*, 2nd ed., 1990, p. 405.
[124] It is easy to see how this misleading interpretation (to classify a director as a trustee) arose. Before 1844, most companies other than chartered or statutory corporations had no independent legal personalities. They were operated under deeds of settlement with property and powers actually vested in trustees. Because of this, directors of the companies were equated with the trustees. See L.C.B. Gower, supra note 119, p. 550.
[125] Id., pp. 550-1.
[126] *Re Forest of Dean Coal Mining Co.* (1878) 10 Ch.D. 450, cited with approval in *Regal (Hastings) Ltd. v. Gulliver* [1967] 2 A.C. 134, p. 147. In the case *Re Faure Electric Accumulator Co.* (1888) 40 Ch.D. 141, at p. 151, Kay J. said: "However, it is quite obvious that to apply to directors the strict rules of the Court of Chancery with respect to ordinary trustees might fetter their action to an extent which would be exceedingly disadvantageous to the companies they represent."
[127] *Ferguson v. Wilson* (1866) L.R. 2 Ch. App. 77, at pp. 89-90.

the first and second situations, the director may be liable to account for the profits made by him either because (a) there is a conflict of interest between him and the company, or (b) on the rationale that he should not profit from his position unless full disclosure is made and specific consent is given.

self-representation and both-side representation

1. the United Kingdom

In general, whenever a transaction involves a conflict of interest between a company and its directors or causes the directors to violate their fiduciary duties, the law may choose either to prohibit any such transaction[128] or to require full disclosure to be made by the directors. Currently, the trend of commercial practice is not to prohibit these transactions but to allow the transactions and require disclosure either to the shareholders in general meeting or, where the company's articles permit, to the board. That is, the articles of the association of a company may allow its directors to make a contract (or arrangement) or to be interested in a contract (or arrangement), with the company without securing the informed consent of the general meeting.[129] The requirement of disclosure imposed by the statute justifies such a relaxation.[130] Based on their fiduciary duties, the directors need to disclose to the company any situation where they may have a conflict of interest.[131] These situations include the following

---

[128] *Aberdeen Ry. Co. v. Blaikie Brothers* (1854) 1 Macq. H.L.S.C. 461; [1843-60] All E.R. Rep. 249. The headnote reads: "The director of a railway is a trustee, and, as such, is precluded from dealing, on behalf of the company, with himself, or with a firm of which he is a partner."

[129] *Guinness plc. v. Saunders* [1990] 2 A.C. 663, p. 692.

[130] s. 317 of the Companies Act 1985 provides that it is the duty of a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company. However, it is worth mentioning that certain types of contracts are still closely controlled by the statute, e.g. corporate loans to directors: s. 330 of the CA 1985.

[131] *Queensland Mines Ltd. v. Hudson* [1978] 18 A.L.R 1; *Ex parte James* (1803) 8 Ves. 338. The headnote reads as follows: "Purchase of a bankrupt's estate by the solicitor to the commission set aside. The Lord Chancellor would not permit him to bid upon the resale, discharging himself from the character of solicitor, without the previous consent of the persons interested, freely given, upon full information."

prototypical transactions: (1) where directors have transactions with the company (self-dealings); (2) when directors seek to use the corporate opportunity;[132] (3) when directors represent both the company and the third party simultaneously in the same transaction; and (4) sometimes where directors receive no direct or obvious benefit such as a commission or share of profit but are indirectly benefited.[133]

In these situations, directors are under a duty to disclose all the material information regarding the object, transaction, or opportunity concerned. This disclosure should be complete, precise, and unambiguous as to every matter within the director's exclusive knowledge, which it is material[134] for the company to know.[135] Disclosure in these cases to the appropriate body of the company (in principle, the general meeting, and in some cases to the board) gives the opportunity for that body to consent to, or ratify, the retention of the interest or advantage by the director in question. Otherwise, all "secret" profits must be surrendered to the company.[136] For example, at common law, the general rule of agency law requires a director to disclose the contract to supply services to the company where he is the proprietor of the supplier. Stated otherwise, this duty comes from the fiduciary relationship between the company and the director governed by the law of trusts (to a certain extent) and the law of agency, which have been the principal sources for the rules of disclosure. As a result, the mandatory disclosure would have limited function here.[137]

---

[132] *Boardman v. Phipps* [1966] 3 All E. R. 721, at p. 747; *Queensland Mines Ltd v. Hudson*, id., p. 8.
[133] For example, in the situation where a director of the company has an interest as a shareholder in another company; he is the person interested.
[134] The meaning of materiality is discussed in Chapter Five.
[135] See Turner and Sutton, supra note 123, p. 401. See also Detlev F. Vagts, *Materials on Basic Corporation Law*, 3rd ed., 1989. p. 550.
[136] See Philip L.R. Mitchell, *Insider Dealing and Directors' Duties*, 2nd ed., 1989, pp. 69, 79. See also *Parker v. Mckenn*, (1874) 10 Ch. App. 96, pp. 124-5.
[137] Mandatory disclosure in this case, see Yellow Book, Chapter 11 (Transactions with related Parties).

2. Taiwan

In Taiwan, the concept of "fiduciary duty" does not exist. Instead, these problems are regulated by the Civil Code; specifically, the law of representation and the law of mandate contract. Theoretically, the board of directors is an organ of the company (the organic theory); its activities on behalf of the company are deemed to be the company's activities; directors are like the hands, the legs, and the brain of the company, the legal person.[138] Thus, in a strict legal sense, when the directors act on behalf of the company, there is only "one" legal personality involved on the company side — the company's. Nonetheless, the law of representation applies to the external relationship between a company and its directors.[139]

It is important to bear in mind that in Taiwan two legal relationships between a director and his company need to be considered. One is the external potentially tripartite relationship governed by the law of agency which forms part of the general principles of the Civil Code (for the sake of clarity, agency is better here called representation); the other is the internal bilateral relationship governed by the contract of mandate in the special part of the Code.

At a general level, representation (agency) and mandate are two separate relationships. Representation may or may not be accompanied by a contract of mandate between the principal and representative (agent) regulating the responsibilities of each. A contract of mandate is a contract whereby the parties agree that one of them commissions the other party to take charge of his affairs, and the latter agrees to do so. In other words, the existence of a representation relationship does not necessarily give rise to a contract of mandate between the representative and the principal because representation can be created by the principal's unilateral declaration of intention, while

[138] A similar concept was mentioned in the English case *Bolton v. Graham* [1957] 1 Q.B. 159.
[139] When an agent represents his principal to deal with a third party, theoretically, there are two legal personalities on the former side, the agent's and the principal's.

the meeting of two minds is indispensable for creating a contract of mandate. For example, if A leaves a message for B asking B to sell A's car, although B is authorised to represent A should he choose to (i.e. B has A's authority to alter A's legal position), no contract is made. However, if B promises to sell the car for A, then, there is a contract of mandate between A and B as well. In such a situation, representation and the contract of mandate exist simultaneously.

external relationship

Following the organic theory, when the company deals with outsiders, the relationship between the company and the director is one of "representation". The concept of "representation" in the Taiwanese Civil Code is slightly different from that of English common law. It means that any juristic act of the representative in the name of the principal, within the scope of its delegated authority, takes effect directly both in favour of and against the principal. If the name of the principal is unknown to the party to the transaction, this is a juristic act of the person who acts, not of the company.[140]

Juristic acts (although extensively referred to are not defined by the Taiwanese Civil Code) have been defined as follows:

> "...the notion of *juristic act* (*Rechtsgeschäft*)...This is one subcategory of the concept of *legal act* in the wider sense (*Rechtshandlung*), signifying any act of a legal person which has effects in private law; ... It is because of a person's *declaration of intention* (*Willenserklärung*) that his juristic act has its legal effect..."[141]

This relationship between a principal and a third party is made possible by the principal's unilateral declaration of intention to confer an authority of representation

---

[140] Article 103 of the Civil Code.

[141] See Konrad Zweigert and Hein Kötz, *An Introduction to Comparative Law*, 2nd ed., 1992, pp. 348-9. The translation of "legal person" seems confusing, as the term legal person is usually used in contrast to the term natural person. The more appropriate translation here (at least as far as Taiwanese law is concerned) appears to be "persons who have legal capacity".

upon the representative. From that moment, a representative has the power to exercise this authority.

One further point is relevant to the particular situations of directors' disclosure. In general, a representative may not, without the specific consent of the principal, enter into a juristic act in the name of his principal with the representative himself in his own name, or with a third party to whom he is the representative; in others words, he may not act on both sides of a transaction.[142] For example, a representative cannot sell the principal's property to himself, or to a third party of whom he is the representative as well. This rule protects the principal against a representative sacrificing the principal's interest for his own or a third party's benefit. Consequently, in such cases, the juristic act is void unless consent is given by the principal, i.e. the principal's legal position as regards the third party is not changed by it. No disclosure requirement is explicitly set out here. What the law requires for such a juristic act to take effect is the specific consent of the principal; with regard to the conditions for obtaining such consent, the law is silent.

The general rule is that if the principal gives his consent freely, the juristic act is valid unless there is fraud or duress when the consent is given. The problem is that simple silence does not generally constitute fraud; if non-disclosure is made passively, (that is, the principal does not inquire) then, are there any specific disclosure obligations which should be imposed on the representative in order to establish fraud if the representative does not comply with them? Two different levels of disclosure are involved. The first level falls into the category of common sense where a representative has to disclose certain information to obtain specific consent of his principal, for example, the object of the transaction in question, the offering price and financing. However, this level of disclosure would not necessarily provide the principal with all material information which is likely to affect the principal's decision on giving consent.

[142] Article 106 of the Civil Code.

Accordingly, the second level of disclosure, i.e. fully disclosing all material information, plays a more important role when the so-called "informed decision" is the aim. The most serious problem of Taiwanese law is that it does not require the representative to fulfil the second level disclosure in any explicit way. For example, if a representative intends to purchase an acre of agricultural land from his principal, he will certainly disclose the location of the land, the price he offers, the market price of the same kind of land in the area, and possibly the reason for his purchase; this is the first level disclosure. However, he may withhold some material information from the principal, which should be disclosed if an obligation to make second level disclosure is imposed by law; for instance, if he know that it is likely in the near future that the government will change the zoning of the land from an agricultural to a commercial one and this will increase the value of the land substantially.

As indicated above, when considering the validity of a representative's authority, the representative generally owes no further obligation to the principal because the conferment of the authority is made by the principal's unilateral declaration. That is, the validity of a representative's authority to represent the principal does not depend on whether or not the representative owes obligations to the principal. Additionally, even though the principal may put a great deal of faith in the representative (which is sufficient under English law to create a fiduciary relationship), it is difficult to argue that a representative should actively disclose all material information to the principal because the concept of fiduciary duty does not exist under Taiwanese law. Moreover, there are no rules of equity in the Taiwanese legal system, in contrast with the common law jurisdictions. Thus, in Taiwan, for a man to give valid consent (a declaration of intention) he must either have the legal capacity (*sui juris*)[143] or have secured consent from his legal guardian in advance.[144] The law respects a person's free will provided that there is no fraud or duress.

---

[143] Article 12. When a person is 20, he or she has this capacity.
[144] Article 77.

In the situation where a company is a principal, one more question needs to be examined: from which corporate organ should a director secure the specific consent? Admittedly, if the shareholders' consent is given in general meeting, the transaction concerned should be valid. The problem is whether the board of directors can give valid consent as well. In principle, unless otherwise required by the statute or memorandum that a resolution by general meeting is required, the board of directors has power to decide everything for the company. Therefore, board consent satisfies such a requirement.[145]

internal relationship

Internal relationships between a company and its directors are governed by a contract of mandate. In fact, even if no contract is made by them, the law regulating a constructive contract of mandate applies.[146] Based on this relationship, the director has a duty of care which amounts to the standard of the ability of a "conscientious and reasonable man".[147]

As discussed above, if the relationship is merely that of representative, the law does not require the representative to make full disclosure (the second level) to his principal before he secures the specific consent. The question arises whether the contract of mandate between the representative and principal has an effect on disclosure. The courts have not yet had addressed this issue. Nor have academics discussed the question. However, it is possible to develop a disclosure obligation from the mandate relationship. When there is a conflict of interest, the director should put the company's interest above his own. He is obliged to help the company make a well-informed judgment, i.e. to help the company decide whether to give consent or not.

---

[145] Article 202, CL. Specific consents which must be given by the general meeting, see Article 209, CL, infra note 155.

[146] Article 192(3), CL, provides: "The relations between the company and its directors shall be governed by the provisions of the Civil Code relating to mandate unless otherwise provided for in this law."

[147] Article 192(3) of the CL and Article 535 of the Civil Code.

The company can do this only with the knowledge of all material information. The director is under the duty of care which may require him to disclose the information to the company. Article 209 of the Company Law reiterates this rule. It provides:

> "A director who does anything for himself or on behalf of another person that is within the scope of the company's business, shall explain to the meeting of shareholders the material contents of such an act and secure its approval."

This Article, which basically deals with the problem of corporate opportunities but is also of a wider application, can help the court explain why the director, based on a contract of mandate with the company, has obligations to disclose fully all material information before he obtains the consent from the company in situations where there is a conflict of interest.

conclusion

In short, the rationales for English and Taiwanese law appear different: English law establishes directors' duties by the application of the concept of fiduciary duty, while Taiwan approaches this problem from the interpretation of the mandate relationship. Nonetheless, both the UK and Taiwan can achieve the same function of disclosure with regard to the relationship between the company and the director.

For example, under English law, when a director (or a promoter) sells his property to the company without full disclosure, even if the shareholders' consent in general meeting is secured, the company can still set aside the transaction because the director has breached his fiduciary duty. In contrast, in Taiwan, although there are no fiduciary duties, the company should be allowed to set aside such a transaction to which the shareholders' consent in general meeting has been given if the non-disclosure has amounted to a violation of the director's duty of care, which must be exercised in the manner of a conscientious and reasonable person.

Thus, the function of mandatory disclosure under English law is subsumed under the idea of fiduciary duty. In contrast, in Taiwan, mandatory disclosure still has certain functions. First, there is no second level disclosure requirement (i.e. disclosing all material information) before consent is obtained in a purely representative relationship. The reason why a director has to make disclosure is because there is a contract (or constructive contract) of mandate, and thus the difficulty in a purely representative relationship is avoided. However, this duty comes from the interpretation of the duty of care and has never been articulated by the courts. Hence, it is submitted that a general mandatory disclosure requirement should be inserted into the statute to ensure that the company is fully informed.[148]

the use of inside information

1. the United Kingdom

The meaning of "inside information" as used in this section of this thesis is broader than what we usually mean by "insider dealing". Here, the term encompasses the situation where a corporate opportunity is involved. The English courts have substituted corporate information for opportunities in certain cases where the companies were unlikely to enjoy such opportunities. For example, in *Industrial Development Consultants v. Cooley*,[149] the court based the director's liability on misuse of information rather than the misappropriation of the opportunity.

---

[148] How to secure a valid transaction in self-representation and both-side representation in Taiwan is tabulated below:

	consent of the principal	full disclosure by the representative
purely representation relationship	yes	? (may not be required)
contract of mandate	yes	yes (should be required)

[149] [1972] 1 W.L.R. 443.

It is an "inflexible" rule of English law that directors cannot make a profit out of their position, and are not permitted to put themselves in a position where their interests and duties conflict.[150] Whenever the opportunity falls into a company's business scope, even if the company has no financial ability or interest to enjoy the opportunity, its directors cannot take over the opportunity unless full disclosure is made and the company's consent is obtained. Although there are good reasons for this rule, its application can sometimes lead to unjust results.[151]

Directors' use of inside information may entail a conflict of interest between them and the company;[152] in such situations, they are under a duty to disclose all the material information to the company. Moreover, in cases of insider dealing,[153] the application of such a rule should be apposite. Under English case law, a director occupies a position of quasi-trustee of and agent for the company. The director is a fiduciary and thus subject to a duty to the beneficiary not to use on his own account information confidentially given him by the beneficiary or acquired by him during the course of the fiduciary relationship. If a director violates this duty, he holds any profit as a constructive trustee for the company which is entitled to recover the profit; loss to the company is irrelevant.[154] Although for directors, no obvious "conflict of duty and

---

[150] *Bray v. Ford* (1896) A.C. 44, at p. 51.

[151] *Regal (Hastings) Ltd. v. Gulliver* [1967] 2 A.C. 134. The facts, briefly cited, were as follows: Company A owned a cinema and the directors decided to acquire two others with a view to selling the whole undertaking as a going concern. For this purpose they formed company B to take a lease of the other two cinemas. But the lessor insisted on a personal guarantee from the directors unless the paid-up capital of company B was at least £5,000. The company was unable to subscribe more than £2,000 and the directors were not willing to give personal guarantees. Accordingly the original plan was changed; company A took up £2,000 and the remaining £3,000 were taken by the directors and their friends. Later, instead of selling the undertaking, all the shares in both companies were sold, a profit of £2.16s.1d. being made on each of the shares in company B. The new controllers then caused company A to bring an action against the former directors to recover the profit they have made.

[152] *Industrial Development Consultants v. Cooley* [1972] 1 W.L.R. 443; *Canadian Aero Service v. O'Malley* [1973] 40 D.L.R. (3d.) 371.

[153] The Criminal Justice Act 1993 (the major source of legal regulation of insider dealing).

[154] *Regal (Hastings) Ltd. v. Gulliver* [1967] 2 A.C. 134, pp. 144-5. It reads: "The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited

interest" occurs here, insider dealing would affect the investors' confidence in the market. Such an effect is not, anyhow, good for the company. Accordingly, to make directors accountable to the company for their benefits in insider dealing is sound even if the company may suffer no loss.

2 Taiwan

In the UK, the company's right to recover profits made by directors' use of inside information derives from the fiduciary duty of directors. In contrast, in Taiwan, the directors' duties derive from contractual (or constructively contractual) obligations. These contractual obligations require directors to exercise a conscientious and reasonable person's duty of care when managing the business of the company.

We first turn to the problem of corporate opportunities. If a company has any possibility of benefiting from an opportunity, then a director will be held liable to the company if he misappropriates such an opportunity. The rationale underlying this rule is that, benefiting from an opportunity, the director violates his obligations to exercise a conscientious and reasonable person's duty of care. However, whether a director can use the opportunity without the violation of his duty which results from the mandate relationship is unclear. The Civil Code does not state whether full disclosure is required before consent can validly be given. Fortunately, the Company Law has a "mandatory disclosure" requirement which solves this difficulty.[155]

Second, turning to "insider dealing", whether because of this contractual relationship, a director has an obligation to refrain from insider dealing under the

---

by his action. The liability arises from the mere fact of a profit having, in the stated circumstances, been made."

[155] Article 209(1) provides: "A director who does anything for himself or on behalf of another person that is within the scope of the company's business, shall explain to the general meeting of shareholders the essential contents of such an act and secure its approval." This Article thus resolves the problem raised in the text by mandating directors to make disclosure to the company. If directors fail to do so, Article 209(5) empowers the company to recover from the directors the profits gained from their unauthorised act.

general law is unclear. It is submitted that directors' contractual obligations are to manage the company with a conscientious and reasonable duty of care. Hence, if the insider dealing does not interrupt the normal operation of the corporate business, the director does not violate his obligation to run the business in accordance with his legal duty. Moreover, even supposing that we can establish a director's breach of duty in this situation, it is difficult to assess the company's loss from insider dealing. If a fiduciary duty was applicable, then the loss to the company would become irrelevant, and the company would be able to recover by claiming that the director had breached his fiduciary duty and held the profit as a trustee. However, without the help of this equitable concept, this avenue is blocked. The company is left with the difficult question whether the contract of mandate has been breached and whether damage ensues therefrom.[156]

the duty of preparing corporate accounts

1. the United Kingdom

It has been a long time since the Joint Stock Companies Act 1844 required directors to prepare the corporate accounts. The problem is that if there was no statutory requirement, would directors be obliged to prepare these documents annually based on their duties? The answer should be negative. The fiduciary duty of directors does not put them in a position that they have to prepare the balance sheet or the profit and loss report.[157] As a result, a mandatory disclosure requirement (here respecting the disclosure made to all members of a company by means of preparing corporate accounts) is justifiable.

---

[156] This reveals the difference between the problem in the UK and in Taiwan. Under English law, only a conflict of duty and interest of directors is required; loss of the company is not taken into account. However, in Taiwan, damage from the breach of contract is required.

[157] See Nigel G. Maw, Lord Land of Horsell, and Sir Michael Craig-Cooper, *Maw on Corporate Governance*, 1994, p.4.

2. Taiwan

In Taiwan, according to Articles 540 and 541 of the Civil Code which govern the contract of mandate, the mandatary must keep the principal informed of the progress of the affairs entrusted to him. He must render a true and detailed account of his principal's affairs at the end of the mandate. Besides that, the mandatary must hand over to the principal the money and things which he receives or collects in connection with the management of the affairs of the principal. According to these provisions, directors should prepare the accounts and the director's report to the company, this being the duty that directors owe to the company as their principal, not to individual shareholders.

Finally, both in the UK and Taiwan, directors would have no obligation to disclose their shareholdings to the company in the situation where they purchase or sell shares from the market rather than from the company itself, if the statutes or regulations had not so required. No conflict of interest arises in this situation; nor does the director make a profit otherwise out of his position as a trustee or an agent. Yet, disclosure of this information to the company is advisable as a matter of public policy because insider dealing should be prevented as much as possible.

promoters

1. the United Kingdom

In the UK, promoters have the same liability as that of company directors. Before the company is formally incorporated, it has no legal personality; therefore it is hard to describe the promoter as the agent of an unborn person. Promoters, however, can be deemed as constructive agents or trustees of this unborn person. The old familiar

principles of the law of agency and trusteeship have been extended, and very properly extended, to meet such cases.[158]

Thus what has been examined above with regard to self-dealing and both-side representation can be extended to apply to the situation where the actors are promoters rather than directors. Stated otherwise, promoters owe fiduciary duties to the unborn company; they have to disclose all material information to the unborn person. As a result of this, disclosure is made either to an entirely independent board of directors[159] or to the existing and potential members as a whole.[160]

2. Taiwan

It is well accepted, in the UK, that before a company is formally incorporated, it does not "exist". However, the Taiwanese legal concept, derived from Germany, is different in that it regards an unborn company as having the same "identity" as the company later formed; "the same identity theory". Hence, this "unborn company", theoretically, is endowed with a "constructive" legal personality,[161] recognised by the courts as well.[162] Expressed otherwise, an "unborn company" conceptually exists. Consequently, once incorporated, the company becomes liable to or entitled under contracts purporting to be made on its behalf prior to incorporation. Thus, no succession and no ratification issues arise, because the "unborn company" and the "company formed later" are the same person. There is no necessity for the company to re-sign contracts after its incorporation. However, this does not mean that all contracts entered into before incorporation will become the company's after incorporation. Only those

---

[158] *Lydney and Wigpool Iron Ore Co. v. Bird* (1886) 33 Ch.D. 85, p. 94.
[159] *Erlanger v. New Sombrero Phosphate Co.* (1878) 3 A.C. 1218.
[160] *Salomon v. Salomon* [1897] A.C. 22; *In re Leeds & Hanley Theatre of Varieties* [1902] 2 Ch. 809. In the latter case, it was held that promoters stood in a fiduciary position towards the persons who were invited to take shares in the company, and it was their duty to disclose to those persons the fact that they were the real vendors to the company (sale of property to the company).
[161] Fang-chih Ko, supra note 91, p. 22.
[162] The Supreme Court, *71 t'ai shang tzu ti 4135 hao.*

transactions which relate to the "preparation for commencing business" are covered by this theory.

Besides that, promoters are required to be jointly and severally liable for debts of the company incurred prior to incorporation.[163] Thus, although the company automatically becomes a party to transactions made by promoters in the situation where transactions were made on its behalf for preparing to commence business, the company will not be worse off because promoters are held to be liable as well.

Thus, promoters to an unborn company are like directors to a company; the former occupy the same position as that assumed by the latter when they carry on business on behalf of the unborn company, and the same duties are imposed on them.

3.2.3.2. Individual Shareholders

In this section, two basic issues common to both the UK and Taiwan jurisdictions are tackled. The first problem is whether and to what extent a director who has a transaction with a member involving the company's securities is bound to make disclosure to the individual member (or shareholder). Second, whether directors who only provide advice to shareholders can be held liable for incomplete disclosure of relevant information.

In the UK, the general view is that directors are under no obligation to disclose information (known to themselves personally but not to individual shareholders) to shareholders in securities transactions due to the absence of any fiduciary relationship. Although the duty owed by directors to individual shareholders has its roots in the law

[163] Article 155(2), CL.

of tort, the scope of information disclosed is considered narrower than in the case of such disclosure on the ground of fiduciary disclosure or mandatory disclosure requirements.

In Taiwan the situation is worse. With the exception of fraud, directors can escape liability in the majority of cases since the concept of "voluntary assumption of liability", not to speak of the possible arising of duty of care, does not exist.

With regard to the first problem, a preliminary distinction needs to be drawn between two separate situations: is the securities transaction made between a director and a shareholder face-to-face or is it a "faceless" market transaction? If it is face-to-face, the issue turns on the question of who approaches whom.

1. the United Kingdom

In the UK, generally, "...no fiduciary duty is owed by a director to individual members of his company, but only to the company itself..."[164] Accordingly, directors' duty to prepare accounts is towards the company itself rather than towards individual shareholders.[165] For example, a shareholder does not have standing to complain of the manner in which a company's accounts are prepared, as the duty to prepare accounts of the company imposed on the directors by the articles of association is a duty owed to the company itself and not to the shareholders individually.[166]

In contract, the traditional rule of sale is *caveat emptor*, literally translated as "buyer beware", under which the seller has no obligations of warranty and neither is the seller obliged to disclose fully material information about the object to the buyer.

---

[164] *Jenkins Committee Report,* Cmnd. 1749, 1962, at para. 89; G.B. Parker, M. Buckley and Sir Raymond Walton, supra note 88, p 1009.

[165] The preparation of accounts is deemed, in this thesis, to be a duty of disclosing corporate information to the company itself.

[166] *Devlin v. Slough Estates Ltd. and others* [1983] B.C.L.C. 497, p. 497.

Nonetheless, buyers did have some rights under the traditional common law: e.g. sellers could not commit fraud. For example, a seller could not actively provide some information which is untrue, or omit some information which renders the whole representation misleading, because it constitutes fraud in both situations. But, simple silence in no way constitutes fraud unless there is a special relationship between the parties, which obliges the person who occupies an advantageous position to disclose material information to the other party such as in a contract of the utmost good faith (*uberrimae fidei*).[167] Mere non-disclosure in this kind of contract provides a basis for rescinding the contract in question.[168]

Following this, when there is a transaction between a director and an individual shareholder face-to-face, the director is not required by law to disclose any information known to him because of his position but not to the individual shareholder, which may be material to this transaction, because he owes no fiduciary duty to the individual shareholder. This rule may apply when an individual shareholder voluntarily approaches a director;[169] however, it may not be true if the situation is reversed. In *Percival v. Wright*, it was held that the defendant directors were under no duty to disclose the negotiations for the sale of the undertaking to the plaintiff shareholders. It should be borne in mind that the fact in *Percival* was that the plaintiff approached the defendant, and the judgment did not point out whether it would have been different if the situation had been reversed.

When a director is the party who initiates this negotiation, the focus may be shifted from the traditional rule of sale to a fiduciary relationship, which may be created by the act of the director. That is, the director's voluntary act may in fact put

---

[167] See Robert Upex, *Davies on Contract*, 6th ed., 1991, p. 103. One of the examples is an insurance contract. See also Bernard Rudden, "Disclosure in Insurance: The Changing Scene", in *Lectures on the Common Law*, Vol. 3, pp. 1-13, 1991.

[168] *Chitty on Contracts*, 1994, pp. 390 et seq.

[169] *Percival v. Wright* [1902] 2 Ch. 421. However, it is notable that where directors are agents for the shareholders under a pre-emption clause in the articles of association they are under a duty of disclosure up to the moment the shareholders agree to the sale under that procedure. See *Company Law Monitor*, 2(8), 3-4, 1994, p. 4. *Munro v. Bogie* [1994] 1 B.C.L.C. 415

him under a duty to make disclosure; such a duty arises because the shareholder puts reliance on the director. Therefore, if the director does not make disclosure, the shareholder should be entitled to sue for redress. The argument advanced by a New Zealand decision in *Coleman v. Myers*[170] could, by analogy, be applied to this situation since the fact, which was present in that case, that the directors actively provided advice to the shareholders bears close resemblance to the situation where directors actively approach shareholders to enter into securities transactions with them.

However, if the transaction is anonymous, then there is no "specified and identified" counterparty to whom the director can make disclosure. Under this circumstance, the director cannot be expected to perform his duty and he should not be held liable to the so-called identified buyer or seller unless we adopt the "disclose or abstain from transactions" rule and impose civil liability on violators.[171]

In these two situations, (1) a face-to-face transaction initiated by an individual shareholder and (2) a transaction executed in an open market, the individual shareholder clearly has no rights under the common law. Mandatory disclosure can help to rectify such unfairness. *The system of mandatory disclosure can impose a duty upon a director, which in law is owed directly by a director to an individual shareholder and this duty will require the director either to make full disclosure to the individual shareholder (in the latter situation, to the public) or abstain from transactions.* Once the law posits an obligation of disclosure, it may further impose civil liability on a director for violation of this obligation.

---

[170] [1977] 2 N.Z.L.R. 225, p. 298. See also *Re a Company* [1986] B.C.L.C. 382.

[171] If directors do not disclose, the only way they can avoid such consequences happening (shareholders incurring losses) is to refrain from transactions. However, the Criminal Justice Act 1993 only provides criminal liabilities; no civil liability is available unless cases fall into the scope of the Financial Services Act 1986, sections 61 and 62. Thus mandatory disclosure requirements are very important. Although the regulations do not mandate directors to disclose to shareholders individually, frequent disclosure by the company to the public under such regulation can help shareholders update information they have. Then, with the help of the deterrence deriving from criminal liabilities, directors cannot cheat shareholders.

Turning to the aspect of torts. A duty in tort to be honest, by nature, requires directors not to mislead shareholders. Thus, directors have to disclose information to shareholders to a certain extent. In *Gething v. Kilner*,[172] Brightman J. held that the directors of an offeree company had a duty not just to the company but towards their own shareholders, which included a duty to be honest and a duty not to mislead, when they provided the shareholders with advice concerning the offer. Nonetheless, the scope of information required to be disclosed under tort duty would comparatively be smaller than that of information which directors have to disclose on the ground of fiduciary duty or mandatory disclosure requirements. In *Prudential Assurance Co. Ltd. v. Newman Industries Ltd.*[173] the court held that the directors, in advising the shareholders to support the resolution approving the agreement made by them, owed the shareholders a duty to give such advice in good faith and not fraudulently. The contents of this advice should cover all material information because the defendants' company was a listed company and thus was regulated by the Stock Exchange. The Yellow Book of the Stock Exchange sets out the full contents of the circular which contained this advice in the case.[174] From the above statement, we observe that regulators are not satisfied with the contents of disclosure deriving from tort law, and thus impose mandatory disclosure requirements.

Furthermore, the evolution of English case law demonstrates that it may be possible in the future for a director to be obliged to disclose fully to individual shareholders even though he only provides advice.[175] As English case law at this stage

---

[172] [1972] 1 W.L.R. 337, p. 341.
[173] [1982] 1 All E.R. 354, p. 366.
[174] See Chapter 11 of the Yellow Book.
[175] *Re a Company* [1986] B.C.L.C. 382. *Per* Hoffmann J. :"I do not think that fairness can require more of the directors than to give the shareholders sufficient information and advice to enable them to reach a properly informed decision and to refrain from giving misleading advice or exercising their fiduciary powers in a way which would prevent or inhibit shareholders from choosing to take the better price." (p. 389) This case did not use the term "directors' fiduciary duty"; rather, it analysed the problem from the perspective of "directors' fiduciary power". Therefore, whether English case law will impose fiduciary duty on directors towards individual shareholders remains uncertain. Moreover, the case did not clearly separate the role a director played as a director from that he or she acted as a substantial shareholder. This would exaggerate the case law development in this case.

has not gone far enough, mandatory disclosure requirements imposed by the City Code on Takeovers and Mergers and the Yellow Book come into play to solve the problem.[176] The clearest and most brave case regarding directors' duty of disclosure to individual shareholders when they provide advice is a New Zealand decision, *Coleman v. Myers*.[177] This case concerned a take-over bid. The respondents were father and son, directors of the company; both of them recommended to the shareholders that they accept a take-over offer made by the son, and all the shareholders accepted this offer. Later on, a minority of the shareholders brought an action for damages or rescission of the sale of their shares, because the statement made by the directors was deficient and misleading, and the directors were under a fiduciary duty to make full disclosure to the shareholders. The court held that the directors had a fiduciary duty toward the individual shareholders when a determination was partly based on information and advice provided by the directors. The extent of disclosure is to disclose material matters as to which the director knows or has reason to believe that the shareholder whom he tries to persuade to sell, is or may be inadequately informed.[178] The court thus ordered damages.

From this, it appears that directors may have obligations to make full disclosure either based on the case law (e.g. in New Zealand, probably) or by mandatory disclosure requirements imposed by statutes or regulations (in the UK). In the UK, at this stage, the duty of directors to shareholders mainly derives from tort law unless there are mandatory disclosure requirements. In *Coleman*, the duty is based on the extent of confidence that individual shareholders have put in the directors. The more directors expect that shareholders will rely on the information they provided, the more likely they are to find themselves in a fiduciary relationship with those shareholders and are thus obliged to make honest and full disclosure. Since English common law has not developed to such an extent, mandatory disclosure is justified.

---

[176] Chapters 10 and 11 of the Yellow Book; Rules 3, 8, 19, 20, 25, 27, and 28 of the City Code.
[177] [1977] 2 N.Z.L.R. 225, p. 298.
[178] Id., p. 333. See also *Re Chez Nico (Restaurants) Ltd.* [1992] B.C.L.C. 192.

2. Taiwan

In Taiwan, although the courts have raised neither of these two problems and academics seldom have commented on them, these problems are not easy ones. This thesis has emphasised many times in the previous sections that Taiwanese law has no concept of fiduciary duty. Therefore the only way to decide the relationship between a director and a shareholder is by virtue of the application of the rules of contract and tort in the Civil Code when the former deals with the shareholder. A director has no obligation to disclose material information to a shareholder during negotiations for the purchase or sale of the shareholder's shares. Consequently, unless fraud can be found (either because the director actively lied to the shareholder or kept silent when the shareholder stated his understanding of the object concerned and that understanding was wrong[179]) the shareholder has no remedies in tort. Moreover, in the situation where a director has inside information unknown to a shareholder, this kind of liability is unlikely to be incurred, because what the director has done is to remain passively silent. As regards the law of contract, since the director has no obligation to make disclosure, there is no breach of contract, and accordingly, no remedies in contract are available to the shareholder in this situation.

The final possible solution is to resort to Article 74 of the Civil Code. This Article is a codified equivalent of a rule of equity,[180] which empowers one party who sustains loss to apply to the court to have the juristic act set aside or to reduce the unconscionable payments. Four conditions must be met before this Article is invoked:

---

[179] For example, since a shareholder does not have the updated corporate information, he may say to a director: "The shares of the company are not worth holding and I would like to sell my shares to you, because after five years of exploration for copper, nothing has been found." When this statement was made by the shareholder, the director knew that a report had been received which stated that the substantial quantity of copper was found. However, the director did not tell the shareholder the truth and just bought the shares.

[180] In Taiwan, as already mentioned, a set of rules of equity have never been established because Taiwan adopts the continental legal system. Nor does Taiwan have a court of equity. The most important rules of equity, such as fairness and good faith, have been codified in several articles of the Civil Code of which Article 74 is an example.

(1) there must be a juristic act, (2) by which one party (the victim) delivers or promises to deliver property rights to the other party (the culpable one); (3) the act is done in situations where the victim is affected by *urgency, indiscretion, or inexperience* which is known to the culpable party and made use of by him; and (4) unfairness of the juristic act must be serious in relation to the concomitant circumstances. A juristic act made under such circumstances is obviously an unfair one, and the law gives the victim a right of action to apply to the court for redress.

Thus, if a shareholder deals in shares with a director in circumstances affected by urgency, indiscretion, or inexperience (for example, when he needs cash immediately, or he has no or only limited experience in securities transactions) and this is known to the director and he intentionally makes use of this opportunity to make a profit, the shareholder will be entitled to a remedy on application to the court. Unfairness caused by the juristic act must be serious, however, otherwise the court has no power to set aside the act or reduce the unconscionable payments.

As far as the second problem is concerned; that is, directors provide shareholders with information to help them reach decisions, directors are not held liable under the Civil Code unless there is deceit which is resolved by the law of torts.

To sum up, in these two situations (transactions between a director and a shareholder, and the provision of advice by a director) the general law cannot achieve the goal of disclosure because it has not enough power to force directors to make disclosure . In other words, mandatory disclosure based on the relationship between a director and a shareholder can be justified in Taiwan if the government decides to give more information to investors, to increase the transparency and fairness of the market, to stop insider dealings, or even more, to compensate a shareholder when he has transactions with a director in the situation where the director makes profits out of his superior knowledge.

3.2.3.3. Creditors

Before an investor becomes a debenture holder of a company (i.e. becomes the company's creditor), he needs financial and business information about the company to make an informed investment decision. Furthermore, after he has acquired debentures, he needs continuing provision of corporate information to decide, e.g., whether to purchase more debentures or to sell those he has. However, in the general law, directors owe no disclosure obligation towards creditors; the only source from which creditors can obtain corporate information is to make such an enquiry during the negotiation of the contract of sale and lay down this kind of provision in the contract.

1. the United Kingdom

In the UK, it is clear that directors owe no fiduciary duty to the company's creditors.[181] Accordingly, creditors are left without any provision of information on the company's business development and financial situation if there is no mandatory disclosure requirement. Even if it is possible, at this stage, to advance creditors' interests by means of interpreting that the "interests of the company" embrace the interests of

[181] "No fiduciary duty is owed by a director to individual members of his company, but only to the company itself, and a fortiori ... none is owed to a person who is not a member." *Jenkins Committee Report*, Cmnd. 1749, 1962, at para. 89. However, this rule may be changed. From the original view that directors owed no duties to creditors to the current interpretation that the interests of the company may embrace the interests of creditors, we can see that signs of change are on the way. The reason for such a change may be traced to a change in the function of the modern company. For the modern company, to maximise shareholders' interests may not be the only concern of directors any more. In the view of some scholars, a company not only bears the function of the maximisation of profits for its members but also bears the function as a social institution, which requires the company to take the social interest into consideration in its operation. See Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, revised ed., 1968, p. 7. This can be clearly observed from German company legislation. See Janet Dine, "The Harmonisation of Company Law in the European Community", in 9 *Yearbook of European Law* 1989, 93-119, 1990, pp. 93-5. Interestingly, the City Code on Takeovers and Mergers provides: "It is the shareholders' interests taken as a whole, together with those of employees and creditors which should be considered when the directors are giving advice to shareholders.", General Principle 9.

creditors,[182] this could not lead to a conclusion that directors owe fiduciary duty towards creditors regarding disclosure. As a result, only by imposing the obligation of disclosure on the company and its directors can creditors gain access to corporate information which they need just as much as shareholders.[183] That is why the Companies Act 1985 provides that debenture holders are entitled to receive a copy of the company's annual accounts.[184]

2. Taiwan

In Taiwan, the general law has no special developments pertaining to this issue of disclosure. The remedies are available in the Civil Code and the Insolvency Act. First,

---

[182] See D.D. Prentice, "Directors, Creditors, and Shareholders", in *Commercial Aspects of Trusts and Fiduciary Obligations*, Ewan Mckendrick (ed.), 1992, p. 73; s. 309 of the CA 1985.

[183] The law has chosen two methods to mitigate the shortcomings of the general law (i.e. the company and its directors are not obliged to disclose to creditors). One is from the case law which admits that directors may owe a fiduciary duty to creditors when the company is insolvent or on the verge of insolvency (as a result, it is possible to interpret that there is obligation of disclosure in this situation by liquidators). The other, which does not relate to disclosure but protects creditors by deterring directors from wrongful trading, is s. 214 of the Insolvency Act 1986. This section holds that directors are liable to make contribution to the company's assets when certain conditions are fulfilled. As regards judicial developments, see *West Mercia Safetywear Ltd. v. Dodd* ([1988] B.C.L.C. 250); *Kinsela & Anor v. Russell Kinsela Pty Limit* ((1986) 10 A.C.L.C. 395). When a company is insolvent, corporate assets in reality belong to the creditors, rather than shareholders. Thus, the substance of directors' fiduciary duties towards the company will be shifted from "shareholders as a group" to "creditors". Expressed otherwise, directors at this stage, manage the company's assets on behalf of creditors. These judicial developments aim to restrict the application of the general rule: that is, any act that falls within the corporate capacity of a company will bind the company if it is done with the unanimous consent of all the shareholders or is subsequently ratified by such consent *(Salomon v. A Salomon & Co. Ltd.* [1897] A.C. 22, p. 57, *Re Horsley & Weight Ltd.* [1982] Ch. 442, p. 454, and *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd.* [1983] Ch. 258). Since, when the company is precarious, the persons whose interests are at stake are creditors rather than shareholders, shareholders should not be allowed to ratify directors' breach of duties which are owed by directors towards creditors. Second, regarding s. 214 of the Insolvency Act 1986 (the details of which are not intended to be discussed here), the conditions for this liability to fall on directors are as follows. First, the company goes into insolvent liquidation at a time when the company's assets are insufficient to pay its debts and other liabilities. Second, before the company goes into insolvency, the director knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, but he did not take every step he ought to have taken with a view to minimising loss to the company's creditors. When both of these conditions are met, the court is empowered to order the director to contribute to the assets of the company (See D.D. Prentice, "Creditor's Interests and Director's Duties", in 10 *O.J.L.S.*, 265-77, 1990, p. 267. Also *Re Produce Marketing Consortium Ltd. (No 2)* [1989] B.C.L.C. 520). However, neither case law developments nor section 214 of the Insolvency Act 1986 deals with the problem of disclosure.

[184] s. 238(1)(6) of the CA 1985.

liquidators can apply to the court to require a transaction to be set aside provided that the transaction is a gratuitous juristic act which is to the prejudice of creditors, or is a non-gratuitous juristic act but is to the prejudice of the creditors and this was known to the debtor and the opposite party at the time the transaction was made.[185]

Second, directors may be held liable based on the law of tort. About three decades ago, it was debated whether "claims" could be the subject matter of torts.[186] However, it is now well accepted that it can be the case; therefore, if the conditions of torts are met, directors will be held liable.[187] Nonetheless, there is, in Taiwan, no equivalent provision of section 214 of the Insolvency Act 1986. It is submitted that since it is not easy to enforce the obligation of disclosure on directors when the company is on the verge of insolvency, it may be desirable to insert such a provision to the Company Law or the Insolvency law as an alternative to disclosure legislation. It is more appropriate to perform this through the Company Law, because the Insolvency Law is applied to all debtors who are unable to liquidate their debts, and the enactment of director's liability would create an otherwise inappropriate exception within the Insolvency Law.

3.2.3.4 Future Investors

If a director owes no fiduciary duty to individual shareholders and creditors, he should not be liable to future individual investors. The director is not obliged to disclose corporate information to these potential investors; he has no legal relationship with such people. The only two situations where his liability may arise are when he

[185] Article 78 of the Insolvency Law and Article 244 of the Civil Code. In the USA, the Uniform Fraudulent Conveyance Act has similar rules. See also ss. 238 and 423 of the Insolvency Act 1986 (UK).

[186] For example, A is a famous singer; he signed a contract with the manager B to perform in the theatre. C, who wilfully wished to harm B, induced A to sign a contract with him and break A's contract with B. This is a tort, of which the subject is a "claim" rather than a physical good. See Yu-po Cheng, *The General Principles of the Law of Obligations* (*Min Fa Chai P'ien Tsung Lun*), 1985, p. 152. See also *Lumley v. Gye* (1853) 2 E & B 216.

[187] Article 184 (1) of the Civil Code.

represents his company to enter into transactions with them (e.g. sells a company's shares or debentures to investors) and he deceives those people (which makes him liable for fraud) or there is a misrepresentation which later becomes a term of the contract and investors seek compensation from the company, which renders the director liable to the company for his breach of duty. In other words, in the former case, there is a liability in torts, while in the latter case, the liability is for breach of duty arising from the contract (or constructive contract)[188] of mandate (in Taiwan) between a company and a director.

No duty of disclosure will arise when a director is faced with the public. If the law has no mandatory disclosure requirements, a director is not required to prepare prospectuses for the public; nor is he called upon to disclose to the public information periodically or in a timely manner. Admittedly, supposing he decides to disclose, the liability may occur should the information he provides be wrong. But there is no way to establish that a director ought to make disclosure to the public if the system of mandatory disclosure does not exist. That is to say, assuming the government intends the public to be well informed, then mandatory disclosure will be necessary because this alone can ensure that certain legal liabilities are imposed on the responsible people and this, in turn, considerably affects the behaviour of the latter.

3.2.4 The Obligation of the Company in the Preparation of Prospectuses

A company was not required to prepare a prospectus when it intended to issue publicly its securities (e.g. shares and debentures) before mandatory disclosure legislation was enacted both in the UK and in Taiwan. This was because at that time, the obligation was decided by the law of contract. As discussed above, no obligation of disclosure is

[188] See supra page 132.

imposed on contractual parties unless there is some special relationship between the parties such as the existence of fiduciary relationship and contracts *uberrimae fidei*.

In the absence of any special relationship between the company and its potential investors, all the obligations between them are determined by the law of contract where transactions are involved. Consequently, a company does not have an obligation to prepare prospectuses for potential investors. The general law cannot impose this duty on the company.

It is true that if there is any misrepresentation in a prospectus, subscribers or purchasers of the securities related may have the right of rescission or of damages. Nonetheless, these are not sufficient grounds to suggest that a company is under a duty to disclose all the "material" information unless non-disclosure combined with what the company has disclosed constitutes a false impression which misleads investors. For example, a pharmaceutical company has just invented a new kind of medicine which, if successful, will bring great profits to the company; however, there is a fifty per cent possibility that the medicine is not effective. In the situation where there is no mandatory disclosure, the company is entitled to omit such information in the prospectus. But once the company decides to disclose it, the company cannot tell a half-truth, i.e. not mentioning the possibility of failure. Accordingly, only mandatory disclosure can require the company to disclose certain information, which the company originally could choose to omit legally even though it may be important to investors.

3.2.5 Others

Under the general law, a company is not required to provide the public with information; all requirements found today are covered by company's legislation and other securities regulations. A company itself is an entity with legal personality aimed at promoting its members' welfare generally, and only occasionally takes the interest of

employees, creditors or the public into account. If public policy requires a creation of a well-informed capital market, mandatory disclosure will be an indispensable tool to achieve this purpose.

3.3 Conclusion

The importance of disclosure is beyond doubt. After investigating the extent of disclosure available under the general law in both the English and Taiwanese legal systems, it is clear that if there is no mandatory disclosure requirement imposed by statutes or regulations, **the general law does not provide investors with enough protection**.

Shareholders cannot claim their rights of information by simply basing the rights on their status as shareholders; directors in principle owe no duty to individual shareholders to disclose to them even though they do have duties to prepare corporate accounts (in Taiwan only) and maintain loyalty towards the company; in the case of creditors, the situation is no better, and could even be worse, than for individual shareholders, since there is no duty on the part of directors to give creditors any information outside the current statutory requirements. All these facts demonstrate that the protection regarding disclosure offered by the general law is insufficient. The current mandatory disclosure requirements which spread over the Companies Act, FSA 1986, and the Yellow Book show that regulators intend to respond to such shortcomings by making disclosure mandatory. If mandatory disclosure is undesirable (e.g. too costly) then what is left to us with the sole help of the general law? It seems from this, that mandatory disclosure can be justified. Nonetheless, the criticism from economists cannot be ignored, and this will be examined in the next chapter.

Chapter Four

Economic Debate on Mandatory Disclosure

The opponents, especially economic opponents, of mandatory disclosure generally base their arguments on four rationales: the efficient market theory, cost-benefit analysis, portfolio theory, and agency theory. There is abundant literature on these subjects but limited by the space of this thesis it is impossible here to have a thorough examination of the topic; nonetheless, analysing such an economic debate to a certain extent is helpful for examining the real justification of mandatory disclosure.

4.1 The Efficient Market Theory

Economists advocate that in a free competition market, market forces drive companies to disclose information voluntarily, and under an efficient capital market, securities prices fully reflect all available information.[1]

Supposing that the market is efficient, all information is reflected in securities prices and the market itself is capable of resolving most problems. Following this, a company which sells good quality securities will try to distinguish itself from other companies, and release a certain amount of information, which can help it achieve this purpose. Mandatory disclosure requirements would therefore be redundant.[2] The quantity of information being disclosed, under this model, depends on whether information is worth disclosing (i.e. whether disclosure of such information is to the advantage of the company).

---

[1] This is the Efficient Capital Market Hypothesis (ECMH). See supra Chapter Three.

[2] It is specifically true when only historical (or past) information is disclosed because it has been reflected in stock prices already.

Information is further available as securities analysts are much more widespread than before. Vigorous competitive efforts on the part of securities analysts can identify overvalued and undervalued securities, and by means of this processing they rapidly uncover all information useful in identifying mispriced securities.[3] Taken together, these arguments point to the conclusion that mandatory disclosure is unnecessary.

Rebuttal

Two reasons are advanced which support the view that the above theory is not convincing.

(1) the characteristic of information and the free-rider problem

A market itself cannot produce enough information required by investors because of insufficient disclosure from companies and securities research. This problem is traceable to the characteristic of information.

Information itself has some of the characteristics of a public good. The key characteristic of a public good is the non-excludability of users who have not paid for it; consumption of the good by one user does not diminish its availability to others.[4] Information is quickly used up when it has been reflected in securities prices, and its non-excludability shows that it matches this characteristic of a public good so that third parties can benefit from other people's efforts without any compensation, the so-called externalities.[5]

---

[3] See Christopher Paul Saari, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry", in 29 *Stanford L. R.*, 1031-76, 1977, p. 1054.

[4] See John C. Coffee, Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System", in 70 *Virginia L. R.*, 717-53, 1984, p. 725.

[5] An externality "arises where one person ..., in the course of rendering some service, for which payment is made, to a second person ..., incidentally also renders services or disservices to other persons ... of such a sort that payment cannot be exacted from the benefited parties or compensation enforced on behalf of the injured parties." (A.C. Pigou, *The Economics of Welfare*, 1932, p. 183) in

Suppose that the efficient capital market hypothesis is held, it can be predicted that information is spread as quickly as possible; also suppose that companies have substantial incentives to disseminate information to investors, and securities analysts have incentives to endeavour to search for information because they can win their clients' trust.[6] But grounded on this public good characteristic, persons who spend money and labour to disclose will not gain the compensation they deserve and will accordingly lose the incentive to carry on further research. Information is far from free even when given away free, and the expenses of obtaining information are dependent on the sources of information, i.e. where the information comes from.[7] Admittedly, the first group of people who acquire the information can make better profit from their information than those who acquire it later. However, this time span is very short. Whenever a piece of information is released, the person who discovers it can only benefit from his efforts to a small degree, because other people will know it very soon afterwards so that he cannot get any compensation from those people.

This phenomenon could also be described as the free-rider problem. The public good characteristic of information will result in information being under-produced because the efforts spent can be easily appropriated by a third party and as a result the externalities will prevent producers of information from supplying the quantity of information which is needed to achieve an efficient market.

C.G. Veljanovski, *The New Law-and-Economics*, 1982. See also Roger Bowles, *Law and Economy*, 1982, p. 166; Frank H. Stephen, *The Economics of the Law*, 1988, p. 28.

[6] Compared with 1930s there are many more securities analysts now. "Analysts should invest in verifying and obtaining material information about corporate securities until the marginal cost of this information to them equals their marginal return. Because of the non-excludability of the use of information, an analyst cannot obtain the full economic value of his discovery, and this in turn, means that he will engage in less search or verification behaviour than investors collectively desire." See Coffee, supra note 4, pp. 725-6.

[7] See Ronald K. Gilson and Reinier H. Kraakman, "The Mechanisms of Market Efficiency", in 70 *Virginia L. R.*, 549-644, 1984. The sequence of expenses of obtaining information from the lowest to the highest is financial press (e.g. newspaper, financial magazines, etc.) distributed by originators, information intermediaries, collectivization (public side: federal securities acts, private side: analyst and trade associations), and espionage (surveillance and investigative analysis).

Applying such a theory to the case of corporate disclosure, it seems that a company may choose not to publish much financial data so long as other companies refrain from publishing similar data. Such behaviour is grounded on the recognition that, while the shareholders of the company pay for the production and publication of financial statements, non-shareholders and other competitors cannot be prevented from using them.[8]

Thus, it is a myth that an efficient market can produce enough information. On the contrary, the premise of an efficient market is that there is a sufficient flow of information. This condition, however, cannot be satisfied by the operation of the market itself because information is somewhat close to a public good and the ensuing externalities will stop information providers disclosing the necessary amount of information. The self-induced disclosure cannot function as well as the opponents of mandatory disclosure suggest.

(2) the efficient capital market hypothesis

As indicated above, one of the reasons which "backs up" economists' disagreement with mandatory disclosure is the efficient capital market hypothesis: under free competition, abundant information will be produced because the market is efficient. This statement fails because it confuses cause and effect.

The ECMH only states that in an efficient market, securities prices fully reflect all available information; it does not answer the question: how can a market become efficient?[9] What is this process? Stated otherwise, the premise of the full reflection of information in securities prices is that a market is efficient. As regards the formation of an efficient market, this is not the concern of the ECMH. Thus, the ECMH itself does

[8] See George J. Benston, *Corporate Financial Disclosure in the UK and the USA*, 1976, p. 102.
[9] See Gilson and Kraakman, supra note 7.

not stand on either side, mandatory disclosure or voluntary disclosure. What it really implies is that market efficiency is fundamental.

As explained earlier,[10] information is vital to market efficiency. Its dissemination decides the level of efficiency: weak, semi-strong, or strong. In turn, the breadth of dissemination of information is decided by its costs. Therefore, using the cheapest way of disclosure can enhance market efficiency. It may be suggested that voluntary disclosure costs less than mandatory disclosure because of the extra expenses incurred in the administrative procedure.

However, when voluntary disclosure fails as a result of such factors as the public good characteristic of information, the third party effect, lemons, and agency costs, mandatory disclosure is thought to cure the imperfection of the market, and this does not conflict with the ECMH at all. On the contrary, the ECMH may support the adoption of mandatory disclosure, because it demonstrates the relationship between securities prices and market efficiency. Suffice it to say that allocative efficiency is desired and can be achieved by means of "correct" securities prices, to use mandatory disclosure for this purpose is appropriate in this situation.

4.2 The Cost-benefit Analysis

Stigler[11] and Benston[12] emphasised the concept of cost-benefit analysis of securities regulation, and cast serious doubts on the legitimacy of mandatory disclosure. Stigler first recognised that the paramount goal of the regulations in the securities market was to protect the innocent investors; nonetheless, he stated: "so far as the efficiency and growth of the American economy are concerned, efficient capital markets are even

---

[10] See Chapter Three, supra pages 91-4.
[11] George J. Stigler, "Public Regulation of the Securities Market", in 37 *J. of Bus.*, 117-42, 1964.
[12] George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934", in 63 *American Economic Review*, 132-55, 1973.

more important than the protection of investors — in fact efficient capital markets are the major protection of investors."[13] Then he examined the performance of newly issued securities before and after the 1933 Act and found that registration requirements for new securities had little effect on the average return for investors purchasing such securities, but that the costs of this registration requirement were high.

Benston initially pointed out that the rationale for the disclosure requirements was to allow investors to make an informed decision, but after this, he argued that the data required by the SEC should be "information" (i.e. something new or useful to investors). By implication, the financial statements must provide investors with data about a company that affected investors' expectations concerning corporate future prospects and relative risks that were not previously known.[14] The problem was that, although the financial statements did convey some information, most of its details appeared to be "known" to the market by the time the statements were publicly released.[15]

Benston then applied a cost-benefit analysis. First, he showed that most of the benefits of mandatory disclosure could not be attained.[16] He admitted that, to some extent, fraud and manipulation could be reduced because of mandatory disclosure requirements, yet fairness to non-insiders could never be achieved by means of mandatory disclosure. That is, even if financial statements were published on a monthly basis, and even if all investors received the statements simultaneously and were able to interpret the information equally quickly and well, investors who traded on other than statement publication dates would pay or receive prices that did not reflect the events that occurred between the statement dates.[17] He also argued that, on the bases of

[13] Stigler, supra note 11, p. 124.
[14] Id., p. 137.
[15] See Benston, supra note 8, p. 131.
[16] The benefits recognised by him are: 1. the prevention or reduction of fraud and misrepresentation; 2. fairness to non-insiders; 3 lower transaction and information costs to investors; and 4. more efficient allocation of the investors' resources among companies. Id., p. 97.
[17] Id., p. 118.

statistical data, securities regulation did not increase the public's desire to purchase shares (in other words, did not increase public confidence in the capital market).[18]

On the other hand, he also thought that the costs of mandatory disclosure were obvious. These costs included direct, indirect, and opportunity costs. Direct costs were incurred by companies in producing and distributing the required information, including the additional expense of keeping records, auditing, organising accounting members, typing, etc. that would not have been incurred in the absence of the disclosure statutes. Indirect costs were the time that corporate officers, government officials, and investors spent to fulfil the disclosure requirements, which would not be wasted should there be no mandatory statutes. Finally, the opportunity costs were those of delay in not being able to release certain types of information, etc.[19] Therefore, Benston firmly expressed his opposition to the mandatory legislation because the benefits of disclosure were not obtainable but the costs were large.

Some British academics also hold the same opinion. For example, Gower's approach was criticised because he underestimated the problem of cost-benefit analysis. He stated:

> "In assessing the optimum degree of regulation *I have not attempted any sort of cost-benefit analysis*, partly because I am not competent to undertake it and *partly because I am skeptical about its practicability.* I can see that it would be practicable to analyse whether markets work more or less efficiently, qua markets, according to the degree of regulation to which they are subject. *But inevitably there is a tension between market efficiency and investor protection which often pull in different directions.*"[20] (emphases added)

---

[18] Id., p. 145.
[19] Id., pp. 154-5. For example, soft information such as projections.
[20] L.C.B. Gower, *Review of Investor Protection, Report, Part I,* 1984, p. 7, para. 1.16.

Some economists disagreed that such a tension existed;[21] they also condemned the claim made by Gower and the SIB that cost-benefit studies would not have contributed much because of the difficulties of analysis and data collection.[22] Moreover, Sealy, a lawyer, also doubts the effectiveness of mandatory disclosure requirements by company law, stating that benefits are not proportional to costs.[23]

Following these arguments, opponents of mandatory disclosure claim that the costs outweigh the benefits, even though they admit the existence of the asymmetric information problem.[24] They still trust this problem to be resolved by the market itself.

Rebuttal

Economists (e.g. Stigler and Benston) state that costs of mandatory disclosure exceed its benefits. This may not be true for two reasons. First, as claimed by Gower,[25] it is difficult to calculate the costs and benefits of mandatory disclosure. Benefits could be tangible or intangible; the increase of investments is observable, while investors' confidence in the market, investor's feeling of fairness, and the reputation of the market are not countable, thus making it very hard to strike a balance between costs and benefits as economists claim.

Second, contrary to the economists' analyses, mandatory disclosure in reality reduces a certain amount of costs for two reasons. First, if there is no mandatory disclosure requirement, information will be under produced; this was demonstrated in the section above. Where there is no mandatory disclosure every investor and

---

[21] By C.G. Veljanovski, see *Financial Regulation — or Over-regulation?* C.A.E. Goodhart and Arthur Seldon (eds.), 1988, p. 11.
[22] Id.
[23] See Leonard Sealy, "The Disclosure Philosophy and Company Law Reform", in *The Company Lawyer*, 2(2), 51-6, 1981.
[24] See Jeffrey K. MacKie-Mason, "Do Firms Care Who Provides Their Financing", in *Asymmetric Information, Corporate Finance and Investment*, R. Glenn Hubbard (ed.), 1990.
[25] Gower, supra note 21.

securities analyst has to make inquiries of companies individually. Since the process of researching and verifying securities information consumes real resources, this outcome will not only waste social resources[26] (because of the overlapping research) but will also hamper the achievement of market efficiency, because, as shown earlier, the costs of obtaining and verifying information determine the breadth of the information dissemination. Therefore, mandatory disclosure can eliminate wasteful duplication of research and secure a greater quantity of information. Stated otherwise, collectivisation minimises the social waste that would otherwise result from the misallocation of economic resources to this pursuit. Second, mandatory disclosure[27] can also save costs by enforcing a uniform disclosure system. When a company voluntarily discloses information, every company has to design its own form of disclosure such as the contents, the time, the accounting standard adopted, etc. The additional costs incurred to the company are beyond doubt; the inconvenience of comparing different types of statements caused to investors should not be overlooked either.

It is true that mandatory disclosure has its own limits, which are based on the evaluation of information; that is, the extent to which information should be disclosed depends on whether that information will affect investors' judgment respecting the value of securities. As a result, it seems that the decision to disclose relates to the value of the information; cost-benefit analysis can contribute little to this issue.

Even though it is undeniable that both the legislature and administrators should consider regulation efficiency, other elements which deeply relate to the nature of law and regulation cannot be ignored either (e.g. fairness, prevention of fraud). What this section pursues is not the nature of law and regulation. Instead, it is intended to make this point: the opponents of mandatory disclosure hold that mandatory disclosure is not good as a matter of policy because the costs greatly exceed the benefits. However, it is

---

[26] See Coffee, supra note 4, p. 733.
[27] Easterbrook and Fischel, *The Economic Structure of Corporate Law*, 1991, p. 291.

difficult to assess either costs or benefits. When costs and benefits cannot be precisely assessed, using this reason to refute the system of mandatory disclosure is not persuasive.

4.3 The Portfolio Theory

According to the portfolio theory, investors can eliminate unsystematic risk by diversification, and thus firm-specific information becomes unimportant.[28] To begin with, from the diversification aspect, there are two risks. One is unique risk[29] and the other is systematic risk.[30] Unique risk stems from the fact that many of the perils that surround an individual company which are peculiar to that company can be reduced by diversification of investments. Systematic risk stems from the fact that there are other economy-wide perils which threaten all business and cannot be reduced by diversification.[31]

Why can diversification reduce unique risk? Suppose that one considers investing £100 in two different companies, one of which makes sunglasses and the other manufactures rain-coats. It is very difficult to predict next summer's weather. The chances may be fifty-fifty. In this situation, the safer way of investment is to diversify the holdings of the two investments, because an investor in such a situation can end up with a sure return on the investment and thus reduce the risk of investment.[32]

---

[28] See William H. Beaver, "The Nature of Mandated Disclosure", in *Economics of Corporation Law and Securities Regulation,* Richard A. Posner and Kenneth E. Scott (eds.), 1980 , pp. 326-7.

[29] It is also called unsystematic risk, residual risk, specific risk, or diversifiable risk.

[30] It is also called market risk or undiversifiable risk.

[31] See Richard A. Brealey and Steward C. Myers, *Principles of Corporate Finance*, 5th ed., 1996, p. 156.

[32] Suppose that shares of both the companies sell for £10 apiece. If it is a rainy summer, each share of the rain-coat company will be £20 and that of the sunglasses company will be £5 and vice versa. If one invests all his money in the sunglasses company, he is taking a gamble that has a 50 percent chance of earning £200, and a 50 percent of earning 50. The same magnitude of payoff results if he invests £100 in the rain-coat company: in either case he has an expected payoff of £125. But if he puts half of his money in each, then if it is sunny he gets £100 from the sunglasses investment and £25 from the rain-coats investment, if it is rainy, he can earn £100 from the rain-coats investment and £25 from the sunglasses investment, he will be sure to get £125 return. Thus diversification diminishes the

Furthermore, in microeconomics, there is a model which measures the amount of risk if there is only one risky asset.[33] This is called the "mean-variance" theory. According to the theory, standard deviation or variance is used to measure the amount of risk. The concept of portfolio diversification is that by diversifying investments, the standard deviation of that portfolio will be equal to or less than the average standard deviation of all investments included in that portfolio, in other words, this will reduce the standard deviation of the portfolio, and hence reduce its risk.

Following this theory, an investor, who originally needs corporate information to judge the risks and return of the investment, can now reduce his risk by means of diversifying his investments, and this causes the provision of individual corporate information to be less useful, hence mandatory disclosure requirements become redundant.

Rebuttal

As pointed out by some economists, diversification can eliminate unsystematic risk and thus specific corporate information becomes useless; this is correct to a certain degree. However, some investors just do not diversify their investments in securities.[34] The reason for this is not necessarily because of their foolishness; the diversification may be made between real estate and one security rather than between different securities (e.g. purchasing a house and one kind of securities as an investment portfolio), thus, to reduce unsystematic risk of securities by diversifying investment on several securities becomes impossible in such a case, and the unsystematic risk still endangers such an investor.

---

investment risk. See Hal R. Varian, *Intermediate Microeconomics: A Modern Approach*, 2nd ed., 1992, p. 221.

[33] Id., pp. 227-32.

[34] See William H. Beaver, supra note 28, p. 327.

Accordingly, it is suggested that, from the point of view of protecting investors, those persons who are ignorant of how to diversify their investments or who choose to diversify them between one security and other kinds of investments, should be protected without discrimination.

4.4 The Agency Theory

It is argued that mandatory corporate disclosure is unnecessary because corporate managers possess sufficient incentives to disclose voluntarily all or most information material to investors.[35]

The argument is straightforward. First, a manager who owns 100 percent of a firm would directly receive all its benefits, while a manager who owns any lesser percentage would have to share the benefits with other owners. This gives him an incentive to maximise perquisites at the expense of the direct benefit claims of other owners.[36] Second, seeing that ownership and control have divorced and a conflict of interest exists between owners and controllers as indicated above,[37] outside shareholders would find it in their interest to enter into a contract to restrict the manager's consumption of perquisites whenever the increase in the value of the firm exceeds the costs of the monitoring or incentive compensation systems.

Stated otherwise, outside shareholders, for the purpose of preventing managers from misappropriating perquisites, have incentives to enter into contracts with managers. Managers, for maintaining their reputation (supposing that they are "repeat players") and convincing outside shareholders that they will not trade for their own

---

[35] See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure", in 3 *J. of Fin. Econ.*, 305-60, 1976.
[36] Id., p. 313.
[37] See Chapter Three, supra pages 85-6.

accounts at the expense of shareholders, also have incentives to make such contracts. The contract can be an incentive compensation one, or with auditing obligations. Since publication of material information is indispensable to ensure that managers are unable to trade for their own accounts at the expense of outside shareholders, "it logically follows that a standard feature of the monitoring contract between the manager and outside shareholders is the voluntary publication of such data."[38]

Rebuttal

Easterbrook and Fischel advocated the theory that corporate managers have strong incentives to disclose voluntarily all material information to investors, and mandatory disclosure is largely superfluous.[39] However, corporate managers do have incentives not to disclose material information in certain circumstances; this justifies the necessity of mandatory disclosure.

The agency theory is based on the premise that managers are "repeat players": if they want to keep their posts, they have incentives to disclose information in order to satisfy their boss's — shareholders' interests. However, they may not be repeat players, especially, when hostile take-over and management led leveraged buy out are concerned.[40] In these situations, it seems to managers that maintaining their current position is more important than considering the problem of future career. The conflict of interest between managers and investors would result in management withholding information from investors.

In addition, the free-rider problem mentioned above also reduces the function of the agency theory. For the purpose of protecting the company's shareholders,

---

[38] Jensen and Meckling, supra note 35, p. 316.
[39] Easterbrook and Fischel, supra note 27, p. 290.
[40] See David J. Schutle, "The Debatable Case for Securities Disclosure Regulation", in 13 *J. of Corporation Law*, 535-48, 1988, p. 538.

managers have incentives to incline to non-disclosure; disclosure is at the expense of their own shareholders to benefit outsiders.

4.5 Others

Some research indicates that investors do not make use of information which is given to them by mandatory disclosure requirements.[41] For example, in consumer protection, the purpose of mandatory disclosure is to cause consumers to change their buying behavior so as either to refrain from buying particular products or services that they otherwise would have bought, or to shop more careful.[42] However, people who are poor or less educated cannot absorb information and thus are still cheated. That is to say, costs that have been spent on mandatory disclosure requirements are wasted and the question is raised: is it worth the effort? This question deserves pondering especially when extensive mandatory disclosure has been employed in today's capital market.

The other criticism comes from the assumption of legislature and administrators: every investor should obtain information equally because of the purpose of investor protection. Nonetheless, no layman can really understand the prospectus, the financial statement, and all other information documents.[43] The design of the system basically marches in the wrong direction. This criticism in reality is against the current mandatory disclosure, not necessarily the idea of mandatory disclosure itself. It is also argued that the contents of mandatory disclosure do not provide much useful information to investors as they are basically historically oriented.

---

[41] See Robert L. Jordan and William D. Warren, "Disclosure of Finance Charges: A Rationale", in 64 *Michigan L. R.*, 1285-322, No. 2, 1966, pp. 1320-2.
[42] See William C. Whitford, "The Functions of Disclosure Regulation in Consumer Transactions", in *Wisconsin L. R.*, 400-70, 1973, p. 403.
[43] Homer Kripke, "The Myth of the Informed Layman", in *The Business Lawyer*, 631-8, 1973, p. 632.

All these arguments are sound. For example, soft information was not allowed to be disclosed until the 1980's in the United States.[44] Historical information may not be very helpful to investors because it has been reflected in stock prices already. That is to say, soft information may play an important role in the process of decision-making of investments by investors. It is also true that a layman cannot be expected to read and understand financial statements. Thus, we must ask; for whom is disclosure designed? It follows that the current forms and contents of financial statement may need to be reconsidered; all these are left to the next chapter.

4.6 Conclusion

The indispensability of disclosure has been demonstrated in Chapter Three. Nonetheless, some of the academics (e.g. Benston, Stigler, Easterbrook (although not wholly against mandatory disclosure, at least, with certain doubts)) do not approve the device of mandatory disclosure. From their point of view, the requirements of mandatory disclosure are superfluous, which not only cannot achieve the goals it aims, but also waste social resources: the benefits do not outweigh the costs. Economists as indicated above claim that the efficient market theory and agency theory show that companies have great incentives to disclose information to investors. Moreover, investors can reduce risks by means of diversifying their portfolio.

But what is of concern here is that market imperfection is not uncommon. When a market does not function well, cannot mandatory disclosure be justified? Is there any better alternative? Even though a market can cure its failure to a great degree, and suppose that the costs of mandatory disclosure under such circumstances outweigh the loss deriving from market imperfection, mandatory disclosure is not necessarily unjustifiable as costs and benefits are not the only concerns of law. Fairness is also

[44] Soft information is information which relates to the future prediction of the corporate financial situation or operation.

important and should not be ignored. In addition, the justification of mandatory disclosure should be separated from its operation; they are related but are different issues. The failure of the latter does not mean that the former is undesirable.

The validity and merits of the so-called cost-benefit analysis has not been proven so far by economists. All they have shown has been a general prediction. Stigler invoked the evidence which revealed that investors were not better off after the securities legislation because they did not earn more than before. However, he did point out that the variance of expected return was reduced. What does this mean? It means that investors have avoided risks in some measures; this should be attributed to the contribution of more information, which is the fruit of such legislation and regulation.

Nonetheless, the shortcomings mentioned by opponents of mandatory disclosure are quite true in some aspects. Information required to be published may not be very useful. The utility of information, its presentation, and the justification of mandatory disclosure by the courts, administrators, and legislators all warrant consideration. The next chapter will deal with these problems.

Chapter Five

The Content of Mandatory Disclosure

5.1 Introduction

As mandatory disclosure becomes a vital tool in regulating securities markets, the design of its content and the enforcement of its norms are the two main determinants of the success of the system. The subject of enforcement will be left to the next chapter where civil liability for non-compliance with disclosure requirements is dealt with, while the present chapter will focus on the problem of the content of mandatory disclosure.

The detailed content of corporate financial disclosure is established by accounting and auditing experts; i.e. accountants and their assistants decide what should be recorded in financial statements and annual reports, while auditors inspect whether these documents have reached the standard of disclosure. These processes are guided by well-developed accounting/auditing principles and standards which serve two purposes: (1) they help corporate managers make business decisions and evaluate performance of each corporate department; (2) they are conducive to investors making informed investment decisions. Hence, the specific item of accounting disclosure and its justification are a matter of accounting rather than legal expertise. The role of a lawyer is rather to examine the policy behind the regulation of mandatory disclosure, and from this point of view to evolve the legal principles guiding disclosure in order to meet the observed policy.

As already discussed in Chapter Three, the purposes of mandatory disclosure are to improve informational efficiency which in turn results in efficient allocation of

resources, and to allow investors opportunities to reach informed investment judgments. These two aims, together with the Efficient Capital Market Hypothesis (the ECMH), reflect the fundamental imperatives of mandatory disclosure:

(1) mandatory information must be relevant and relevant information must be disclosed as to investment decisions;

(2) mandatory information must be expressed in a way that is easy to understand for its users. Different users have different information needs. Thus, the amount, depth, simplicity, and clarity of information a user needs depends on who that user is; and

(3) mandatory information must be disclosed in time.

On the bases of these three principles, the content of mandatory disclosure is analysed and we will also examine whether the current regulations in the UK and Taiwan need further improvements.

5.2 Relevant Information for Investment

5.2.1 The Meaning of Relevance

In the UK, mandatory information comes mainly from the following sources:

a. the Companies Act 1985;

b. the FSA 1986;

c. the Public Offers of Securities Regulations 1995 (the POS Regulations);

d. the Listing Rules of the Stock Exchange; and

e. the City Code on Take-overs and Mergers

Theoretically, information required by these regulations should be relevant to investment decisions; otherwise, this would be a waste of administrative resources unless such disclosed information serves some other functions. For example, the disclosure of an internal accounting control system is important from the viewpoint of preparing and auditing corporate accounts because it ensures the reliability of data

recorded in the books. This information is closely related to the management of the company's internal affairs and is thus indispensable to managers. Nonetheless, investors are more concerned with the earning ability of the company than a detailed statement pertaining to this system; consequently, such information, although correlatively useful, is of little interest to investors. Another example is the problem of disclosing the "environmental activities" of the company, which did not arise until the social consciousness of environmental protection had become an important public issue. A company's environmental policy, in a strict sense, does not relate to a profit oriented investment decision; even though there undoubtedly are people who would not invest in a company unless it helped environmental protection. But such social concern is a different issue from the original purpose of securities regulation. Over the last two decades, whether environmental information should be disclosed has been hotly debated. The American SEC finally adopted a compromise solution which asks a company to disclose if compliance with any federal, state and local environmental protection laws may have *material* effect upon capital expenditure, earnings and the competitive position of the company. As a result, the environmental issue is emphasised from its economic perspective.[1]

The current mandatory disclosure system is, in practice, a product created by the mutual influence of accounting and legal requirements. It can be said that the current system is founded on the existing accounting principles and practices. These, in turn, have been adjusted from time to time whenever the accounting/auditing practice shows or the legislature (or administrators) requires that more (or less) information should be disclosed or a different way of preparing accounts or reports is preferred. Such

[1] For the detailed discussion, see James O. Hewitt, "Developing Concepts of Materiality and Disclosure", in 32 *The Business Lawyer*, 887-956, 1977, pp. 914-20; Richard Y. Roberts and Kurt R. Hohl, "Environmental Liability Disclosure and Staff Accounting Bulletin No. 92", in 50 *The Business Lawyer*, 1-17, 1994. The Taiwan SEC also compels companies to disclose environmental information concerning the amount of compensation and fine, estimated contingent liability, the responding policy for improving pollution, and the possible effect on the issuer's earnings, competitive advantages, and capital payment. See the Rules for Preparing Financial Reports by Securities Issuers (Art. 18), the Rules on the Contents of the Annual Reports of Publicly Issuing Companies (Art. 10(4)), and the Rules on the Contents of Public Offers Prospectuses (Art. 13(4)).

methods of preparation and their subsequent changes could become legally effective by introducing them into statutes or regulations.

However, due to the origin of the accounting system, disclosed information may not be relevant from an investor's point of view. The original purpose of an accounting system was to provide managers with a comprehensive description of an enterprise's business and financial position, along with the analyses of the figures. Nonetheless, the evolution of the accounting system and the emergence in modern companies of new users of financial statements have required mandatory information to be limited to new users' needs. Accordingly, information that is only for managers' use need not be disclosed.

Hence, the term "relevance" here is limited to the information which is relevant to investors' investment decisions only. Its scope may be quite broad and the content of disclosure based on this term is likely to vary from situation to situation as investors make decisions in different circumstances (e.g. in subscribing to shares or accepting a take-over offer).

First, in the case of listing particulars (or prospectuses when securities are offered to the public in the UK for the first time (s. 144(2) of the FSA 1986), relevance of information is decided by the Stock Exchange by means of setting out mandatory information in the Listing Rules or imposing any extra requirement.[2] The FSA 1986, nonetheless, provides a minimum (or residual) definition of relevance in s. 146(1):

> "... any listing particulars ... shall contain all such information as investors and their professional advisers would reasonably require and reasonably expect to find there, for the purpose of making an informed assessment of—
> (a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities; and
> (b) the rights attaching to those securities."

[2] s. 144(2) of the FSA 1986.

Obviously, if information has any effect on making an informed measure of the above listed issues, it would be relevant. One point requires mention. Such a test is different from the "reasonable person" one, which is popularly adopted in torts; instead, it lies in investors' and their professional advisers' reasonable inquiries. Nonetheless, "reasonableness" is not a precise concept; therefore, section 146(3) states that the nature of the securities, of the issuer of the securities, and of the persons likely to consider their (the securities) acquisition should be reckoned with at the time of deciding disclosed information. Also, regard should be had to the fact that certain matters may reasonably be expected to lie within the knowledge of the professional advisers of any kind whom these persons (investors) may reasonably be expected to consult and whether information would be or have been available from other sources.[3] The most intimate situation is "insurance" misrepresentation where a prudent insurer's judgment is the standard for deciding the "materiality" of any misrepresentation.[4]

As mentioned earlier, the major body of disclosed items is specified in the Listing Rules and the Stock Exchange may impose further requirements on a case by case basis if it is considered appropriate, i.e. unspecified information is relevant. Section 146(1) of the FSA 1986 thus serves to illustrate the situation in which information is relevant and closes the loopholes which might arise since the Listing Rules could not possibly be exhaustive. Comparing the Listing Rules with s. 146(1) of the FSA 1986 demonstrates that the contents of the Listing Rules include more information than that required by s. 146(1),[5] while s. 146(1) represents a stronger sense of relevance. That

[3] That is, information required by the Listing Rules (s. 153) and information required under Schedule 4, 2(2)(b), which states that "the exchange must where relevant, require issuers of investments dealt in on the exchange to comply with such obligations as will, so far as possible, afford to persons dealing in the investments proper information for determining their current value."

[4] *Pan Atlantic Insurance Co. Ltd. v. Pine Top Insurance Co. Ltd.* [1993] 1 Lloyd's Rep. 496; [1994] 3 All E.R. 581, H.L. There are thorough analyses regarding the problems of insurance and materiality in Bernard Rudden, "Disclosure in Insurance: The Changing Scene", in *Lectures on the Common Law,* Vol. 3, 1991, pp. 1-13.

[5] For instance, information required for the admission of shares or convertible debt securities to listing includes seven categories: a. the persons responsible for listing particulars, the auditors and other advisers; b. the shares for which application is being made; c. the issuer and its capital; d. the group's

is, information in s.146(1) is the core of disclosed information and therefore occupies a stronger position in the sense of relevance.

Second, with respect to continuous disclosure, relevance is expressed not infrequently in the way of "price-sensitive" information. For instance, a listed company is obliged to disclose immediately to the Company Announcement Office (which is the sub-institution of the Stock Exchange) any major new developments in its sphere of activity which are not public knowledge but have an effect on its assets and liabilities, financial position, or on the general course of its business, leading to substantial movement in the price of its listed securities. Price movement becomes a major signal to decide the relevance of information.[6] If new information is required to be disclosed in an annual or half-yearly report, it is more similar to the situation of issuing listing particulars, and the meaning of relevance in this case should be the same as that of listing particulars.

Third, in certain situations, relevance would be defined as covering the information which helps investors and the company to detect certain undesirable transactions. The best examples are transactions made between a company and its related parties and insider dealing.

---

activities; e. the issuer's assets and liabilities, financial position and profits and losses; f. the management; g. the recent development and prospects of the group. But s. 146(1) only covers the above listed categories b, e, and g.

[6] To employ the price-sensitive signal in immediate disclosure occasions is criticised by Besorai. He argued: "Both of the objectives of securities regulation — protecting investors and ensuring efficient securities markets — share the common purpose of making public sufficient reliable information to promote informed investment decisions; informed investment decisions not only for the purpose of quick financial gain but also to enable investors to appraise the position of the company with a view to a long-term investment. From a practical point of view, the price-sensitive test must also fail." See Ahal Besorai, "Disclosure of Tentative Information by Listed Companies", Part I, in *The Company Lawyer*, 16(8), 236-42, Sept., 1995; Part II, 16(9), 263-70, Oct., 1995, in Part II, p. 264.

(1) transactions with related parties

In listed companies, related parties are persons who have influence on corporate management or those who are close to the companies. They include substantial shareholders, the company's (including its subsidiary undertaking, parent undertaking, and a fellow subsidiary undertaking of its parent undertaking) directors and shadow directors (including being directors or shadow directors within the 12 months preceding the date of the transaction), and associates[7] of the former two groups.

A substantial shareholder means any person (a bare trustee excluded) who is, or was within the 12 months preceding the date of the transaction, entitled to exercise or to control the exercise of 10% or more of the votes able to be cast on all or substantially all matters at general meetings of the company (or any other company which is its subsidiary, parent undertaking, or a fellow subsidiary of its parent undertaking).[8] The present provisions of the Companies Act 1985 on disclosure of interests in shares result from the implementation of the Directive on the Disclosure of Significant Shareholdings (the Major Shareholdings Directive).[9] The basic differences between the Directive and the old UK law were that the Directive's disclosure regime

---

[7] Associate means in relation to either a director or a substantial shareholder who is an individual: (i) that individual's spouse or child (the individual's family); (ii) the trustees of any trust of which the individual or any of the individual's family is a beneficiary or discretionary object; and (iii) any company in whose equity shares the individual or any member or members (taken together) of the individual's family or the individual and any such member or members (taken together) are directly or indirectly interest (or have a conditional or contingent entitlement to become interested) so that they are (or would on the fulfilment of the condition or the occurrence of the contingency be) able to exercise or control the exercise of 30% or more of the votes able to be cast at general meetings on all, or substantially all matters; or to appoint or remove directors holding a majority of voting rights at board meetings on all, or substantially all matters. In relation to a substantial shareholder which is a company, associate means (i) any other company which is its subsidiary undertaking or parent undertaking or fellow subsidiary undertaking of the parent undertaking; (ii) any company whose directors are accustomed to act in accordance with the substantial shareholder's directions or instructions; and (iii) any company in the capital of which the substantial shareholder, and any other company under (i) or (ii) taken together, is interested in the manner described in the third situation above. See 11.1(d), (e) of the Listing Rules.

[8] 11.1(c) of the Listing Rules.

[9] Directive 88/627/EEC, OJ 1988 L 348/62 Two statutory instruments have been made to implement this Directive: the Disclosure of Interests in Shares (Amendment) Regulations 1993 (S.I. 1993/1819) and the Disclosure of Interests in Shares (Amendment)(No 2) Regulations 1993 (S.I. 1993/2689).

was based on the possession of voting power whereas the old UK law was based on interest in share capital, and the threshold of disclosure was different. Accordingly, the UK amended the old rules and distinguished material interests from non-material interests. Any person who has material interests is obliged to disclose to the company within 2 days[10] when the aggregate nominal value of the shares in which those material interests subsist is equal to or more than 3 per cent of the nominal value of the share capital; and in the case of having non-material interests, 10 per cent becomes the threshold of disclosure.[11] Non-material interests in principle refers to investment managers and operators of unit trusts or collective investment schemes.[12] One writer suggested that as the UK Companies Act 1985 did not shift to the "voting power" standard, the UK might be in default of its EC obligations.[13]

However, in the case of related persons transactions, the Listing Rules defines the substantial shareholders as those who are or were entitled to exercise or to control the exercise of 10% or more of the votes. Under the current disclosure system, identifying these persons is by no means easy, because all the disclosed figures are based on the percentage of nominal value of the shares to the nominal value of that relevant share capital, not voting power.

If a listed company proposes to enter into a transaction with a related party, then particulars of the transaction, the consideration, the name of the related party concerned, and the details of the nature and extent of the interest of the related party in the transaction are all relevant information.

---

[10] ss. 199(2)(a), 202(1) of the CA 1985.
[11] s. 199(2)(b), of the CA 1985.
[12] s. 199(2)(a) of the CA 1985. As regards the amendment, see Colin Mercer, "Disclosure of Interests in Shares: Implementation of EC Major Shareholdings Directive", in *Corporate Briefing*, 7(9), 228-31, 1993; Allen & Overy, "Disclosure of Interests in Shares", in *In-House Lawyer* (IHL), 36-7, July/Aug., 1993.
[13] See Janet Dine, "Implementation of the Acquired Rights Directive", in *Corporate Briefing*, 15(5), 143-4, 1994. Mathematically, this seems very unlikely to happen.

(2) insider dealing

To detect insider dealing, two sets of information require special attention: the change of shareholdings of insiders, and identification of inside information. Regarding the first kind of information, it relates to the disclosure of shareholdings by insiders (e.g. directors and substantial shareholders), which has been partly dealt with earlier. However, the disclosure of shareholding may not be effective in bringing other insiders (e.g. tippees[14] and any person who has inside information by means of his employment, office or profession[15]) into the open. Consequently, the second kind of information would be relevant in deciding whether there is insider dealing.

In the Criminal Justice Act 1993, inside information is described as unpublished price-sensitive information,[16] which means that if that information were made public, it would be likely to have a significant effect on the movement in the price of the securities. All these descriptions still cannot concretely delineate what "price-sensitive" means. The Stock Exchange published the guidance note on the dissemination of price-sensitive information in which precise definition of price-sensitive information is still missing, because "it is not feasible to define any theoretical percentage movement in a share price which will make information price sensitive."[17] It could only be borne in mind that "the more specific the information, the greater the risk of it being price sensitive".[18]

It may be worth considering why the regulation focuses on the price movement of securities. First, such regulation reflects the ECMH. According to the ECMH, if a market is efficient, prices will fully reflect all available information. Thus, information

[14] s. 57(2)(b) of the Criminal Justice Act 1993.
[15] s. 57(2)(a)(ii), of the Criminal Justice Act 1993.
[16] s. 56(1) of the Criminal Justice Act 1993.
[17] See Colin Mercer, "Disclosure of Price Sensitive Information: Guidance from the Stock Exchange" in *Corporate Briefing*, 8(2), 2-5, 1993, p. 2.
[18] Id.

which would cause prices to move must have a certain influence on the value of the securities. For the purpose of efficient allocation of resources, this kind of information is important, in that insiders can take advantage of the price fluctuation. Second, to protect investors, such information should be disseminated to all market participants simultaneously; it is forbidden to prejudice investors by giving insiders opportunities to benefit from inside information.

Finally, in take-overs and mergers, relevance refers to all information which could help shareholders make decisions as to the acceptance or rejection of the tender offer and whether or not to support the merger proposal. It follows, the target company's current financial position, business performance and future prospects constitute relevant information; the bidder's corresponding information and its plan following the success of take-overs are likewise relevant. Besides that, the conditions of tender offer should be fully disclosed.

In short, whether a piece of information is relevant depends on the circumstances which it relates to. As a result, the content of mandatory disclosure could have different versions in different situations, and the paramount guiding rule is that disclosure of information is compulsory for improving market efficiency and protecting investors.

5.2.2 Material v. Non-Material Information

5.2.2.1 Materiality in the UK

Although it is submitted that mandatory information must be relevant, the term "relevant" is not used often. Instead, the courts and academics have other terminology to classify information. One of the most frequent terms is "material" information.

Two things should be borne in mind when English law is considered: (1) such classification is used mostly in cases where civil or criminal liabilities are determined;[19] (2) the analysis of this classification is aimed at distinguishing different levels of information; thus, the classification only demonstrates that when the content of mandatory information is examined, the importance of information should be valued first, and if there is any deficiency in the disclosure of this kind of information (i.e. material information), the law should act to make it good. This does not imply that only material information will be disclosed in a practical sense. As discussed above, the accounting experts contribute to the current disclosure system substantially and they have authoritative expertise to decide what other information should be reported even if it may not be material (from an investor's point of view); it is also true that legislators or administrators may impose extra disclosure requirements which purport to achieve some social goals other than investment decisions. Information disclosed under these two latter circumstances could be omitted from our discussion provided it does not confuse investors.

(1) what is materiality (from the legal perspective)?

Section 47(1)(a) of the FSA 1986 provides as follows:

> "Any person who makes a statement, promise or forecast which he knows to be misleading, false or deceptive or dishonestly conceals *any material facts* is guilty of an offence if he makes the statement..." (emphasis added) [20]

---

[19] Notably, para. 3(4) of Part I, Sched. 4 of the CA 1985 mentions "materiality", it says: "Items to which Arabic numbers are assigned in any of the formats set out in section B below may be combined in a company's accounts for any financial year if either (a) these individual amounts are not *material* to assessing the state of affairs or profit or loss of the company for that year; or..." (emphasis added) However, it is not to indicate that only material information needs disclosure; rather, it only points out that if any amount is immaterial, it could be combined with other items.

[20] See also s. 200(1) of the FSA 1986: "A person commits an offence if (a) for the purposes of or in connection with any application under this Act; or (b) in purported compliance with any requirement imposed on him by or under this Act, he furnishes information which he knows to be false or misleading in a *material* particular or recklessly furnishes information which is false or misleading in a *material* particular." (emphases added). This is, once again, a material requirement in liabilities rather than a standard for disclosure design.

Unfortunately, s. 47 fails to define what "material" facts mean. Section 150(1) of the FSA 1986 lays out the constituents of the civil liability for compensation for false or misleading particulars. The wording it uses does not include any term like "material facts"; rather, it states:"... suffered loss in respect of them as a result of any *untrue or misleading* statement in the particulars or the omission from them of any matter required to be included by section 146 or 147 above". This is different from the provisions of the USA and Taiwan. The American Securities Act 1933, §11 provides that "...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...". Also in the Taiwanese Securities and Exchange Law (the SEL), Article 32 provides that "should a prospectus referred to... contain false information or omission in its *material* contents..." Both of them clearly point out that "materiality" is the criterion.

The absence of the term "materiality" in English legislation regarding civil liability possibly springs from the automatic assumption that since materiality of information is an indispensable element when liability for misrepresentation is considered, the statute is not bound to repeat the requirement. Accordingly, the meaning of materiality could be clarified only through common law cases regarding misrepresentation. Insurance cases undoubtedly serve as good examples. In *Pan Atlantic Insurance Co. Ltd. v. Pine Top Insurance Co. Ltd.*,[21] the House of Lords held that the test of materiality of disclosure is whether the non-disclosure or misrepresentation *would* have had an effect on the mind of a prudent insurer in weighing up the risk rather than the test of decisive influence. Therefore, in the case of securities misrepresentation, accompanied by s.146 of the FSA 1986, the test could be re-stated in the following wording:

[21] [1994] 3 All E.R. 581.

> "The test of materiality of disclosure is whether the non-disclosure or misrepresentation would have an effect on the minds of investors and their professional advisers in weighing up the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities and the rights attaching to those securities in order to decide whether to enter the transaction or, if so, on what terms."

In other words, whether non-disclosure or misstatement would affect a reasonable investor's (or his professional adviser's) judgment in making investment decisions remains the key issue as regards the establishment of liability and affects the preparation of disclosure.[22] Therefore, a representation or non-disclosure that is not material would by definition be of such a trivial nature that its untruth would cause but little loss to the representee.[23]

In the cases concerning misrepresentation of corporate financial statements such as prospectuses, materiality is described in a simpler form. For example, in *Angus v. Clifford*,[24] the court looked at the "importance of that phrase";[25] and in *Glasier v. Rolls*,[26] the court held that "...to convey, to the mind of an intelligent reader of this prospectus considering whether he should invest his money in *Rolls & Sons, Limited*".[27] In *Boss v. Estates Investment Company*, the question of materiality was thought to be "one of vital importance as inducing persons to take shares" which focused on the impact of information on the decision-making process as the standard laid out above in insurance cases and such thinking was repeated in *Edgington v.*

---

[22] A "might" test was observed in one insurance case. See *Locker and Woolf, Ltd. v. W. Australian Insurance Company, Ltd.* [1936] 1 K.B. 408. "... a fact which if known to the company *might* lead them to take the view that the proposers were undesirable persons with whom to have contractual relations", *per* Slesser L.J., p. 414.

[23] See David K. Allen, *Misrepresentation*, 1988, p. 19. There have been many cases of false representation in prospectuses, e.g. *Ross v. Estates Investment Co.* (1868) 3 Ch. 682; *Central Railway of Venezuela v. Kisch* (1867) L.R. 2 H.L. 99; *Edgington v. Fitzmaurice* (1885) 29 Ch.D. 459; *Arnison v. Smith* (1889) 41 Ch.D. 348; *Derry v. Peek* (1889) 14 A.C. 337; *Glasier v. Rolls* (1889) 42 Ch.D. 437; *Angus v. Glifford* [1891] 2 Ch. 449, etc. See D.L. McDonnell and J. G. Monroe, *Kerr on the Law of Fraud and Mistake*, 1952, reprinted 1986, pp. 103-4.

[24] [1891] 2 Ch. 449.

[25] Id., p. 468.

[26] (1889) 42 Ch.D. 437.

[27] Id., p. 447.

Fitzmaurice.[28] In some cases the courts based their finding of materiality simply on the fact that information is sufficient to induce the victim to enter into the transactions, or put in another way, is misleading.[29] The court would also inspect the nature and character of the representation and the cumulative effect of several statements, rather than pinpoint any single item, because even though each specific item of information is correct, they, as a whole, may be misleading.[30]

A further examination of "the extent of influence" of information is necessary. As mentioned above, English law does not accept the criterion of decisive influence; that is, information, being material, must be such that if disclosed would cause a reasonable investor to change his mind; this rule is too strict to be acceptable because if such a standard is followed few cases could be successfully sustained. However, the "average prudent investor would be affected" test, deriving from the traditional tort standard[31] also seems harsh to investors. "Would" denotes a probable rather than a clear effect, and the question is: should we lower the threshold of the probability in securities cases? American law is worth noting here. American cases nowhere reveal a coherent and commonly accepted concept about the extent of influence. A "might" test,[32] a "would" test[33] and, in between them, a "significant propensity" test[34] and a "substantial likelihood" test[35] all exist. Currently, the rule developed in *TSC Industries* which defined a material fact as one to which it is reasonably likely that a reasonable investor would attach importance in making a decision because the fact would significantly alter

---

[28] (1885) 29 Ch.D. 459. At page 471, it was stated: "How can one for a moment say that that is not a matter which might most seriously have entered into the consideration of a person who was subscribing money upon such bonds as these?"

[29] Id., continued the sentence above: "If so, is not that statement, put in that way, fragmentary, misleading and imperfect, condescending to a particular which makes it all the more misleading"; see also *Re Walter L. Jacob & Co. Ltd.* [1989] B.C.L.C. 345, p. 345, and *Arnison v. Smith* (1889) 41 Ch.D. 348, p.348.

[30] *Arnison v. Smith*, id., p. 367; *Edgington v. Fitzmaurice*, id., 467; and *Re Malden's application*, Q.B., unreported, CO/108/93 (Transcript: John Larking), 27 January 1994.

[31] *Broome v. Speak* [1903] 1 Ch. 586.

[32] *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128 (1972).

[33] *List v. Fashion Park, Inc.*, 340 F.2d 457 (2nd Cir. 1965).

[34] *Mills v. Electric Auto-Lite Company*, 396 U.S. 375 (1970).

[35] *TSC Industries, Inc. v. Northway*, Inc., 426 U.S. 438 (1976).

the total mix of available information, has general academic and judicial support. The rule laid down by the SEC also provides guideline on this issue; it reads:

> "whether or not a particular description, representation, illustration, or other statement involving a material fact is misleading depends on evaluation of the context in which it is made. In considering whether a particular statement involving a material fact is or might be misleading, weight should be given to all pertinent factors, including, but not limited to, those listed below."[36]

The SEC enumerates the situations in which the statements are material. Even more, the SEC specifically defines "materiality" as "when used to qualify a requirement for the furnishing of information as to any subject, limit the information required to those matters to which there is a *substantial likelihood* that a reasonable investor would attach importance in determining whether to buy or sell the securities registered".[37]

It seems that there is no good reason why the criterion set up by the SEC regarding the furnishing of information in mandatory disclosure should be different from the definition given by the court when civil or criminal liability is at issue. Otherwise, either information disclosed would be too much or too little. If more information is required by the SEC than by the court, it would cause administrative waste and overburden companies unless the SEC had better justification (such as public interest in social improvement). By contrast, if information required by the SEC turns out to be inadequate, whether companies could escape from liability on the ground that they rely on the SEC rules is open to question. This does not imply that the court should have the last word on the definition of materiality, although in practice this may be the case. It is submitted, the only acceptable response from the court is that whenever there is a gap between the court's view of materiality and the view taken by other institutions, the court should search for the reason causing this discrepancy and be prepared to change its view if some other's view is demonstrated better. Moreover, it is further submitted, a similar argument should be applicable in the UK. Even though

---

[36] 17 C.F.R. § 230.156.
[37] 17 C.F.R. §§ 240.12b-2, 230.405.

the definition of materiality was developed by case law where civil liability has been in issue, mandatory disclosure requirements imposed by the Stock Exchange, guided by the FSA 1986 should take that definition into account and avoid over-disclosure or inadequate disclosure.

(2) a true and fair view

More interestingly, the Companies Acts also use the term "a true and fair view"; the development of "a true and fair view" in the Companies Acts and the accounting principles, bases, and standards, which are referred to when the court is faced with auditors' liabilities, provides another standard of mandatory disclosure. Thus, it is necessary to consider the relationship between "materiality" and "a true and fair view".

Each Companies Act has provided that the balance sheet and profit and loss account shall give a true and fair view ever since the Companies Act 1947 was enacted.[38] Such a principle was subsequently adopted by the Fourth Company Law Directive.[39] The problem is: what does "a true and fair view" mean? Could this question be answered by arguing that if all material information is disclosed (supposing for this purpose that materiality is the only element of a true and fair view), then the requirement of a true and fair view would be satisfied.

Legal academics insist that whether a financial statement presents a true and fair view is a question of law for the court.[40] Therefore, it would not be right to claim that only accounting principles are relevant to the question of a true and fair view.[41] This

---

[38] Now is s. 226(2) of the CA 1985.

[39] OJ 1978 L 78/660. Some academics suggest that since a true and fair view has become a Community requirement on financial statements, a Community level of interpretation of a true and fair view is necessary. See K.P.E. Lasok and Edmond Grace, "Fair Accounting", in *J. of Bus. Law*, 235-9, 1988.

[40] See Andrew McGee, "The 'True and Fair View' Debate: A Study in the Legal Regulation of Accounting" in 54 *M.L.R.*, 874-88, 1991.

[41] For the opposite opinion, see T.A. Lee, "The Evolution and Revolution of Financial Accounting" in 9 *Accounting and Business Research,* 292-9, 1979, p. 294; D. Tweedie and J. Kellas, "Setting the Accountants' Record Straight", in *Accountancy*, 19-20, Jan., 1988, p. 19; and P. Walton,

argument is logical and evident from the literal meaning and spirit of s. 226(4) and Schedule 4, Part II, para. 15 of the Companies Act 1985 where a departure from accounting principles is permitted for the purpose of complying with a true and fair view requirement. Stated otherwise, a true and fair view is the primary principle superseding any concrete rules and principles and is left to the court for final judgment.[42] Nonetheless, a true and fair view is such an abstract concept that it is by no means possible to produce a satisfactory definition to identify what "true" and "fair" mean. For instance, Drayton criticises "fair" as an ambiguous word; Cowan, a New Zealander, considers the term itself lacking clear definition of the objectives of financial reporting; and South Africa in the early 1970s abandoned such a standard.[43] On the other hand, some academics argue that the lack of definition of the term is in fact a strength of the concept,[44] by which, as Popoff claims, "a stimulus for a continuing critical examination of accounting methods and procedures and of the quality and relevance of the statements" is produced.[45]

As a result, the practices and views of accountants and auditors are extremely helpful and the more authoritative these practices and views are, the more ready the

---

"Introduction: the True and Fair View in British Accounting", in *European Accounting R.*, 49-58, May, 1993, p. 52.

[42] For example, *Argyll Foods* Case, see P.A. Bird, "After Argyll Foods what is 'a true and fair view'?", in *Accountancy*, 80-1, June, 1982. The company, Argyll Foods, included in its consolidated balance sheet at 31 December 1979 the affairs of Morgan Edwards Ltd. for which negotiations to purchase began in November 1979 but were not finalised until March 1980. According to the legal definition, Morgan was not the subsidiary of the Argyll Foods by the time the consolidated balance sheet was prepared; as a result, it violated ss. 150 and 154 of the Companies Act 1948 and of SSAP 14. Such breach was clearly disclosed in the accounts and annual reports; however, the auditors certified that the balance sheet presented a true and fair view even with the breach. The case was heard before magistrates and the court held that the balance sheet did not give a true and fair view. Later on, the Department of Trade made it clear that the advocacy of substance over form must not be at the expense of compliance with law. (see The True and Fair View and Group Accounts, Jan., 1982) See also P. Bird, "What is 'A True and Fair View?'", in *J. of Bus. Law*, 480-5, 1984.

[43] See H. Drayton, "When is 'Fair' not Fair? The Auditor's Report Criticized" (in Accountant, 88-9, p. 89, Jan., 1962); and T.K. Cowan, "Are Truth and Fairness Generally Acceptable?" in (Accounting Rev., 788-94, Oct. 1965, p. 788), in R.H. Parker and C.W. Nobes, *An International View of True and Fair Accounting*, 1994, pp. 3, 5.

[44] See R.H. Parker and C.W. Nobes, id., p. 13.

[45] See B. Popoff, "Some conceptualizing on the true and fair view" (in International J. of Accounting, Fall, 1983, 43-54, p. 52), in R.H. Parker and C.W. Nobes, id., p. 13.

court will be to follow them.[46] In *Odeon Associated Theatre Ltd. v. Jones*[47], Pennycuick V.-C held:[48]

> "In so ascertaining the true profit of a trade the court applies the correct principles of the prevailing system of commercial accountancy. I use the word "correct" deliberately. In order to ascertain what are the correct principles it has recourse to the evidence of accountants. The evidence is conclusive on the practice of accountants in the sense of the principles on which accountants act in practice. That is a question of pure fact, but the court itself has to make a final decision as to whether that practice corresponds to the correct principles of commercial accountancy. No doubt in the vast proportion of cases the court will agree with the accountants but it will not necessarily do so."

Also the court in *Lloyd Cheyham v. Littlejohn*[49] ruled: "While they (statements of standard accounting practice) are not conclusive, so that a departure from their terms necessarily involves a breach of the duty of care,... they are very strong evidence as to what is the proper standard which should be adopted and unless there is some justification, a departure from this will be regarded as constituting a breach of duty".[50] One the other hand, the court may challenge the statement if it is found inappropriate. For example, in *Re Thorn EMI plc*[51]., Harman J. criticised the phrase "written off" in SSAP 22 as misleading.

In addition, the amendments brought about by the Companies Act 1989 give statutory recognition to the existing accounting standards and thus strengthen the likelihood that the courts will treat compliance with accounting standards as the basis of presenting a true and fair view.[52]

---

[46] M.H. Arden, "Accounting Standards Board, The True and Fair Requirement — Opinion", in *Current Accounting Law and Practice*, Robert Willott (ed.), 1988, [D]-008.
[47] [1971] 1 W.L.R. 442.
[48] Id., p. 454.
[49] [1987] B.C.L.C. 303.
[50] *per* Woolf J., p. 313.
[51] (1988) 4 B.C.C. 698, p. 700.
[52] s. 256 and para. 36A of Sched. 4, the CA 1985. See M.H. Arden, "The up-dated Opinion of English Counsel on true and fair" (21 April 1993), reprinted in R.H. Parker and C.W. Nobes, supra note 43, pp. 149-50.

Since a true and fair view is elusive and cannot be covered solely by accounting principles, we would suggest that the question should be examined from its foundation, that is, the problem of materiality. Materiality, pursued by both law and accounting, is the other side of the coin[53] and it may be easier to embark on our work from this perspective. Or, it may be more appropriate to argue that materiality is a tool and a true and fair view is the goal.

In fact, as we emphasise throughout this chapter, it is accountants and auditors who really construct the framework of corporate disclosure. These experts have come to a consensus that the principal function of financial statements in the context of mandatory disclosure is to provide users with a comprehensible statement of the corporate financial and business position (that is, to present a true and fair view) which can be achieved only by disclosing "material" information. Information, if less than necessary, would leave investors with half the truth; but if it is more than required it would confuse investors equally. Therefore, if it not material, it should be possible to disregard it.

(3) what is materiality (from the accounting perspective)?

The connection between "a true and fair" view and the problem of materiality once again turns on a wide open-ended debate with respect to the definition of materiality of information in the accounting field. Although the Statements of Standard Accounting Practices (SSAPs) employ the same usage as that of the legal profession by saying that "it is...of such materiality that its non-disclosure *would* affect the ability of the users of

[53] This is evidenced by the statement in the "Tentative Statement on Accounting Practice" issued by the Board of Research and Publications of the New Zealand Society of Accountants in 1964 where it states that a true and fair view implies disclosure and appropriate classification and grouping of all material items, and consistent application of understandable, objective and significant accounting principles. See the Institute of Chartered Accountants in Australia, "Recommendations on Accounting Principles" (in the Accountants' Journal, 91-2, Oct., 1964), in T.K. Cowan, "Are Truth and Fairness Generally Acceptable?", in *Accounting Rev.*, 788-94, Oct., 1965, p. 789.

financial statements to reach a proper understanding of the financial position"[54] (emphasis added), this definition in no way helps accountants or auditors; nor is this the definition that they generally look for. This section does not plan to examine the accounting standards concerning the establishment of materiality; these should be left to accounting and auditing experts themselves. Instead, only those elements which are generally quoted regarding materiality are discussed and the purpose of this section is to further the ability of the legal profession to identify the issue of materiality and to appreciate its elements. To begin with, it has been said:

> "[I]f financial statements are to be prepared and examined with anything approaching reasonable economy, and if they are to be meaningful and useful, such a doctrine (materiality) is indispensable."[55]

However, it is also stated that:

> "In spite of its pervasiveness, materiality remains an ill defined concept. There is presently no precise definition of its meaning that is accepted within the (accounting) profession for determining whether a given fact or circumstance is material."[56]

Indubitably, it is almost impossible in the near future for accountants to produce a universal definition of materiality and it is clear that they are not working in this direction. They could not rely simply on the legal definition of materiality (in English law) which connotes a "would" effect on the decision process of a reasonable investor

---

[54] para. 23, SSAP 17. Also "In deciding whether to qualify his audit opinion, the auditor should have regard to the *materiality* of the matter in the context of the financial statements upon which he is proposing to report. In general terms, a matter should be judged to be material if *knowledge of the matter would be likely to influence the user of the financial statements. Materiality* may be considered in the context of the financial statements as a whole, the balance sheet, the profit and loss account, or individual items within the financial statement. In addition, depending upon *the nature of the matter*, materiality may be considered in relative or absolute terms." (emphases added) See *The Accountant's Manual*, 1990, p. Auditing 7.

[55] See Ernest L. Hicks, "Materiality" in *J. of Accounting Research*, 158-71, Spring, 1964, p. 158.

[56] By Peat Marwick & Mitchell, in Marianne M. Jennings, Philip M. Recker, and Daniel C. Kneer, "A Source of Insecurity: A Discussion and an Empirical Examination of Standards of Disclosure and Levels of Materiality in Financial Statements", in *J. of Corporation Law*, 639-88, Spring, 1985, p. 640.

(or an average prudent investor); in preparing financial statements which present a true and fair view, they are standing in the front line. This is why they prefer to have a set of rules which provides instructions on each specific item regarding materiality, although this is also unrealistic in that no rules could be exhaustive and too many formulated rules concerning materiality would hamper the flexibility of accounting which is vital for accountants to deal with any possible occurrence of different situations. There is a dilemma here. The current situation turn out to be that the Accounting Standards Board (or Accounting Standards Committee before 1990) issues from time to time the principles and standards piecemeal to cover certain items of accounting. On the other hand, a number of articles written by accounting or auditing experts contribute to clarify this problem.

The Accounting Standards Board (ASB) which took over the task of setting accounting standards from the Accounting Standards Committee (ASC) in August 1990 is empowered under the Companies Act to make, amend or withdraw accounting standards on its own authority.[57] Hence, the accounting standards issued thereafter by the ASB (the new rules are designated Financial Reporting Standards (FRSs)) together with the then existing 22 Statements of Standard Accounting Practices (SSAPs)[58] are statutorily binding.[59] As the ASB's foreword to accounting standards points out:

> "Accounting standards are authoritative statements of how particular types of transaction and other events should be reflected in financial statements and accordingly compliance with accounting standards will normally be necessary for financial statements to give a true and fair view."[60]

Accordingly, accounting standards mainly serve to deal with corporate transactions or other events in order to present financial statements in a true and fair view, and as

---

[57] s. 256 (1) (3) of the CA 1985.
[58] These SSAPs were issued by the Councils of the six major accountancy bodies following proposals developed by the ASC. See *Current Accounting Law and Practice*, supra note 46, p. [D]-002.
[59] Para. 36(A) of Sched. 4 of the CA 1985.
[60] para. 16 of the Foreword, see supra note 46, p. [D]-004.

mentioned above, materiality is the other side of the coin to the problem of "a true and fair view", it is thus imaginable that accounting standards would center on the problem of materiality. A good example is the SSAP 2 (disclosure of accounting policies). First, three terms need clarification: accounting concepts, accounting bases, and accounting policies.

accounting concepts:

Accounting concepts are defined as broad basic assumptions which underlie the periodic financial accounts of a business enterprise; four concepts are generally recognised: 1. the "going concern" concept; 2. the "accruals" concept; 3. the "consistency" concept; and 4. the "prudence" concept. The going concern concept presumes that the enterprise will continue in operational existence for the foreseeable future when the profit and loss account and balance sheet are prepared; that is, there is no intention or necessity to liquidate or curtail significantly the scale of operation. Under the accruals concept, revenue and costs are recognised as they are earned or incurred, not as money is received or paid (accruals) and matched with one another so far as their relationship can be established or justifiably assumed and dealt with in the profit and loss account of the period to which they relate. The consistency concept means that there is consistency of accounting treatment of like items within each accounting period and from one period to the next. Finally, according to the concept of prudence, revenue and profits are recognised by inclusion in the profit and loss account only when realised in the form of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty; provision is made for all known liabilities (expenses and losses) whether the amount of these is known with certainty or is a best estimate in the light of the information available.[61]

[61] Id., p. [D]-015.

accounting bases:

Accounting bases are the methods developed for applying accounting concepts to financial transactions and items for determining the accounting periods in which revenue and costs should be recognised in the profit and loss account and for determining the amount at which material items should be stated in the balance sheet. In other words, they are a standard for judging materiality. Nonetheless, by their nature accounting bases are more diverse and numerous because "they have evolved in response to the variety and complexity of types of business and business transactions, and for this reason there may justifiably exist more than one recognised accounting basis for dealing with particular items".[62]

accounting policies:

> "Accounting policies are the specific accounting bases selected and consistently followed by a business enterprise as being, in the opinion of the management, appropriate to its circumstances and best suited to present fairly its results and financial position."[63]

Based on these definitions, the SSAP 2 requires a business enterprise to disclose its accounting policies followed for dealing with "*material* and critical" items in determining profit or loss for the year and in stating the financial position. The ASB (and also the ASC) would rather spell out rules to govern materiality of an individual item whenever the importance of that item (i.e. its effect on a true and fair view) is recognised than provide a general definition of materiality. Thus, it is left to accountants to judge whether any specific item is material and then choose its accounting basis.

---

[62] Id., pp. [D]-013-16.
[63] Id., p. [D]-16.

How can preparers of financial statements judge an item's materiality? It is submitted that two elements are decisive: users' needs and corporate circumstances.[64] Even more, the current popular method of quantifying materiality and the economic consideration of auditing should be discussed as well.

(a) users' needs

It has become well established that the materiality of information mainly depends on users' needs.[65] Such a statement is evident from the analysis of misrepresentation where information which would affect the decision-making process of a reasonable investor is defined as material; that is, materiality is judged from a prudent investor's viewpoint. Taking accounting and auditing into consideration the statement is also viable, as the purpose of preparing and auditing financial statements is to help users of the financial statements understand corporate position, and thus, users' needs stand as the primary concern of accountants and auditors.

The difficulty is that to clarify the meaning of "users" is easier said than done.[66] Users of financial statements are defined, for the purpose of this thesis, as investors. This definition could hardly be inappropriate, especially since this thesis focuses on the disclosure requirements of the public distribution of securities and securities

---

[64] Tom Lee, *Materiality: A review and analysis of its reporting significance and auditing implications*, 1984. This point of view taken by accounting experts is also shared by legal professionals. The Companies Act 1985 provides clues to these two elements. For example, the Companies Act always emphasises that to present a true and fair view is the most important thing, therefore, if any specific circumstances require, it is lawful to depart from accounting standards. (see s. 226(5), and para. 15, Part II of Sched. 4.). As regards users' needs, the FSA 1986 clearly requires listing particulars to provide all information which investors and their advisers would reasonably expect (s. 146). This demonstrates that users' needs is one of the prime concerns when financial statements are prepared.

[65] See C. William Thomas, "Materiality guidance for auditors", in *J. of Acct.*, 74-7, Feb., 1979, p. 77; Tom Lee, id., p. 5.

[66] A writer even suggested: "...recourse must be had to the views of economists, financial analysts, investment bankers, accountants and other concerned with the theory of investment for a determination of more precise rationales and guides as to the information required to make investment determinations". See Harry Heller, "Disclosure Requirements under Federal Securities Regulation", in *The Business Lawyer*, 300-20, 1961, p 304.

transactions thereafter in secondary markets. Nonetheless, the problem of defining investors yet remains.

To begin with, investors do have, among themselves, a variety of levels of knowledge with respect to financial statements, and this will result naturally in different requirements for disclosed information.[67] The clearest case is the obvious distinction between individual investors and institutional investors. The latter, undoubtedly, enjoy the advantage of having experts analysing all available information and are able to digest much information. Individual investors (i.e. the general public), however, lack this facility and accordingly, too much information would not benefit them. Therefore, to reach a consensus among companies, regulators, and the judiciary as regards the definition of investors would be the first task when mandatory disclosure is designed.

We could embark on this task by classifying investors into various categories. The first distinction is drawn between individual and institutional investors. Then, individual investors could be labeled under four headings: (1) investors who do not appreciate the meaning of business terms and have no interest in reading financial statements; (2) investors who have a misty understanding of financial terms; (3) investors who have more understanding of financial statements than the second kind of investors but are not experts; and (4) investors who are markedly knowledgeable in financial markets, e.g. accountants, financial advisers, and securities analysts. One may criticise the above categorisation as arbitrary; it is, however, sustainable in the context of analysing users' needs. For it only serves to highlight the limitation on the range of disclosure.

---

[67] See Baruch Lev, "Toward a Theory of Equitable and Efficient Accounting Policy", in 63 *Accounting Rev.*, 1-22, 1988, p. 13; B. Popoff, "Some Conceptualizing on the True and Fair View", in *International J. of Accounting*, 43-54, Fall, 1983, pp. 46-7; L.E. Rockley, *A Policy for Disclosure*, 1980, pp. 4-5.

It is, then, a formidable choice to make among these different groups of investors to decide which group is the relevant one where mandatory disclosure is designed to meet users' needs. Although the statute (e.g. the FSA 1986, s. 146) and courts have never explicitly ruled out institutional investors as the target group of regulation, the implication of both the statutory text and judicial statement seems to centre on the protection of individual investors.[68] For instance, misrepresentation could be analysed from both the subjective and objective perspectives. The objective aspect that we have already addressed is the "would be" impact of information on investors, that is, materiality, while the subjective aspect relates to the reliance of the investor. The element of reliance itself tempts us to concentrate on individual investors because reliance is a mental process normally appropriate to natural persons. This does not mean that legal persons cannot claim damages on the basis of misrepresentation; the point is that only a natural person's state of mind can be the base on which to judge the existence of reliance. Moreover, as already discussed, if the dominating purpose of mandatory disclosure regulation is prevention of fraud, it is the ignorant investors who need protection. Institutional investors seem unlikely to be regarded as the main object of protection.

However, if the preference is given to individual investors simply on the above mentioned grounds, it is far from persuasive. Two problems call for answers. First, even if the standard of individual investors is adopted in order to judge materiality, which group of investors should be identified as users? Second, why cannot institutional investors be accepted as the standard?

<u>what kind of individual investor should we choose?</u>

It appears reasonable to rule out the first and fourth group as reasonable investors here. The first group is not acceptable for two reasons. (1) If materiality is judged from

[68] Regarding investor protection, see Chapter Three where the justification of disclosure is addressed.

the most ignorant investors' point of view, the information they need will be substantially less than that of the current disclosure requirements because they cannot and will not read any financial statements. Consequently, the interests of other groups will be denied. (2) From a policy perspective, not to define users as the first group of investors has a positive effect on market efficiency. According to the ECMH, as more information is published, the market becomes more efficient. Thus, to limit the range of disclosed information to the needs of the most ignorant investors is unnecessarily narrow. In addition, these investors will benefit from more information in light of the availability of more accurate securities prices. These arguments have been fully demonstrated in Chapter Three. On the other hand, the information required by the fourth group of investors is no different from that of institutional investors and thus this group does not warrant a separate discussion.

Therefore, it follows that either the second or the third group is the ideal standard for deciding materiality.[69] The matter becomes a policy choice, for two reasons. First, we lack any conclusive evidence regarding which group of investors represents a majority of all investors, so that it is difficult to get a sense of reasonable investors. Second, the number of investors may in any case not be the primary concern. Instead, market efficiency and investor protection stand alone as policy objectives. Materiality based on the needs of the third group, i.e. investors who have more understanding of financial statements than the second kind of investors but are not experts, makes more information available to the market and thus the third group is recommended.

---

[69] The general survey shows that users would like more disclosure rather than less, but are not greatly interested in complex additional disclosures and often do not appear to use what they do receive. See A.J. Richardson and M. Gibbins, "Behavioural Research on the Production and Use of Financial Information" (Behavioural Accounting Research: A Critical Analysis, D. Ferris (ed.), 1988), in Michael Gibbins, Alan J. Richardson and John Waterhouse, *The Management of Financial Disclosure: Theory and Perspectives,* 1992, p. 15. Although the articles did not specify the meaning of users, it seems that the second or even the third kind of investor as we describe here are the most possible groups the articles dealt with.

institutional investors as a possible standard

Due to the bias in favour of individual investors referred to above, institutional investors are seldom considered as an appropriate standard. It seems, however, that institutional investors are highly suitable for this purpose.

The strongest reasoning to bolster this argument is the ECMH. The semi-strong form of efficiency is thought to be practical, and mandatory disclosure should be designed to meet this goal. In semi-strong efficient markets, all publicly available information is fully reflected in securities prices. It is evident that without experts' participation such efficiency is not attainable because ordinary investors who have relatively little knowledge cannot use information to its maximum. This demonstrates the importance of institutional investors. Supported by their experts, institutional investors could channel all available information into securities prices by means of continuous transactions. They also have the ability to perform this function of the ECMH because of their financial strength.

Moreover, in a market where institutional investors dominate the transactions and ownership of securities in the market, they are the persons who really ask for information. The American markets are the best examples of this. In the UK, this argument should also be viable because institutional investors are extremely active accompanied by the popularity of unit trusts. Nonetheless, whether the argument is applicable to the Taiwanese market will be discussed later.

Accordingly, a conclusion could be drawn from the above analyses. Two possible choices lie open to us: (1) individual investors with moderate knowledge or (2) institutional investors. If institutional investors are active and play a crucial role in the market, it cannot be seen why a reasonable institutional investor's judgment could not be used to judge materiality. The only drawback which we have to face is the problem

of costs, costs to issuers. Since the cost-benefit analysis has been dealt with in Chapter Four, it is unnecessary to reiterate it here.

two specific problems in the UK

Before closing this section, two points are worth mentioning. One is the contradiction of the terms in s. 146 of the FSA 1986; the other is the relationship between the definition of users where materiality is concerned and the scope of users where the duty of care is examined in tort of negligence.

As regards the information that should be disclosed in listing particulars, s. 146 lays out the supreme rule: all the information that "*investors* and their *professional advisers*" would reasonably require should be disclosed. Thus two groups of users are pointed out by s. 146. The judgment of materiality by "investors" (if the definition of individual investors is adopted) and "professional advisers" is different because the latter will definitely require more information than the former. As a result, if investors are considered to be individual investors who are not experts in financial markets, those investors who have no professional advisers will be discriminated against as compared with those who have advisers when materiality of information is determined. If the definition of "investors" refers to institutional investors, the expression "professional advisers" would seem to be redundant because institutional investors must be deemed to have professional advisers. Therefore, if the legislature intends to adopt the standard of institutional investors, it should make it clear by providing that "listing particulars should contain all such information as an institutional investor would reasonably require".

The second problem is the differential scope of the meaning of "users" as between the assessment of materiality and the extent of the duty of care. As the legislature and regulators are inclined to provide investors with as much useful

information as possible, they define investors as the investing public when materiality is judged. This is evident from the Yellow Book in which it is claimed that information is for general investors, not only for shareholders. But when investors claim in respect of the negligence of auditors or directors, the courts limit the possible liability by excluding plaintiffs at the stage of "the test of duty of care" and refuse to expand the scope of duty of care (this will be closely analysed in the next chapter). Although this is a policy choice and there is a judicial tradition of limiting the liability in negligence for economic loss, the conflict is undeniable and calls for more attention by both regulators and the courts.

(b) corporate circumstances

The reason why corporate circumstances must be considered is that the significance of two items of same monetary value may be quite different in the situations of two different companies. For example, both A companuy and B company may receive a refund of £500,000 of income tax paid for the previous two years; if such a refund is material then, it should be shown as a "special credit" rather than be drawn into the net income as a whole for the year of receipt. When A's net income for this year (£2.5 million) and the previous four years are examined, we find the average net income to be £5 million. Therefore, although the tax refund amounts to 20% of this year's net income, it is only 10% of net income in the light of the five-year average. By contrast, in company B the refund amounts to 15% both of this year's net income and of the five-year average income as well. Thus in A's case, the refund may be reported as part of the net income without specifically separating it as a special credit, while it must be treated by company B as a special credit.[70] This example not only provides a good illustration of the relevance of corporate circumstances but also reveals the fact that quantifying the effect of an accounting item is not always workable. In addition, some information, although material, may not be suitable for disclosure due to the specific

[70] This example is developed from the case given by Ernst L. Hicks, see supra note 55, p. 161.

situation of the company. For example, it may be premature to disclose information regarding merger negotiations; it is also inappropriate to disclose business secrets, the disclosure of which will or may give an advantage to business rivals.

(c) quantifying materiality

The materiality of any financial item is first judged by statement preparers and accountants when these persons decide whether the item should be disclosed and whether to apply the generally accepted accounting principles (i.e. the SSAPs and FRSs in the UK) to the item, and if so, in what way. After the first step, materiality is evaluated further by auditors. These processes unavoidably involve subjective judgment by accountants and auditors. Accordingly, it is predictable that various differences will ensue among these experts.[71] The possibility of reaching different decisions increases as there is no unified definition of materiality in accounting and auditing. Therefore, it is natural for these experts to search for guidelines with a view to ensuring a "correct" judgment on materiality. Among these, the most popular approach is to quantify materiality.

To quantify materiality means to set up percentage standards for specific items. For instance, what percentage of shares must a company hold to be deemed to have a participating interest in another undertaking?[72] At what percentage of net income must an item receive separate accounting treatment? and so forth.

This method is convenient, but noticeably, has its drawbacks as well. The main advantage is clear enough: accountants and auditors do not need to make difficult judgment. Its drawbacks are even clearer and may substantially dilute this advantage. In the first place, the fixing of percentages is necessary arbitrary.[73] Why 10%, not 8%?

---

[71] See Bart H. Ward, "An Investigation of the Materiality Construct in Auditing", in *J. of Accounting Research*, 138-52, Spring, 1976.
[72] ss. 258, 260, and Sched. 10 of the CA 1985.
[73] See Benzion Barlev, "On the Measurement of Materiality", in *Accounting and Business Research*, 194-7, Summer, 1972, p. 194.

Or why 20% rather than 15%? We could never on any economic ground justify the differentiability between 9% and 10%, or 14% and 15%. Would such a difference of one percent affect users' needs as being the most dominating factor as regards materiality? Even though a range of percentages could be advanced to increase the flexibility of this approach, the range is still arbitrary and the threshold is doubtful. The provision of a graduated range of percentage would thus not remedy the defect of this method.

Second, quantifying materiality hampers the flexibility of accounting and auditing which is at the centre of accounting and auditing business. The only goal for accountants and auditors to achieve is to prepare financial statements which present a true and fair view, and thus subjectivity is indispensable when exercising such professional judgment. From the point of view both of users' needs and corporate circumstances, whether or not an item has reached a specific percentage does not necessarily show its materiality or immateriality. Moreover, percentage is not the main concern. For example, "sensitive payments" to public officials by the management of the company could be material even though they represent a trivial percentage (e.g. 5%) of the net income because such payments relate to the integrity of the management.[74]

Because of these two drawbacks, we would not suggest that quantitative dividing lines are ideal. Nonetheless, in a practical sense, they have become more and more popular in GAAPs[75] and this demonstrates the way in which practical convenience may compromise an ideal theory.

---

[74] Sensitive payments refer to questionable, improper, or illegal corporate payments or practices. In the USA, this problem surfaced at the time of Watergate Investigation. "During the course of those investigations it was determined that a number of American corporations had illegally made contributions to various political campaigns, notably the Presidential campaign of 1972. The Commission became interested in such contributions as a consequence of its concern with the adequacy of corporate disclosure." See James O. Hewitt, supra note 1, pp. 920 et esq.

[75] For example, SSAP 1 (20% as a standard to identify associated companies), SSAP 3 (dilution of 5% or more of the basic earnings per share is regarded as material...), SSAP 21 (90% for lease definition), SSAP 23 (accounting for and acquisitions and mergers), SSAP 24 (defined benefit scheme), SSAP 25 (segmental reporting), FRS 2 (subsidiary undertaking), etc.

(d) economical and efficient auditing

Auditors who are responsible for delivering auditor's reports have to make an economical and efficient auditing plan before they embark on any auditing business. Theoretically, auditors are not obliged to search diligently for fraud in financial statements unless required by legislation or contract. Nonetheless, if there is misrepresentation or omission in a financial statement and it has lost its true and fair view, auditors must qualify the report. Otherwise, they may be sued by the company or investors concerned at a later stage. Since there are thousands of items in a financial statement, it is impossible for auditors to check them all thoroughly. In essence, the auditor would establish a preliminary estimate of allowable error for individual components of the financial statements based on his preliminary estimate of materiality for the financial statements taken as a whole.[76] Thus, Boatsman and Robertson identify eight variables which professional literature considers relevant to materiality judgment.[77] This demonstrates that in a practical sense the requirement of materiality would be discounted to a certain extent.

Second, the judgment of materiality would also be affected by the relationship between the company and its auditors. This possibility has been demonstrated by research.[78] This is why the Companies Act always emphasises the independence of auditors[79] and confers power on auditors to ask information from the company.[80]

---

[76] See George R. Zuber, Robert K. Elliott, William R. Kinney, Jr., and James J. Leisenring, "Using Materiality in Audit Planning" in *J. of Acct.*, 42-54, March, 1983, p. 46.

[77] See James R. Boatsman and Jack C. Robertson, "Policy-Capturing on Selected Materiality Judgments" (Accounting Review, April, 1974, pp. 342-3), in C. William Thomas, see supra note 65, p. 75. They are: nature of the item, relationship of item to current year net income, relationship of item to total revenue or expense, effect of item on net working capital, earnings growth rate, whether the item reverses the earnings trend, absolute (net-of-tax) size of the item and relative risk of the stock. As regards the materiality in auditing planning, see W. Wade Gafford and D.R. Carmichael, "Materiality, Audit Risk and Sampling: A Nuts-and-Bolts Approach", Part I, in *J. of Acct.*, 109-18, Oct., 1984; Part II, 125-38, Nov., 1984; and Carl. S. Warren, "Audit Risk", in *J. of Acct.*, 66-74, Aug. 1979.

[78] See Homer L. Bates, Robert W. Ingram, and Philip M.J. Reckers, "Auditor-Client Affiliation: The Impact on 'Materiality'", in *J. of Acct.*, 60-3, April, 1982.

[79] s. 27 of the CA 1989.

[80] s. 389A of the CA 1985.

5.2.2.2 Materiality in Taiwan

As a general proposition, Taiwanese law embarks on defining materiality mainly from the perspective of users' needs; unfortunately, the message carried by the term "users' needs" is diluted by the misuse of the term "interested parties". On the other hand, although the statute (the SEL) does employ the word "material contents" on some occasions, the Law does not go further to provide a satisfactory definition for it.

The definition of materiality is covered both by legislation (the SEL) and regulations (promulgated by the SEC) in Taiwan. The former, when it deals with this problem, could be likened to English law (the FSA 1986) in the sense that materiality is emphasised when civil or criminal liability is at issue. By contrast, the regulations, either declaring the general purpose of a financial statement (which could be treated as a statement of materiality) or laying down the disclosure details (which show the importance of certain information), in reality serve a better understanding of materiality and thus are the main concerns of this section. However, provisions in the SEL need general examination first.

the SEL

The SEL mentions materiality of information in two contexts: (1) the design of the content of mandatory disclosure; and (2) in relation to material misrepresentation in civil or criminal liability. As regards the design of the content of mandatory disclosure, although the statute requires publicly issuing companies to issue prospectuses at the time of the public distribution of securities and to prepare annual, half-yearly, quarterly, monthly, and immediate financial statements or reports,[81] materiality is inserted not into normal financial statements but immediate reports. The second

[81] Article 13 of the SEL requires issuers to publish prospectuses whenever public distribution of securities is concerned; Article 36 asks all publicly issuing companies to prepare annual, half-yearly, quarterly, monthly (para. 1), and immediate financial reports (para. 2).

paragraph of Article 36 (2) provides that "any matter, the occurrence of which has a significant impact on shareholders' equity or the price for the securities, should be reported to the SEC within two days from the date of its occurrence". The phrase "impact of information on shareholders' equity or the price for securities" embodies the concept of materiality in such special circumstances where an immediate disclosure is demanded. Nonetheless, it is not a general definition of materiality and nor is the term "materiality" explicitly used. But at least a good illustration has been provided.

The concept of materiality is more often employed in the SEL where civil and criminal liability is imposed. Article 32 sets out civil liability for misrepresentation in prospectuses where it states that "[s]hould a prospectus...contain false information or omission in its *material contents* the following persons shall be liable...". (emphasis added) Unfortunately, the Article does not go further to clarify the meaning of "material contents". In contrast, Article 157-1, where civil liability for insider dealing is contemplated, like Article 36(2), adopts a "concrete" standard: inside information is relevant only where it has a material impact on the securities price, and as the Article points out that information is material when it relates to corporate finance, business, or market demand for securities and has a significant impact on securities prices or on investment decisions.

From the above, it could be reasonably argued that the SEL is inclined to introduce the criterion of "price-sensitive" information into the statute when the more general definition of materiality is not employed. Such a method has its counterpart in English law. For instance, the Criminal Justice Act 1993 enumerates the criteria for determining "inside information",[82] among which, the requirement of "a significant effect on the price of any securities"[83] is the same as that of Article 157-1 of the Taiwanese SEL. Even more, the immediate disclosure obligation imposed by the UK

[82] s. 56 of the Criminal Justice Act 1993
[83] Id., s. 56 (1) (d) and (2).

Yellow Book on listed companies is similar to that of Article 36 (2).[84] The drawback of such a standard is that there is no absolute measure of significance. Supposing that a company's shares are £5 per share, will a £0.2 price movement constitute a "significant effect"? Besides that, it may be asked why only information with a "significant effect" is material. Even though the price movement is not substantial, investors' investments are still at stake and the loss to them (investors) may not be insignificant if a large amount of money is involved.

the regulations

Turning to the regulations promulgated by the SEC where materiality is dealt with, four regulations are relevant: (1) the Rules for Preparing Financial Reports by Securities Issuers (1991); (2) the Rules on the Contents of the Annual Reports of Publicly Issuing Companies (1988); (3) the Rules on the Contents of Public Offer Prospectuses (1984); and (4) the Rules Implementing the Securities and Exchange Law (1988). They are all promulgated by the SEC under the authorisation of the SEL. The common feature of these four rules is that the required information, which is presumed to be important from regulators' point of view, is specified in detail. However, a general statement of the purpose of financial statements is missing from the above mentioned Rules. The Rules for Preparing Financial Reports by Securities Issuers (the RPFRSIs) happen to be the only Rules which contain the statement. Therefore, going straight to the RPFRSIs immediately highlights the basic assumed purpose of the financial reports; we then briefly examine other Rules as illustrations.

---

[84] "A company must notify the Company Announcement Office without delay of any major new developments in its sphere of activity which are not public knowledge which may: (a) by virtue of the effect of those developments on its assets and liabilities or financial position or on the general course of its business, lead to substantial movement in the price of its listed securities; or (b) in the case of a company with debt securities listed, by virtue of the effect of those developments on its assets and liabilities or financial position or on the general course of its business, lead to substantial movement in the price of its listed securities, or significantly affect its ability to meet the commitment." See 9.1 of the Yellow Book.

The RPFRSIs[85] are aimed at providing securities issuers with a detailed picture concerning what kind of information should be disclosed whenever a financial report is demanded. Article 5(1) declares that the contents of the financial statements should be able to *"fairly and appropriately present"* the issuer's financial situation, operation results, and cash flow, and should not mislead the judgments and decisions of *interested parties*. This is the fundamental principle underpinning and justifying the thereafter required information, like the "true and fair view" requirement in the British Companies Act 1985.[86] It should be noted that the Taiwanese Accountants Law suggest another standard that auditors should fulfil when they audit financial statements. That is, auditors, in their auditing reports, should address the question whether information provided by companies *"fully"* articulates the corporate financial status.[87] In addition, the Taiwanese GAAP 2 provides that the recording and presentation of enterprises' accounts should be based on objective facts. It is the so-called "principle of objectivity". Academics interpret the term "objectivity" as fairness and without bias.[88] All these terms, including "fairness and appropriateness" are highly abstract concepts. As discussed above in relation to English law, we would prefer to shift to the other side of the coin, "materiality". But at least, it is clear that a similar idea of "a true and fair view" does appear in Taiwanese law as well.

At first sight, a general definition of "materiality" is missing from this Rules. However, Article 4(1) reveals a clue to this question when it states that financial reports refer to financial statements, important accounting items and any other disclosed events and explanations which help *users* when making decisions. An impact on "users' decision-making" is the leading factor guiding the design of mandatory disclosure of the RPFRSIs. It is true, nonetheless, that such a provision was not

---

[85] Authorised by Article 14 (2) of the SEL.
[86] s. 226 (2).
[87] Art. 26(3) of the Accountants Law. It would be interesting to point out that in English law before 1900 the Companies Act (1844 (s. 35), 1862 (para. 94, Table A), and 1879 (s. 7, concerning banking companies)) repeatedly referred to such a standard.
[88] See Jing-liang Hsu, *The Interpretation and Comments on the GAAPs (I Pan Jung Jên K'uai Chi Yüan Tsê Chih Ch'üan Shih)*, 1989, pp. 16-7.

carefully thought through at the time it was made and it does worry us whether this provision was enacted by design or by accident. The reasons for this suspicion spring from both the formative and substantive aspects.

From the formative perspective, users' needs or "fairness and propriety" are never set out in the SEL (the legislation), but are found in one of numerous regulations (which are inferior to legislation) and not[89] repeated by any other important regulations relating to the public disclosure of issuing companies. To find such an important provision only in regulation rather than in the text of principal legislation is abnormal. Even though this gives rise to no contradiction between the SEL and the RPFRSIs due to the fact that the SEL is silent as regards the general standard of disclosure, it is unsatisfactory in that we should not leave such an important principle to a regulation that it will not attract much attention. One point is worth noting: the Accountants Law, Article 26, requires accountants to opine whether the financial reports fairly present the operation results and the financial situation at the end of the fiscal year. Such a provision, although it reminds accountants of their duty, does not map out the full picture of the purpose of financial statements, especially their reliability. After all, the SEL is a more appropriate legal instrument for regulating this issue.

Furthermore, from the substantive point of view, the "impact on users" is itself too rough an idea because it does not clarify the extent of the impact envisaged by regulators. As examined earlier, American law adopts a spectrum from the "would" test to the "might" test (English law adopts the "would" test). Thus, Taiwanese law should be criticised; the lack of a clear criterion would leave the courts in great difficulty if they ever had to deal with this problem.

[89] Noticing the Rules on the Contents of Public Offer Prospectuses, Article 2.

The other problem concerns the term "interested parties". The term "interested parties" is not found in the SEL although it is popular in other fields of legislation. It generally refers to those persons who are at stake with respect to a specific legal relationship. The employment of this term in the Taiwanese Company Law is a good example. Article 393 provides that only "interested parties" can apply for access to registered information at the Competent Authority.[90] The purpose of this provision is to prevent the public from gaining access to corporate information and the term "interested parties" with its natural character of limitation performs this function. However, in the case of publicly issuing companies, the SEL adopts an the entirely opposite position, evidenced by Articles 13, 36, and 157-1. Thus, the restrictive character of "interested parties" does not seem to fit into the disclosure system. Nonetheless, it is very logical to interpret Articles 4 and 5 of the RPFRSIs in the light of seeing them as a whole, and to connect "users" with "interested parties". The limitation of "users" to "interested parties" makes the purpose of disclosure incomprehensible. Therefore, it may be safe to conclude that it is highly possible that regulators borrow the idea of users' needs from the accounting principle where users' needs are stressed, and misuse the term of interested parties without any second thought.

The definition of users is missing from the Rules and the courts. Following the discussion in the earlier section, users could be individuals or institutional investors.[91] Currently, institutional investors, although strongly encouraged by the SEC to participate in securities markets, play a very limited role in the Taiwanese markets. The statistical data revealed that more than 83% of corporate shares were in the hands of

---

[90] In the central government, it is the Ministry of Economic Affairs; in the province, it is the Department of Construction; and in the municipal government, it is the Bureau of Construction. See Article 5 of the Taiwanese Company Law.

[91] Institutional investors are defined as including domestic investment trust companies which establish open-ended mutual funds or closed-ended mutual fund, domestic securities dealers, and foreign investment companies. Therefore, if securities are held or transacted by banks, normal non-investment oriented companies, governmental institutions, and other legal persons are not considered by this section.

individual investors; the share of institutional investors (only around 1% in 1994) is far less than that of normal corporate shareholders (i.e. whose business is not investment business).[92] Even if we analyse capital sources of listed companies, individual investors generally hold half the portion of capital provision, whereas governmental institutions and normal (i.e. non-investment oriented) companies contribute the other one quarter. In short, institutional investors have no more than 8%.[93] Looking at the turnover of securities transactions, 92% of the turnover of the Stock Exchange was transacted by individual investors, while institutional investors only contributed around 3% in 1994.[94] In 1995, the turnover of securities transactions made by institutional investors in the market increased but not much.[95] Noticeably, in March 1996, it (the turnover of securities transactions performed by institutional investors) increased to 12% because the government strongly encouraged institutional investors to participate in the stock markets.[96] In this situation, it is still far too early to advocate that in Taiwan users of information should be identified as institutional investors when the content of mandatory disclosure is concerned.

In addition to declaring the general purpose of preparing financial reports, the RPFRSIs also indicate that financial reports should be prepared based on the Rules and relevant legislation[97] and regulation, and if no provision available therefrom, resorting to the GAAPs issued by the Committee of Accounting and Auditing Standards.[98] Thus, comparison of English law as analysed above demonstrates that Taiwanese law regards the GAAPs as a supplementary source of law and emphasises the hierarchic priority

---

[92] See Y. Chang and W. Chen, "The Current Analyses of the Structure of Taiwanese Securities Investors" (Tang Ch'ien Wo Kuo Chêng Chüan T'ou Tzu Jên Chih Fên Hsi), in 401 *Materials on Securities Transactions (*Chêng Chüan Tzu *Liao)*, 14-23, 1995. The statistics are of the year of 1994.

[93] See Economic Daily News, *Finance and Securities Yearbook of the Republic of China 1995*, 1995, p. 694.

[94] See Y. Chang and W. Chen, supra note 92, p. 19.

[95] See *Securities Management (Chêng Chüan Kuan Li)*, 13(4), 1995, p. 127.

[96] *Economic Daily News*, 17.4.1996.

[97] For example, the Commercial Accounting Law.

[98] It is the sub-organisation of the Accounting Research and Development Foundation of Taiwan, established by accountants and took over the function of issuing accounting standards from the Committee of Financial Accounting of the National Federation of CPAs' Association; the issued accounting principles are called Bulletins on Financial Accounting Standards.

among different sets of rules. In practice, when the courts come across accounting or auditing issues they may consult the National Federation of CPAs' Association as the Association[sic] is thought to be the authoritative institution with respect to accounting issues. Nonetheless, it is worth mentioning that accountants are also used to seeking advice from government taxation departments whenever the application of GAAPs is unclear as regards whether the application of a Principle would comply with regulations.[99]

Such a methodology reveals two significant phenomena underlining the legislation: (1) an undervaluation of the importance of accounting and auditing professionals; (2) the direct incorporation of most of the accounting and auditing principles and bases into the law. These two points are evidenced by the fact that the law always sets out detailed disclosure items and identifies the accounting bases for each of them. This reflects two further phenomena: the weakness of accounting and auditing practices among professionals, and the basic belief that binding rules should spring mainly from the public authority rather than a self-regulating body.[100] The lack of good accounting and auditing practices has lasted for decades and is still unresolved. Some scholars attribute this to the crude contents of the GAAPs,[101] the low quality of accountants and auditors, a lack of knowledge of business, and the low pass rate on the CPA examinations which has deterred students with formal university education from entering the accounting profession, in which retired military or government officials can easily obtain an accountant licence by satisfying some simple criteria.[102] The last factor has been alleviated to a certain extent since 1989 as the pass

---

[99] *73 nien tu shang su tzu ti 2060 hao.*

[100] The Taiwan legal system rarely has self-regulation.

[101] It is said that the published accounting and auditing standards of the National Federation of CPAs' Association were only thirty-four pages in length. See Jane Kaufman Winn, "Banking and Finance in Taiwan: The Prospects for Internationalization in the 1990s" (in International Lawyer, 25/4 (winter, 1991), 947), in Brian Wallace Semkow, *Taiwan's Capital Market Reform*, 1994, p.204, footnote 146.

[102] See Brian Wallace Semkow, id., 184. Regarding the special easy test of obtaining accountant license, see Article 2, the Accountant Law.

rate was increased to 20%. Nonetheless, as regards other factors, there is a long way to go before any visible improvement can be made.

It is suggested that the traditional culture of the "personal relationship net" cannot be ignored when the above mentioned problem is contemplated. People in Taiwan are used to "massaging" the figures (i.e. "adjusting" any financial statements) without fearing any possible punishment because it is outweighed by the concerns of commercial profits and personal relationship. People would not conceive this kind of dishonesty as socially disapproved; rather, they would perceive it as a favour done to friends. The bribe payments in political elections provide another similar ideology: receivers of payments treat the money as "transportation fees". Therefore, without a change of such attitude, improvement is unforseeable. Although the law has imposed an "independence" requirement on accountants[103] and the SEC has commissioned the National Federation of CPAs' Association [sic] to upgrade its standards, the results remain to be seen.

Consequently, it is understandable that administrators and legislators are inclined to encompass these accounting and auditing rules under the umbrella of law, rather than entrusting them to professionals; that is, the traditional preference for governmental intervention is strengthened by accounting malpractice and low professional standard. This in turn justifies the insertion of accounting and auditing rules into legislation. Ironically, however, the SEC, for the purpose of improving the reliability of financial statements by means of strengthening a company's internal accounting system, has stated its intention of relying on professional knowledge of accountants and auditors to review a company's internal control and auditing system within six months after the re-election of directors and supervisors.[104] Although

[103] Article 23 of the Accountant Law, and Article 22 of the RPFRSIs.
[104] See *Economic Daily News*, Taipei, 24.12.1995.

desirably this policy may be, it is difficult to see how it can be carried out given the current development of accounting and auditing profession.

The RPFRSIs were amended recently[105] to oblige companies to disclose information regarding investment in China.[106] Such a region-specific rule reveals that the tense relationship between China and Taiwan may have material effect on investors investment judgments if the political situation deteriorates. The amendment also reflects anxiety about the unstable economic reform in China.

The next two regulations mentioned are the Rules on the Contents of the Annual Reports of Publicly Issuing Companies (RARs) and the Rules on the Contents of Public Offer Prospectuses (RPOPs). Each of them emphasises the principle of honesty, i.e. there should be no fraudulent statement in or omission from prospectuses or annual reports.[107] They also enumerate all items of information which must be disclosure.[108] Like the RPFRSIs, the RPOPs employ the term "interested parties"; it reads:

> "...Before publication of the prospectus, if there is any transaction or event which is sufficient to affect the judgment of interested parties, it should be disclosed."[109]

Thus, "materiality" of information is implied here; as regards the defects of the term "interested parties", it has been analysed earlier in this section.

---

[105] 07.11.1995.
[106] Article 6(18) of the PRFRSIs.
[107] Article 3(1) of the RARs and Article 2(1) of the RPOPs.
[108] In principle, the mandatory information includes: corporate general information (e.g. general introduction of the company, company's organisation, capital and shares, corporate debentures and bonds, and special shares), operational situation (e.g. the corporate operation, fixed assets, and other real estates, important investment, significant contracts, and other necessary supplementary information), business plan, financial situation (e.g. financial information, the accounting and auditing results, departmental financial information), etc.
[109] Article 2(2) of the RPOPs.

The last set of regulations to be mentioned are the Rules Implementing the Securities and Exchange Law (RISEL). The Rules themselves do not provide any general guideline of materiality as they only deal with several separated issues in order to clarify some provisions in the SEL. Notably, there are two articles setting out: (1) the situations in which the financial reports must be re-prepared and re-published; and (2) what constitutes so-called price-sensitive information.

First, Article 6 of the RISEL requires the company to re-prepare and re-publish its financial reports in any one of the following events:

1. the corrected amount of profit (loss) is over NT$10 million;
2. the corrected amount of profit (loss) is over 1% of the original net income; or
3. the corrected amount of profit (loss) is over 5% of the paid-in capital.

This provision is a very good example of quantifying materiality as a number or The RPFRSIs, likewise, include many illustrations of quantifying materiality[110] which show that the Taiwanese government has accepted this measure of materiality; unfortunately, it seems that no one has ever challenged the inflexibility of this method.

Second, Article 7 of the RISEL supplies a definition for the expression "price-sensitive" information which occurred without definition in Article 36(2)(ii) where an immediate disclosure obligation is imposed on companies. Nine events are laid down:

1. Cheques issued by the company are dishonoured by non-payment by the bank because of insufficient deposit, the company has been rejected for transactions, or other events which cause the company to lose its credibility;
2. There is litigation, administrative decision, or administrative litigation which has a great impact on corporate finance or business;

[110] For example, para. 1, subsections 5 and 7, para. 2, subsection 2 of Article 8; para. 1, subsections 5 and 7 of Article 9.

3. The production of the company is reduced substantially, the factory or the major production facilities are leased, or all or most of the assets are pledged or mortgaged, with an impact on corporate business;
4. There occurs one of the situations referred to in Article 185 of the Company Law;
5. The court, upon petition by an interested party or *ex officio*, prohibits transfer of the shares of the company during the procedure of corporate reorganisation;
6. The chairman of the board of directors, general manager, or one-third of the directors are removed;
7. The appointed certified public accountant is removed;
8. The company enters into an important contract, makes material changes in its business plan, develops a product, or takes over another enterprise;
9. Any other event likely to have a major effect on corporate operations.

To sum up, accounting and auditing development in Taiwan is still in its early stage and most of the accounting principles have been incorporated in law. This fact of itself hampers the modernisation of the rules because the law cannot be easily changed. Moreover, although it is not the object of this thesis to suggest that there should be a unified definition of materiality, in the Taiwanese case, it is difficult even to discern a general definition of materiality at first sight. Our analyses has revealed that a general meaning of materiality can be extracted from the concept of users' needs though it is confused by the introduction of "interested parties", although this problem has been resolved to a certain extent by laying down the detailed items of information required. Nonetheless, users' needs are insufficiently clear. As a result of which it is still impossible to identify the precise scope of disclosure on a logic basis. Finally, the unsatisfactory quality of accountants and auditors has frustrated substantially all the efforts made to the improve mandatory disclosure system so far as statements are not as reliable as the law expects.

5.3 The Layout of Mandatory Disclosure

The problem of the layout of financial statements and business reports is closely related to users' needs. Different users have different requirements both of the content of disclosed information and of the method of expression (the layout). Institutional investors (or professional investors) and the most ignorant individual investors stand at the two ends of the spectrum, as discussed above, showing their entirely different attitudes towards the content requirements. This phenomenon reappears when the layout of information is in issue. For institutional investors, complicated expression of information would not impede their understanding. On the contrary, they appreciate the provision of abundant information in this way; whereas the most ignorant individual investors can only digest information presented in the simplest language if at all.[111] Thus, regulators face a formidable choice.

Supposing that institutional investors are targeted when contents of disclosure are enumerated, there is a great amount of information calling for disclosure. The question is whether a simple method of expression will suffice. If abundant financial information is to be disclosed, it is almost inevitable that complexity of expression and jargon will be used.[112] Since it seems impossible to combine simple expression on the one hand with disclosure of sufficient information (from institutional investors' point of view) on the other, this in practice demonstrates an unobserved point ubiquitous in regulations: the scope of mandatory disclosure is broad enough to cover much information of no interest to ignorant individual investors whereas regulations reiterate and emphasise that information should be disclosed in a simple and understandable

[111]Laymen would not be able to understand complicated financial statements. See L.E. Rockley, supra note 67, p. 10.

[112] See Homer Kripke, "The Myth of Informed Layman", in *The Business Lawyer*, 631-8, January, 1973.

form. This point is true both in English and Taiwanese law. The British Yellow Book provides:

> "Particulars must provide factual information, in *as easily analysable and comprehensible a form as possible*. Such information must be set out in words and figures. Pictures, charts, graphs or other illustrations must not be included (except as a result of the requirements of paragraph 5.24) unless the Exchange is satisfied that it is the only way in which the relevant factual information can be *clearly and fairly presented.* The Exchange may require that *prominence be given in the particulars to important information* in such manner as it considers appropriate."[113] (emphases added)

English law stresses clearly the simple expression of mandatory disclosure because it is "logical" that only analysable and comprehensible statements can help investors make decisions. However, such an argument fails to appreciate that a financial statement carrying complicated information is not susceptible of analysis and comprehension in view of the lack of professional knowledge of individual investors. Undoubtedly the difficulty could be resolved if investors in this case are defined as institutional investors. Unfortunately, for whose benefit the statements are analysable and comprehensible is unclear in the regulation. In the light of the spirit of the regulation, the requirement of "easiness" seems redundant if the regulation aims at protecting institutional investors; however, taking individual investors as the protected group falls into the "impossibility trap", in a practical sense, as we have demonstrated above.

The same myth is repeated in Taiwanese law. Both in the RARs and RPOPs, the layout of annual reports and prospectuses is required to be simple and understandable.[114] More interestingly, the RARs require publicly issuing companies to use pictures, charts, graphs or other illustrations, apparently in the belief that they are easier for investors to understand. As the securities markets are dominated by

---

[113] Para. 5.7 of the Yellow Book.
[114] Article 3(2) of the RARs; Article 2(1) of RPOPs.

individual investors, the definition of investors in Taiwan at this stage unambiguously refers to individual investors with no professional knowledge, and this, again, casts doubt on the reality of the regulation.

Finally, the "position" (i.e. prominence) of any important information and the balanced presentation of conflicting facts bear some weight in the design of mandatory disclosure. A piece of indispensable information would lose its function if buried amongst numerous other items without any special emphasis. Also, if conflicting facts are not presented in a balanced manner under an "equal prominence rule", investors may easily be misled.[115] That is why the Yellow Book declares that the Stock Exchange may require prominence to be given in the particulars to important information. It is also possible to deter preparers of financial statements from burying important information by the threat that this kind of activity may be interpreted as misrepresentation, especially omission.[116]

5.4 Timely Disclosure

One of the severe attacks advanced by economists is that mandatory disclosure is often too late to be helpful. Such a question could be thought of through two streams: (1) immediate disclosure requirements; and (2) listing particulars (as well as prospectuses) and other periodic mandatory disclosure.

The emergence of important information (which is defined as price-sensitive information in most cases) is required to be disclosed immediately both in English and Taiwanese law. In this sense, timely disclosure would not cause any significant trouble and is achievable. The real difficulty lies in the periodic disclosure and listing

---

[115] See Marianne M. Jennings, et al., supra note 56, p. 652; *Arnison v. Smith*, supra note 23, p. 370.
[116] See Roger J. Dennis, "Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix", in 25 *William and Mary L. R.*, 373-419, 1984, p. 385. American cases are good examples, see *Gould v. American-Hawaiian Steamship Co.* 535 F.2d 761 (3rd Cir. 1976).

particulars (prospectuses) which are prepared for the purpose of presenting a company's financial and business circumstances over a period of time or its position on a specific day. Thus, inevitably, most of the information disclosed is historical.

The strongest argument proposed by some economists is that since information has been fully reflected in securities prices already, such disclosure would not serve market efficiency in any sense. Nonetheless, it has been established that historical information is still helpful in the light of reviewing securities price movements, evaluating investment risks of individual companies, and comparing previously available information with the authentic information released by companies to see if the previous information was correct. That is, two functions are asserted: (1) the function of supplementing information which was partially uncovered before the release of mandatory disclosure;[117] and (2) the function of verification.

These two functions can be placed in a broader context. First, as we have examined in Chapters Three and Four, voluntary disclosure fails to supply all the information required by investors. This is known as market asymmetry. Thus, mandatory disclosure fills the gap left by incomplete information available through research by market participants. Moreover, securities prices reflect information but do not, by themselves, tell investors the way the prices are formed; in other words, exactly what the risk is attached to an investment is not detectable merely through the observation of price movements.[118] Investors require detailed information of corporate capital structure, cash flow, industrial performance, and so forth, which can only be obtained as a whole from such mandatory disclosure. Second, as mentioned above, under voluntary disclosure, fraud is widespread and this can be alleviated by mandatory

---

[117] See Jeffrey N. Gordon and Lewis A. Kornhauser, "Efficient Markets, Costly Information, and Securities Research", in 60 *N.Y.U. L. R.*, 761-849, 1985, p. 796.

[118] See John C. Coffee, Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System", in 70 *Virginia L. R.*, 717-53, 1984, pp. 748-51.

disclosure backed by legal penalties.[119] As a result, information contained in mandatory disclosure is likely to be more correct and will reduce the possibility of providing false information before periodic disclosure. Accordingly, the merits of such periodic disclosure easily outweigh any shortcoming due to the gapping time between the time which information relates and the time of its disclosure.

5.5 Conclusion

In examining the content of mandatory disclosure, it is clear that both English and Taiwanese law are defective in dealing with the materiality problem. English law fails to make it clear, in the FSA 1986, that materiality should be the criterion of mandatory disclosure; far less does it provide a definition of what is material. Even though the case law has provided some explanations of the term, there is a lack of thorough analysis. Materiality is further blurred by the concept of "true and fair view". As both the terms, "materiality" and "a true and fair view", are highly abstract, their relationship is unclear. The ignorance of "users' needs" also highlights this problem.

Taiwanese law, on the other hand, does employ the term "materiality" to a certain extent. Nonetheless, the same defects which are observed in English law are repeated in a slightly different form in the Taiwanese jurisdiction. In particular, the term "users" is confused with the concept of "interested party", a term incompatible with a general obligation of disclosure.

Thus, it is suggested that both jurisdictions should introduce "materiality" and "users' needs" into their statute comprehensively and fully delineate the relationship between "materiality" and "a true and fair view" (or, in Taiwanese law, "a fair and appropriate presentation"). In addition, as regards the definition of users, it is

---

[119] See Joel Seligman, "The Historical Need for a Mandatory Corporate Disclosure System", in 9 *J. of Corporation Law*, 1-61, No. 1, Fall, 1983, pp. 9, 18 et seq.

reasonable to propose that English law should adopt the "institutional investors" definition while Taiwanese law may opt for the "individual investor with moderate financial knowledge" standard. As regards the form of financial statements, it seems appropriate to prepare an abridged version in which financial jargon is avoided for the benefit of individual investors. However, a detailed copy should be attached to it and a statement which specifically draws investors' attention to the risk of simply relying on the abridged copy should be included.

For English law, one further observation may be made. Only listed companies are obliged to prepare half-yearly reports in relation to consolidated financial statements. It seems that all publicly issuing companies should bear the same obligations, and furthermore, quarterly and monthly reports should be available to the public concerning any individual company's position.[120]

Taiwan suffers from widespread accounting malpractice which causes financial statements to be unreliable. The Taiwanese legislature also faces the dilemma of choosing between a capital market where individual investors prevail and abundant disclosure requirements designed to improve market transparency and efficiency, as these two (individual investors and complicated disclosure) can never function properly at the same time. Maybe it would be a good proposal to recommend that individual investors should be encouraged to consult securities analysts who can digest financial information for them in order to reach informed decisions.

[120] See Carol A. Frost and Grace Pownall, "Accounting Disclosure Practices in the United States and the United Kingdom", in *J. of Accounting Research*, 32(1), 75-102, Spring, 1994.

Chapter Six

Civil Liability for Non-Disclosure and Untrue Statements

6.1 Delimiting the Scope of Research

A wrong generally gives its victim two possible rights: to removal of such an infringement privately or judicially, and to compensation (if there is any damage, except where it is actionable *per se* or where nominal damages are available).[1] This chapter is concerned solely with compensation and thus the first limb of the rights (removal) is only treated briefly and other forms of remedy (e.g. restitution and rescission) are excluded.

Removal (abatement of injury)

It is fair to describe the right of removal of an infringement as a right available only when law specifically so provides. For example, a person may regain his chattel in hot pursuit from the tortfeasor who has tortiously deprived him of his possession.[2] However, while compensation is a general remedy which the law gives whenever all the conditions of liability exist, the right of removal does not appear to have any function at all in relation to non-disclosure and untrue statements in English law and plays a limited part in Taiwan.

---

[1] See John Cooke, *Law of Tort*, 2nd ed., 1995, p. 3. A similar classification is advanced. Nominal damages may be awarded in all cases of breach of contract and in torts actionable *per se*. See Harvey Mcgregor, *McGregor on Damages*, 15th ed., 1988, p. 249. Since this chapter focuses on damages for non-disclosure and untrue statements, emphasing the aspect of tort, nominal damages will not be analysed.

[2] In Taiwan, the Civil Code, Article 960(2); in the UK, self-help is permissible so long as it is peaceful and involves no more force than is reasonable. See B.S. Markesinis and S.F. Deakin, *Tort Law*, 3rd ed., 1994, p. 410. Also one may seek an injunction where a trespass to land is threatened. See *Llandudno UDC v. Woods* (1899) 2 Ch. 705.

It is submitted that the contents of such a right (removal) could cover only two things: to require the wrongdoer to disclose what he should have disclosed or to require the wrongdoer to correct an untrue statement which he should not have made. Consequently, the fact that the right of removal in the light of non-disclosure or untrue statements does not function in English law can be analysed from these two perspectives.

First, as regards compelling disclosure, no individual investor has such a right of action under English law.[3] In *Devlin v. Slough Estates Ltd.*,[4] the plaintiff shareholder complained that the directors did not prepare the corporate accounts properly.[5] But the court ruled that the standing of an individual shareholder to bring a personal action to challenge the form of a company's accounts was not unlimited in scope; that is, the individual shareholder did not have the standing to complain about the non-disclosure of certain information.[6] Obviously the result would be the same if the shareholder brought an action requiring the directors to correct any untrue statements in the accounts.[7] By inference, nor can non-shareholding investors complain about corporate accounts.

---

[3] Some public authorities in certain situations have such a right. For example, the Secretary of State can apply to the court for granting an injunction restraining the contravention of s. 47 (about misleading statements) in s. 61(1) of FSA 1986. The Stock Exchange may itself publish the information which it considers appropriate for the purpose of protecting investors and maintaining the smooth operation of the market if the issuer fails to comply with such a requirement of publishing information. See *Yellow Book*, 1.7. However, these are not private rights and are not taken into account here.

[4] [1983] B.C.L.C. 497.

[5] The directors of the company omitted in the accounts all references to possible contingent liability for damages in an action commenced against the company and one of its subsidiaries in France for breach of contract.

[6] See supra note 4, p. 497.

[7] Under s. 245 of the Companies Act 1985, the directors may voluntarily prepare revised accounts or a revised directors' report when they find the document not complying with the requirements of the Act (misleading statements are included, because the Act provides that these reports must give a true and fair view). If the directors do not do so, the Secretary of State and the Financial Reporting Review Panel may apply to the court for an order requiring the directors to prepare revised accounts (not including directors' reports). See ss. 245A, B, and C. The Financial Reporting Review Panel was delegated such a power by the Secretary of State according to s. 245 C and the Companies (Defective Accounts) (Authorised Person) Order 1991 (S.I. 1991/13). Its main duty is to receive and investigate complaints regarding the annual accounts of companies.

Second, whether a subscriber or purchaser can require the company to disclose or to correct untrue statements in listing particulars or prospectuses is uncertain. No case has ever specifically dealt with this problem. It might be thought, at first sight, that the rectification of documents is a possible means to that end. The listing particulars and the prospectus are required to be registered with the Registrar of Companies. As there is no equivalent of amendment provisions available in respect of annual accounts in the Companies Act, it seems that a subscriber or purchaser may allege such an equitable remedy to require full disclosure or correction of listing particulars and prospectuses. However, the court may not grant it because in this situation the removal of the wrongful act (i.e. ordering the company to disclose or correct the untrue statement) will not help victim investors in any way; they need compensation.[8]

By way of contrast, in Taiwan, the final version of annual accounts and reports must be approved by a general meeting of shareholders.[9] If there is any untrue statement or omission in the said documents, the shareholders can propose changes that need to be made and if the memorandum or articles of the company does not provide otherwise, the change should be decided by the votes of the shareholders. It needs shareholders holding and representing a majority of the total number of issued and outstanding shares to attend the meeting in person or by proxy, and at which a majority of the votes held by the shareholders present is cast in favor of such a resolution.[10] Here is revealed a great difference between English and Taiwanese law. The reason why shareholders have the opportunity to correct misleading statements in annual accounts and reports is due to the fact that they have an opportunity to approve the documents while the shareholders in the UK do not.[11]

---

[8] For rectification, see I.C.F. Spry, *The Principles of Equitable Remedies*, 4th ed., 1990, chapter 6.
[9] Art. 230, CL. See also supra Chapter Two about the procedure set in Art. 36 of the SEL.
[10] Art. 174, CL.
[11] Even though they do have an opportunity to raise queries about the statements in the general meeting, this does not mean that they have rights to ask directors to correct the misleading statements.

However, non-shareholders would not have the same right. Besides that, as regards prospectuses, not being documents which need to be approved by shareholders, subscribers or purchasers have no standing to require directors to correct them. Even more, the right of removal is not helpful because investors are looking in fact for compensation.

On the other hand, among the many forms of remedy, compensation is the most relevant to securities transactions cases. Rescission is not impossible if misrepresentation is material, e.g. where the plaintiff subscribed in reliance on a prospectus; nonetheless, as privity is indispensable in this situation, i.e. between a subscriber and company, as long as we focus on the statutory compensation provisions and common law liability regarding continuous disclosure where a contractual relationship mostly is not required or does not exist, we shall not examine this problem in-depth even if we may come across it occasionally. As regards restitution which denotes a response aligned with compensation and other forms of remedy,[12] there is hardly any important scenario where restitution is claimed (although we cannot deny its existence, especially after rescinding a contract) in the field of litigation over securities transactions. Accordingly, this chapter is concerned only with the question of damages for non-disclosure or untrue statements. The legal sources of damages and their elements are well developed by the laws of contract and tort. However, these rules springing from normal civil liability may not fit with the civil liability for misrepresentation on securities transactions. They need to be closely examined.

[12] See Peter Birks, *An Introduction to the Law of Restitution*, 1989, pp. 9-10. The elements of restitution are : (1) the defendant is enriched; (2) at the expense of the plaintiff; (3) the enrichment is unjust; and (4) no other considerations which are obstacles to the claim. And the term "unjust enrichment at the expense of another" provides generic conception to all events giving rise to restitution. Id., pp. 16-22.

(1) the United Kingdom

Damages (or liability for compensation in the words of the statutes) are imposed both by English common law and statutes. The latter mainly[13] refer to the Companies Act 1985 (now to the Public Offers of Securities Regulations 1995) and the Financial Services Act 1986 (the FSA 1986). Section 67 of the Companies Act 1985 imposed the liability for compensation on the persons responsible towards **subscribers** of any shares or debentures on the faith of **prospectuses**. Section 150 of the FSA 1986 on the other hand controls misrepresentation in listing particulars; responsible persons are liable to **acquirers** of any shares and debentures on the faith of **listing particulars**. Since 1995 June, the Public Offers of Securities Regulations 1995 (the POS Regulations)[14] have replaced Part III of the Companies Act 1985 and employ similar wording to that of s. 150 of the FSA 1986. Hence in English law, we will concentrate on s. 150 of the FSA 1986 in order to elucidate liability for damages regarding misstatement in prospectuses and listing particulars;[15] in addition the rules developed by the common law will be examined simultaneously. As regards continuous disclosure, common law is the only source because statutes do not specify any such liability.

(2) Taiwan

Four liabilities provided by the Securities and Exchange Law (the SEL) are discussed in this chapter: (1) the liability for compensation should prospectuses not be delivered to subscribers before they subscribe securities; (2) the liability for compensation in the

[13] Doubtlessly, the Misrepresentation Act 1967 is also one of the statutory sources; this thesis will touch upon it in a later stage.
[14] reg. 14.
[15] By fault to make any misleading, false, or deceptive statement, promise or forecast is prohibited by s. 47 of the FSA 1986. And s. 61 provides remedies for such contravention, which is also the basis of civil liability in the cases of take-over or market manipulation. However, the application can only be brought by the Secretary of State, not private investors; therefore, it is not the concern of this thesis.

case of misstatement in prospectuses;[16] (3) the liability for compensation in the case of misstatement in any continuous disclosure documents; (4) and the liability for compensation in insider dealing.

First, Article 31 provides that before subscribers subscribe for securities, they should be given prospectuses. Otherwise, persons who do not fulfil this statutory duty are liable to bona fide subscribers if any damage ensues from such a breach. A liability of this kind is now imposed in the UK but is slightly different. It is unlawful in the UK, before the time of publication of the prospectus, to offer the securities to the public; any contravention of this shall be actionable at the suit of a person who suffers loss as a result of the contravention subject to the defences and other incidents applying to actions for breach of statutory duty (s. 156B(5), the FSA 1986). At a very general level, under mandatory disclosure requirements, both jurisdictions compel issuers to prepare prospectuses. However, the Taiwanese SEL requires issuers or underwriters not only to publish prospectuses but also to deliver them to subscribers, while English law only requires prospectuses to be published and available. Nonetheless, the civil liability in the UK only applies to prospectuses required under the FSA 1986, not to the POS Regulations. Thus, for unlisted securities, the old rule has not been altered.[17] Here, whether there is any untrue statement or omission is not at issue. What these persons are breaching is the obligation to publish in the UK (or deliver to investors, in Taiwan) prospectuses before subscribers make investment decisions.[18]

---

[16] In Taiwan, no distinction between listing particulars and prospectuses is made; whenever public distribution of securities is concerned, prospectuses should be prepared. Even though application of listing is submitted, still only prospectuses are required (no documents called listing particulars exist in Taiwan). In other words, no double paper work is necessary.

[17] Although the repealed ss. 56(2) and 72(5) of the CA 1985 (the UK) made it unlawful to issue any form of application for securities of a company unless the form was issued with a prospectus. The penalty for contravention was a fine, not civil liability towards investors. The new rule provides that when securities are offered to the public in the UK for the first time the offeror shall publish a prospectus by making it available to the public (reg. 4(1) of the POS Regulations); there is still no civil liability for non-compliance.

[18] Both English and Taiwanese law require issuers to prepare and publish prospectuses; as well as to give a notice regarding where copies of prospectuses are available. But Taiwanese law imposes an extra requirement: before subscribers subscribe for securities, they must be given (i.e. delivery of prospectuses by issuers or underwriters) prospectuses by issuers or underwriters.

Persons who are liable for delivery include issuers and underwriters, according to the academics' interpretation.[19] And persons entitled to compensation are subscribers who suffer loss as a result of not being given prospectus.

Second, Article 32 of the SEL, similar to the two sections mentioned above in the UK POS Regulations and FSA 1986, provides that those responsible persons are liable to any "bona fide counterparties" who suffer loss as a result of material false statements in or omission from prospectuses unless they can prove that they have no fault (the proviso). The scope of "bona fide counterparties" is unclear; it is analyzed below.

Third, Article 20 of the Act provides:

> "In the course of public offering, issuing, and trading of securities, falsity, fraud and other misleading behaviour are prohibited. (Art. 20(1))
> Untrue statements or omissions in the financial reports or any other business documents filed or published by an issuer are prohibited. (Art. 20(2))
> Persons who violate any of the preceding two paragraphs are liable for damage sustained by *bona fide buyers or sellers* of the securities in question." (Art. 20(3)) (emphasis added)

The first paragraph is a general anti-fraud provision. It encompasses a broad scope of liability. If a wrong cannot be complained about under any other more "specific" provisions, such as misrepresentation in prospectuses and insider dealing, this general provision can be resorted to.

It is manifest from Article 20(2) that if there is any misrepresentation in continuous disclosure documents, such as annual, half-yearly, quarterly, and monthly

---

[19] Yin-chao Lai, *The Interpretation on the Securities and Exchange Law (Chêng Chüan Chiao I Fa Chu T'iao Shih I),* 5th ed., 1990, Vol. 2, p. 239; Hsueh-ming Yu, *The Securities Administration (Chêng Chüan Kuan Li),* revised ed., 1983, p. 540.

reports, and any immediate reports,[20] certain persons are made responsible. This will be dealt with in a later section.

The wording of Article 20, second paragraph, raises an interesting question: is this a strict liability? Or is "scienter"[21] a necessary element of the liability? First, comparing this paragraph with Article 32 where liability on prospectuses is stated reveals that no proviso similar to that in Article 32 is laid out in this paragraph. Therefore, it seems that such a liability is a strict one. However, for two reasons this should not be a strict liability: (1) both in Article 32 and this paragraph, the wording "untrue statements or omissions are prohibited" is identically used; and (2) there is no reason to impose a greater liability on responsible persons regarding continuous disclosure documents than regarding prospectuses, especially as in some countries, e.g. the UK, there is still no statutory liability for compensation concerning misrepresentation in continuous disclosure documents. Consequently, the liability under this paragraph could not be a strict liability; it might be a negligence liability like that in Article 32. Moreover, as no proviso is provided, it may be inferred from general principle that the plaintiff has to prove the fault of the defendant.

Nonetheless, if American law is taken into account, something more than negligence on the part of the defendant may be required. Although American law has no authority in Taiwan, that Taiwanese securities legislation and administration usually follow the American track is a fact without doubt. According to the American Securities Exchange Act 1934, §§ 10b and 18(a),[22] where similar liability is provided,

---

[20] See Art. 36 of the SEL, regarding its details, see supra Chapter Two.

[21] Lat. knowingly, knowledge by the misrepresenting party that material facts have been falsely represented or omitted with an intent to deceive. This term, as applied to conduct necessary to give rise to an action for civil damages under the US Securities Exchange Act 1934 refers to a mental state embracing intent to deceive, manipulate, or defraud. See *Black 's Law Dictionary*, 6th ed., 1990.

[22] The Securities Exchange Act 1934, § 18(a) provides: "Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder ... which the statement was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for

the courts held that mere negligence was insufficient.[23] In other words, there should exist "scienter" on the part of the defendant. The lower courts have in some cases ruled that scienter includes "recklessness". The problem is that there is no unanimous definition of application of the recklessness standard by the courts.[24] In Taiwan, however, no such term like "scienter" exists. As a result, it is unclear whether intention is required, or gross negligence suffices.

Fourth, Article 157-1 prohibits certain persons[25] from insider dealing; therefore, insiders who violate this provision are held liable to bona fide counterparties who have traded for damages to the extent of the difference between the buying or selling prices prior to the disclosure and the average of the last reported selling prices for ten business days after disclosure. The court may also, upon the request of the bona fide counterparties, treble the limit of the liabilities of the said persons should the violation be very serious.

This brief comparison shows that the scope of civil liability in Taiwan is broader than that in the UK. To say the least, liabilities for continuous disclosure documents and insider dealing have been codified in Taiwan, while in the UK, the common law is still struggling with the former problem,[26] let alone the problem of insider dealing.[27]

---

damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." See also Louis Loss and Joel Seligman, *Securities Regulation*, Vol. IX, 3rd. ed. 1993, pp. 4296-300; Note, "Civil Liability for Misstatements in Documents Filed under Securities Act and Securities Exchange Act", in 44 *Yale L. J.*, 456-77, 1935.

[23] *Ernst & Ernst v. Hochfelder* 425 U.S.185 (1976); *Magna Inv. Corp. v. John Does One through Two Hundred* 931 F.2d 38 (11th Cir. 1991).

[24] See Paul G. Mahoney, "Precaution costs and the Law of Fraud in Impersonal Markets" in 78 *Virginia L. R.*, 623-70, 1992, pp. 648-9.

[25] See supra Chapter Two.

[26] See infra pages 240-46.

After delimiting the scope of research, the next step is to structure the remaining sections of the chapter. Defining the "nature" of or characterizing liabilities for damages is very important, seeing that different sources of liability result in emphases being laid on different elements of liability thus causing variant standards to be applied when elements are judged.

Hence, the following text of this chapter is divided into four parts: (1) characterising these liabilities in the UK and Taiwan; (2) going further to abstract the important elements of liabilities in different sources to analyse the problem of establishing liabilities; (3) measuring damages; and (4) scrutinising the difference between liabilities for insider dealing and misrepresentation in prospectuses (and listing particulars in the UK).

6.2 Characterising the Nature of Liability for Damages

Obligations to pay damages spring from three sources of law: torts, breach of contract, and statutes. Non-disclosure and untrue statements may breach any of the three. For a long period of time English law concerning securities transactions cases has brought liability for damages in line with tortious measures while Taiwanese law has swayed, but is yet to settle, regarding the nature of damages liability. Nonetheless, it could be strongly argued that to characterise such a liability as a statutory one, would be most appropriate in Taiwan.

---

	listing particulars prospectuses	continuous disclosure	insider dealing
UK	V	? very limited	X
Taiwan	V	V	V

27

(1) the United Kingdom

In English law, there is next to no argument about the nature of liability for damages in this kind of case. Misrepresentation in securities transactions, i.e. non-disclosure and untrue statements, may constitute breach of contract; nonetheless, as the topic of this thesis covers information whose disclosure is mandated in listing particulars, prospectuses, annual reports, and other continuous disclosure documents, misrepresentation in such cases has, for a long time, been defined by the courts as tort.[28] Even though this liability has been introduced into the statutes (the POS Regulations, reg. 14; the FSA 1986, s. 150), the case law still emphasizes that they are statutory tort cases.[29] Such a position does not deprive plaintiffs of the right to rescind the contracts made between them and the company (or the underwriter, if the latter is the principal). However, this problem is not the focus of the thesis.

(2) Taiwan

Insufficient effort has been made in characterizing these liabilities. Three possible answers may be suggested: torts, breach of contract, and statutory liability.

First, tort is considered. The simplest situation is that by deceit, documents are misleading. Deceit, originally giving rise to a right of rescission to a plaintiff was interpreted by the court as also being a tort.[30] Consequently, if cases fall into this

---

[28] *Derry v. Peek* (1887) 37 Ch.D. 541; *Clark v. Urquhart* [1930] A.C. 28; *Doyle v. Olby* [1969] 2 Q.B. 158; *Smith New Court Securities Ltd. v. Scrimgeour Vickers (Asset Management) Ltd. and another* [1994] 4 All E.R. 225. The Directors Liability Act 1890 was passed as a result of the decision in *Derry v. Peek* which exposed the inadequacy of the common law tort of deceit as a remedy for investors who suffered loss as a result of misleading prospectuses. See L.C.B. Gower, *Principles of Modern Company Law*, 15th ed., 1992, p. 344.

[29] *McConnel v. Wright* [1903] 1 Ch. 546; *Clark v. Urquhart* [1930] A.C. 28.

[30] The courts swayed on this issue. They first admitted that deceit constituted a tort. See 45 *Judicial Juan Public Report*, pp. 29-30. They later, however, overruled this point of view. See *66 t'ai shang tzu ti 1552 hao*, 1977. The latest opinion came back to the first one and confirmed that deceit was tort. See *67 t'ai shang tzu ti 434 hao*, 1978, and the resolution of the Thirteenth Supreme Court Civil

category, they can be characterised as tort cases. This does not help, however, in the situations of negligent misrepresentation and insider dealing. If they are treated as torts, the next question following this is what kind of right is infringed? It is questionable whether "the availability of correct and full information" can be recognised as a right.

Second, the problem of breach of contract comes into play. Taking the simplest case, the public distribution of securities in which contracts are made between investors and the company (the wrongdoer), can investors claim that the company has breached the contracts because it did not properly provide them with information? Although it is true that a company has an obligation to disclose under the mandatory disclosure regulations; however, whether this legal obligation can be treated as part of the obligation of contract is not without doubt.[31] In other cases where no contract between wrongdoer and victim is made or it is very difficult to identify the counterparty of the contract (e.g. insider dealing), breach of contract may not be alleged. For example, a company publishes false information which causes investor A to purchase securities from B. The contract is between A and B, not A and the company. No breach of contract can be claimed by A as against the company. Or in insider dealing, given a stock exchange market, there is no way to identify the "real" sellers or buyers to the transactions. Even if insiders have obligations to disclose to their counterparty, the counterparty is not identifiable. In these situations, to base liability on breach of contract is very tenuous.

Judicial Conference, 1978. See also Ming-hsien Wu, "The Co-existence of Deceit and Tort" (Cha Ch'i Hsing Wei Yü Ch'in Chi'ün Hsing Wei Ping Ts'un), in *The Law Monthly*, 147-9, 47(3), 1995. In fact, if the reason against the concept that deceit is tort is scrutinised, it reveals that the courts which held that deceit was not tort were based on the fact of no damages existing. Therefore, it did not in reality rule that deceit was not tort; instead, it emphasized an indispensable element of tort liability being damage. Accordingly, if a deceit causes damage, it amounts to a tort.

[31] In the USA, some scholars characterise this as a form of breach of contract, because "one party fails to furnish another with information required in the regular course of dealing, or he furnishes information but default in his duties, making the information inaccurate". See Frank H. Easterbrook and Daniel R. Fischel, "Optimal Damage in Securities Cases", in 52 *U. of Chicago L. R.*, 611-52, 1985, p. 614.

Third, turning to statutory liability. If the legislature aims to impose a certain civil liability, it can do so by legislation, no matter whether the wrongdoing constitutes torts, breach of contract or neither of them. Should liability in damages on securities transactions cases be treated as statutory liability, all elements of liability are decided by statutes. When elements are not clearly set out by statutes, the closer standard of torts or breach of contract should be referred to. As mentioned above, four kinds of liabilities exist in Taiwan. It is very difficult to advocate that they all constitute torts; seeing that the kind of right being infringed may not be recognised by ordinary tort law. On the other hand, contracts are not often found between wrongdoers and victims in these cases; even though there are contracts, whether statutory disclosure obligations automatically become part of contractual obligations is obscure. Even more, as discussed in Chapter Three, if there is no mandatory disclosure requirement, in most situations disclosure is not compelled according to the general law; by inference then, no liability occurs. Thus it is argued that characterising these liabilities as statutory ones is most apposite; when the elements of liability are not clear, the standards used by torts or breach of contract (depending on which one is closer to the liability under certain circumstances) should be referred to.

The liability for damages resulting from misrepresentation in securities transactions is characterised as tortious in the UK, while in Taiwan there is no clear answer as yet. Setting aside the problem of characterisation, three elements are common to all sources of liability and are examined carefully. They are: fault (the duty of care), causation and damage. Damage, is common to all three sources of liability in damages, while causation, as will be shown below, is of specific interest to the thesis in measuring liability for damages in securities cases.

A duty of care is the prerequisite of the liability. For negligence cases, only where a defendant has a duty of care which he breaches, will there be fault. Accordingly, the logical order is followed to examine these three topics sequentially: starting from "a

duty of care", ending with damage, and in between examining causation (its first angle).

6.3 The Duty of Care

It is clear that, in the UK, persons responsible for listing particulars or prospectuses owe a duty of care to any acquirers of securities in question; however, the courts are inclined to limit (or reluctant to admit) the duty of care when continuous disclosure is scrutinised. Such a discriminatory treatment demonstrates a conflict between the statute where liabilities are extended and the attitude of the courts fearing the so-called floodgate effect. It is proposed that the legislature may have to consider whether to introduce liabilities for continuous disclosure into the statute. By way of contrast, Taiwanese law provides equal protection to both situations but lacks the clarity as regards the strictness of the liabilities for misrepresentation in continuous disclosure; nor is the scope of responsible persons in the context of continuous disclosure sharply drawn.

6.3.1 The United Kingdom

When liability regarding a negligent untrue statement or omission is tackled, a duty of care should first be considered. Not every person who has made an untrue statement or omission of information should be liable to those who suffer loss as the consequence; he must owe the victim a duty of care when he provides such information but fails to fulfil that duty. A duty can be imposed by statute, by contract, or by some other relationship, such as fiduciary relationship.

The duty of care on disclosure in the situations of public distribution of securities and the obligations of publicly issuing companies can be discussed in two parts. The first part covers the issue of listing particulars and prospectuses; while the second part

is concerned with continuous disclosure by publicly issuing companies, because these are the two situations where civil liabilities will arise in securities misrepresentation cases.

6.3.1.1 The Duty of Care in Relation to Listing Particulars and Prospectuses

Whenever a company publicly offers its securities, it is unlawful to offer the securities in question to the public before the time of publication of the prospectus, and the prospectus should be available to the public at an address in the UK from the time the company first offers the securities until the end of the period during which the offer remains open.[32] Listing particulars are required to be published should the company apply for listing on the Stock Exchange except where a public offer is made in the UK for the first time.[33]

This section focuses on defendants' statutory liabilities. However, liabilities under common law are not affected. For listing particulars, admittedly, to allege the statute is to the plaintiff's advantage. Nonetheless, if the POS Regulations regarding prospectuses are narrowly interpreted (this will be dealt with later), market purchasers may have to rely on the common law liability and thus rules developed in section 6.3.1.2 is applicable in this situation.

a. who is responsible

It is clear by the statutory provisions[34] that all who have consented to be named on the listing particulars or prospectuses are liable for untrue statements and omission, i.e. a statutory duty of care. They are the issuer of the securities, the person who has authorised himself to be named in the listing particulars or prospectuses as a director

[32] s. 156B(1), FSA 1986 and reg. 4(1) of the POS Regulations (the UK); Article 31, Taiwan SEL.
[33] ss. 144(2A) and 144(2), the FSA 1986.
[34] ss. 152 and 154A of the FSA 1986, and reg. 13 of the POS Regulations.

or as having agreed to become a director of the corporate issuer, the person who accepts responsibility for any part of the listing particulars or prospectuses and so stated in them, and any other person who has authorized the contents of any part of these statements.

Directors attract special attention. As a general rule, directors issue all these documents on behalf of a company; thereby they are responsible in principle. However, the statutes (reg. 15 of the POS Regulations and ss. 151 and 154A of the FSA 1986) give them an opportunity to prove the opposite situations which exempt them from liability. That is, should the publication of these documents be made without a director's knowledge or consent and on becoming aware of the publication he forthwith gives reasonable public notice that the documents are published without his knowledge and consent, the director is not liable.[35]

Where a person has accepted responsibility for, or authorised, only part of the contents of any particulars, he is responsible for only that part and only if it is included in (or substantially in) the form and context to which he has agreed.[36]

The statute has conferred on these persons a duty of care to those who acquire the securities. In other words, they have to exercise a reasonable person's ability of care because this is not a strict liability. According to ss. 151 and 154A of the FSA 1986 and reg. 15 of the POS Regulations, they have statutory defenses.[37]

---

[35] ss. 152(2) and 154A of the FSA 1986; reg. 13(2) of the POS Regulations.
[36] s. 152(3) of the FSA 1986; reg. 13(3) of the POS Regulations.
[37] The statutory defences are classified into seven groups: defendant's reasonable belief, the reasonable reliance on an expert's statement, correcting the defect, false statement coming from official statements and documents, plaintiff's knowledge of the truth, permitted omission, and no requirement for supplementary listing particulars. See s. 151, the FSA 1986 and reg. 15 of the POS Regulations.

b. to whom they are liable

The scope of persons entitled to compensation in the situation of listing particulars was broader than that of prospectuses before the enactment of the POS Regulations. But now any person who has acquired any of the securities in question and suffered loss in respect of them as a result of any untrue or misleading statement in particulars or prospectuses or the omission from them of any matter required to be included by the FSA 1986 and the POS Regulations is entitled to compensation.[38]

The meaning of acquiring securities is not limited to subscription for securities. It, instead, also refers to investors' contracting to acquire securities or interest in securities.[39] For example, investors who subscribe for options to subscribe for the securities fall into the protective scope of this statutory liability because investors have an interest in corporate securities by means of exercising options. However, options should be exercised within a reasonable time of the offer.[40] Although the statute does not set a time limit for compensation, it is suggested that a reasonable time limit should be imposed; otherwise, the effect of misrepresentation on securities prices will be diminished (because whenever new information becomes available, prices will reflect it; and as time passes, it becomes increasingly difficult to recognise the impact of the wrong information on the prices).

Whether subsequent purchasers of securities, relying on the listing particulars and purchasing from markets or previous subscribers who subscribed for securities directly from the issuer or intermediary, are also protected needs to be considered. The common factor of these purchasers is that they purchase securities in reliance on the contents of the listing particulars. Will such reliance entitle them to compensation? Section 150(1) of the FSA 1986 does not explicitly set out the scope of persons from

[38] ss. 150(1) and 154A, the FSA 1986; reg. 14(1) of the POS Regulations.
[39] ss. 150(5) and 154A, the FSA 1986; reg. 14(5) of the POS Regulations.
[40] Louis G. Doyle, "Liability for Listing Particulars, Part I" in *Law for Business*, 3[2], 70-2, 1991, p. 71.

whom the securities are acquired, instead, the provision only states that "... acquired any securities ... as a result of any untrue or misleading statement in the particulars or the omission from them of any matter..." According to the wording of the provision, all these purchasers are treated in the same way as the first subscribers of the securities. However, for prospectuses, there is a different interpretation of acquirers. The key lies in the extra words of "to which the prospectus relates" after "acquired any securities" (reg. 14(1), the POS Regulations). Thus, the acquirer is defined as "the placee in respect of the shares originally allotted to them".[41] This thesis, nonetheless, defines acquirers in both cases as meaning the same. If subscribers are intended by the new legislation, there is no reason to substitute "acquirers" for "subscribers" for two reasons: (1) the term acquirers literally denotes a broader meaning; (2) replacing the old term by using the word employed in the FSA 1986 implies that the legislature aims at bringing prospectuses in line with the listing particulars.

Following this, those who purchase the securities from the market in reliance on the contents of the listing particulars or prospectus, it is submitted, should also be within the definition of acquiring the securities as a result of the misrepresentation of the listing particulars or prospectus. Any argument which tries to distinguish these market purchasers from the earlier category purchasers (i.e. who purchase securities from the first subscribers and their derivative purchasers) is not convincing.

In case *Al-Nakib Investments (Jersey) Ltd. v. Longcroft*[42], the court held that directors did not owe a duty of care to shareholders or anyone else who relied on the prospectus for the purpose of deciding whether to purchase shares through the stock market. In this case, the prospectus and interim reports were drawn for the purpose of a rights issue; in consequence the court ruled that there was insufficient relationship

[41] *Possfund Custodian Trustee Ltd and another v. Diamond and others* [1996] 2 All E.R. 774, p. 783.
[42] [1990] 3 All E.R. 321. As regards eligible plaintiffs, see Anthony Hofler, "Company Securities — misinformation and litigation", in *The Company Lawyer*, 16(3), 67-71, March, 1995, p. 71. *Cf. Cullen v. Thomson* (1862) 6 L.T. 870. See also Simon Morris, *Financial Services: Regulating Investment Business*, 2nd ed., 1995, pp. 288-9.

between the directors and the shareholders. This case dealt with the misrepresentation of the prospectus and according to the Companies Act 1985 which has been repealed,[43] liability for compensation was owed by directors to "subscribers" of securities only. That is to say, the scope of protection was limited to those transactions directly related to the prospectus in question. Therefore, the court have recourse to the common law rule where negligence liability was closely scrutinized; proximity should be found. But as noticed, the POS Regulations have replaced Part III of the Companies Act 1985 and responsible persons in both prospectuses and listing particulars have become subject to the same liability, i.e. responsibility to acquirers. The scope of "acquirers" therefore needs to be re-identified. Securities flow on a stock market. Their identity is of no concern for securities transactions; this causes the identity of sellers to be meaningless. Thus, the distinction made above is not acceptable and accordingly, it is suggested that market purchasers should also be protected.

Even though there is no "market" (Stock Exchange or the AIM), securities being purchased from original subscribers and securities being purchased from someone else have no substantial difference. To accentuate the providers of securities seems unjustifiable. The real problem is whether the transaction in question has any connection with the listing particulars or prospectuses, rather than its connection with the sellers of securities.[44] The protection of the former group of purchasers logically will bring about the protection of the latter group, that is, market purchasers.

The only problem accompanying this argument is whether such a definition of protection will be so broad as to make it unreasonable and unjust to those responsible

---

[43] s. 67.

[44] Happily, such a proposal is supported by *Possfund* (supra note 41). In that case, Lightman J. has endeavoured to extend the scope of duty of care to include market purchasers mainly from the perspective of defendants' intention. The difference between the argument in this thesis and that case is that this thesis interprets acquirers broadly while in that case they are limited to the placees and thus the court has to apply the common law rule. However, the idea of extending the scope of protected persons to market purchasers is shared.

persons. This question should be answered in connection with the discussion of the second part of this section which is dealt with below.

6.3.1.2 The Duty of Care in Relation to Continuous Disclosure

A company, especially a listed company, has continuous obligations of disclosure. In the UK, however, every company, except listed companies (and companies which have securities traded in a UK regulated market, e.g. AIM, according to the Traded Securities (Disclosure) Regulations 1994[45]), has only annual obligations regarding continuous disclosure. Listed companies, under the listing rules, have extra obligations of preparing half-yearly disclosure and timely reports when certain events happen.[46] The question is whether those who are responsible for preparing these continuous disclosure documents are liable to pay compensation if any investors acquire (or even sell) the securities in reliance on the misleading contents of these documents; put another way, whether these persons have a duty of care in this situation.

There is no such statutory liability to private investors imposed on these persons (the issuer, the directors, and the experts who consent to be named on the documents)[47] as the statute provides in the case of listing particulars and prospectuses. Therefore, in order to see whether such a duty of care exists it is necessary to resort to the common law.

Misrepresentation is in three categories, namely, fraudulent misrepresentation, negligent misrepresentation (i.e. honest but careless) and innocent misrepresentation (i.e. honest and careful). This section concentrates on negligent misrepresentation for two reasons: (1) the longest established category, among these, is the fraudulent one in which an intention is required and obligations deriving therefrom have been well

[45] S.I. 1994/188.
[46] See Yellow Book, Chapter 9.
[47] s. 61 of the FSA 1986, see supra note 15.

recognised;[48] (2) for innocent misrepresentation, there is no common law liability, but the equitable right to rescission of the contract and to indemnity continues. Damages is available in lieu of rescission since the Misrepresentation Act 1967 (s. 2(2)). However, all these are proceedings arising out of the contractual relationship. As this chapter focuses on the tortious measure of damages, this category is excluded.

In the 1960s, the common law developed a liability for negligent misrepresentation. In *Hedley Byrne & Co. v. Heller & Partners*,[49] the defendants (Heller & Partners), merchant bankers, at the request of the plaintiff's bank, gave references regarding the credit-worthiness of Easipower Ltd. (the plaintiff's customer). The plaintiff relied on such references and as a result it suffered loss when Easipower went into liquidation. The House of Lords held that "a negligent, though honest, misrepresentation, spoken or written, may give rise to an action for damages for financial loss, ... since *the law will imply a duty of care when a party seeking information from a party possessed of a special skill trusts him to exercise due care, and that party knew or ought to have known that reliance was being placed on his skill and judgment.*"[50] (emphases added)

This case was a good starting point, but it did not clearly define the conditions for such a duty to occur. It emphasized that a duty of care may arise not only from fiduciary relationship but also voluntary assumption of liability.[51] The defendants' act has constituted the latter relationship, and they knew or at least ought to have known that the reliance was being placed on them. All these made them liable; the only reason that finally relieved them from liability was an express disclaimer of liability.

---

[48] *Derry v. Peek* (1887) 37 Ch.D. 541; *McConnell v. Wright* [1903] 1 Ch. 546; *Doyle v. Olby* [1969] 2 Q.B. 158.
[49] [1964] 1 A.C. 465.
[50] Id., p. 466.
[51] Id., by Lord Reid, pp. 486-7.

In effect, it is nearly impossible to have a set of rules about the situations where a duty of care arises in the case of given information containing a misrepresentation. Before *Hedley*, Denning L.J. in *Candler v. Crane Christmas & Co.*[52] had put forward several elements of such a duty. First, he limited the responsible persons to those who had special skill, such as accountants, surveyors, valuers and analysts. Second, these persons should exercise the duty of care not only to their employers and clients, but also to any third person to whom they themselves showed the statement, or to whom they knew their employer was going to show the statement as to induce him to invest or take some other action on them. And finally, there must be a specific transaction within the knowledge of these professionals.

These requirements were clarified in the later cases. Just as Judge Cardozo in *Ultramares Corp. v. Touche*[53] held, that it was undesirable to recognise liability in an indeterminate amount for an indeterminate time to an indeterminate class, the English courts also aim to develop these rules more reasonably and comprehensively. In *Anns and others v. Merton London Borough Council*,[54] proximity was advanced as a criterion to judge the existence of duty of care. Between the alleged wrongdoer and the person who has suffered damage there must be a sufficient relationship of proximity or neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter.[55]

Additionally, in *JEB Fasteners Ltd. v. Marks, Bloom & Co.*,[56] foreseeability was stressed:

---

[52] [1951] 1 All E.R. 426.

[53] 255 N.Y. 170, (1931). To limit liabilities in negligent misrepresentation is also supported by the scholars who apply the economic analysis to this kind of case. See William Bishop, "Negligent misrepresentation: an economic reformation", in *The Economic Approach to Law*, Paul Burrows and C.G. Veljanovski (eds.), 1981.

[54] [1977] 2 W.L.R. 1024. This case was overruled by *Murphy v. Brentwood District Council* ([1990] 2 All E.R. 269), but is not on the basis of whether proximity should be an element for duty of care. The concept of proximity is not new to the law of negligence, e.g. *Le Lievre v. Gould* [1893] 1 Q.B. 491, 497 (*per* Lord Esher MR), see B.S. Markesinis and S.F. Deakin, supra note 2, p. 80.

[55] Id., p. 1032.

[56] [1981] 3 All E.R. 289.

> "Whether the defendants owed a duty of care to the plaintiff in regard to their preparation of the accounts of the company depended on whether they knew or ought reasonably to have foreseen at the time the accounts were prepared that persons such as the plaintiffs might rely on the accounts for the purpose of deciding whether to take over the company and might suffer loss if the accounts were inaccurate."[57]

It shows that, from *JEB*, the foreseeability of possible reliance is insufficient; the foreseeability of a specific transaction is also required. The foreseeability of a specific transaction is in fact the problem of proximity.

The most important case *Caparo v. Dickman and others*[58] has finally discussed these elements in detail. At Court of Appeal, three issues were considered as the elements of a duty of care: foreseeability, proximity, and reasonableness and justice of imposing the duty.

Regarding foreseeability of reliance, it is agreed that defendants usually have this ability. The spread of information is easily foreseeable even though such dissemination may not be wished by the providers of information. Therefore, proximity is a tool used to limit the excessively broad liability brought about by the first requirement. And this in reality is the real point which affects judgments in many different cases.

Lord Atkin in *Donoghue v. Stevenson*[59] explained the term proximity as:

---

[57] Id., p. 289.

[58] [1989] 2 W.L.R. 316, at Court of Appeal; [1990] 1 All E.R. 568, at House of Lords. "The *Caparo* decision has proved controversial within the accounting profession and outside it. Generally auditors have welcomed it, bankers dislike it, and many commentators have called for a change in the law... It is understandable that people believe the court's interpretation is too narrow and that it disregards commercial practice." See Paul Rutteman, "Corporate Governance and the Auditor", in *Contemporary Issues in Corporate Governance*, D.D. Prentice and P.R.J. Holland, 1993, pp. 64-5. *Cf. Scott Group Ltd. v. McFarlane* [1978] 1 N.Z.L.R. 553; *Dixon v. Deacon Morgan McEwan Easson et al.* [1990] 70 D.L.R. 609.

[59] [1932] A.C. 562.

> "...such close and direct relations that the act complained of directly affects a person whom the person alleged to be bound to take care would know would be directly affected by his careless act."[60]

There is proximity between parties to contracts and between fiduciaries and their beneficiaries. A person who voluntarily assumes responsibilities also has proximity in relation to the person for whose benefit the responsibility is assumed. In other cases the absence of proximity serves to limit the duty of care in order to prevent the undesired situations described by Judge Cardozo.

Accordingly, should there be no contract, no fiduciary relationship, or no voluntary assumption of liability, to establish proximity is not easy. Bingham L.J. in *Caparo* ruled that the duty to use due care in a statement arose from the fact that the person who made it knows, or ought to know, that others, being his neighbours in this regard, would act on the faith of the statement being accurate.[61]

However, the House of Lords later in *Caparo* rejected the concept of "proximity" as unhelpful and replaced it with:

> "the defendant knew that his statement would be communicated to the plaintiff, either as an individual or as a member of an identified class, specifically in connection with a particular transaction or transactions of a particular kind."[62]

Looking into the substance of this requirement, it just reflects the general description of proximity in this kind of case, not a real objection to the traditional standard. Moreover, in *McNaughton Papers Group v. Hicks Anderson,*[63] the Court of Appeal held that the purpose for which the statement was made, the purpose for which the statement was communicated, the relationship between the maker or giver and the

---

[60] Id., p. 581.
[61] [1989] 2 W.L.R. 316, p. 327.
[62] [1990] 1 All E.R. 568, pp. 576, 589, 607.
[63] [1991] 1 All E.R. 134.

recipient, the size of any class to which the recipient belonged, the state of knowledge of the maker or giver, and any reliance by the recipient should all be considered when a duty of care was decided. All these show that it may be impossible to have a very general rule to decide whether there is a duty of care; to make a judgment on a case by case basis may be a more appropriate solution.

For example, in *Morgan Crucible Co. Plc. v. Hill Samuel Bank Ltd. and others*, in the Chancery Division,[64] Hoffmann J. (now Lord Hoffmann) ruled that the profits forecasts, financial statements and defence documents of the target company prepared by the directors and financial advisers were to advise the shareholders of the target company whether to accept the bid, and they were not meant for the guidance of the bidder. Hence, it was held that there was no sufficient proximity between the directors and financial advisers of the target company and the bidder to give rise to a duty of care. While at the Court of Appeal,[65] the court clearly indicated that there may be proximity. The attitude of the House of Lords so far is inclined to admit such a duty of care only in exceptional cases. Why the House of Lords holds this position is not clear. It may base its position on a traditionally restrictive attitude towards negligence cases; possibly it prefers to trust the Secretary of State and the Financial Reporting Review Panel to correct misleading statements rather than allow too many actions for compensation to be commenced.

All these cases reveal the phenomenon of judicial opinion affecting the judgment on the existence of proximity. The precedents seem to leave the courts in later cases flexible in order to make different decisions which meet a policy choice. For example, in securities transactions cases, when negligent misrepresentation comes into play, the court may be reluctant to find proximity between the parties. Consequently, the

---

[64] [1990] 3 All E.R. 330.

[65] [1991] 1 All E.R. 148. The proximity resulted from the fact that the defendants voluntarily provided the advice. See A.J.E. Jaffey, *The Duty of Care*, 1992, p. 136.

legislature faces a policy choice as regard whether to enact a statutory duty of care in this kind of case.[66]

6.3.1.3 The Inconsistency of the Rules

As discussed above, the responsible persons under the FSA 1986 are liable to any investor who acquires the securities in reliance on the contents of the listing particulars if there is any misrepresentation in such particulars. Since academics[67] alledge that the definition of acquiring securities is quite broad, thus the later purchasers from the first subscribers and their derivative purchasers are also under the protection of the Act, though, possibly not so for market purchasers. Nonetheless, it is submitted that no distinction between the subsequent purchasers mentioned above and market purchasers should be drawn. The reason proposed is quite simple: seeing the impossibility of identifying securities in the market, market purchasers who make such investment decisions in reliance on the listing particulars are no different from those who also rely on the listing particulars and purchase from the first subscribers. Accordingly, either both groups should be protected, or neither should be protected.

However, when continuous disclosure comes up for discussion, the courts show a reluctance to impose any broad liability and, an inconsistency between the statutory liability for listing particulars and the common law liability as regards the continuous disclosure is unearthed.

The publication of listing particulars is for the purpose of protecting investors in the primary market, while the publication of continuous financial statements and business reports is to protect investors in the secondary market. Securities do not end

---

[66] See A.J.E. Jaffey, id., chapter two.

[67] Louis G. Doyle, supra note 40, p. 71; Robert R. Pennington, *The Law of Investment Markets*, 1990, pp. 322-3; Stephen Griffin, "Damages for Misstatements in Company Prospectuses", in *Company Lawyer*, 12(11), 209-12, 1991, p. 211.

their life after their public offer; the transaction market (the secondary market) is no less important than the primary market. If investors in the primary market are well protected, why should investors in the secondary market be treated any worse? It is even more odd when investors may be shareholders as opposed to strangers. In other words, in the secondary market, those who claim compensation may already be shareholders or public investors, while in the primary market, subscribers will not become shareholders before they enter into transactions.

Why does the law give persons relying on listing particulars privileges? Why do the courts declare that it is unreasonable and unjust to impose unlimited liability towards unlimited number of persons about continuous disclosure while the interpretation of the statute about listing particulars marches in an entirely opposite direction? It is submitted that the historical factors and the varying attitudes of legislature and judges towards different markets contribute to such a discrimination.

First, historically, scandals of fraud on listing particulars or prospectuses have attracted the most attention. This has caused legislature and judges to make great efforts to reduce them. The contents of listing particulars or prospectuses are becoming more and more complete, the civil liabilities increasingly strict. By way of contrast, the regulation on continuous disclosure seems to be lagging behind.

Second, regulation of disclosure on the secondary market has long been ill established. For example, in the UK, if a publicly issuing company is not a listed company, regardless of its size, there is no disclosure obligation imposed on it beyond annual statements. If no mandatory disclosure is introduced, no civil liability for its contravention will be established. In such a situation, continuous disclosure, as a whole, could be said to be ignored even though for listed companies more obligations

of disclosure are imposed. Therefore, the legislature would not consider making the violation of continuous disclosure obligation a civil liability, and the courts will try to limit these makers' liability as they always do in other negligence cases.

Is the ignoring of liability in continuous disclosure a defect? Not necessarily. From the policy point of view, to limit liabilities, sometimes, may be more just. However, the issue of consistency should be taken into account, especially as the secondary market is no less important than the primary market; the interpretation of statutory liability for compensation in respect of listing particulars should be reconsidered together with the common law liability to continuous disclosure.

6.3.2 Taiwan

First, since civil liability is imposed with respect to both prospectuses and continuous disclosure documents, here it is unnecessary to separate the discussion into two parts as was done for English law. Second, all these liabilities are codified, so the existence of a duty of care is beyond doubt. The only questions left are the scope of responsible persons and the scope of protected investors.

a. who is responsible

The persons responsible for any misrepresentation in prospectuses are clearly set out by Article 32 of the SEL. Generally, as in English law, persons who sign prospectuses are liable. Therefore, issuers and their responsible persons[68] are liable; any employees of the issuer, accountants, lawyers, engineers, and also any other persons who sign prospectuses. What marks the difference from English law is that in Taiwan such a liability is imposed on underwriters as well. The purpose of bringing underwriters into

[68] Responsible persons, according to Article 8 of the Company Law, are directors, promoters, and supervisors.

line with all persons mentioned above is to enhance the protection of investors by means of making the financial intermediary discharge their duty of supervision. Underwriters have been widely employed to assist companies to publicly distribute their securities. Although they are not responsible for drafting prospectuses, most prospectuses are sent out by them. That is why the law makes them responsible for misrepresentation in prospectuses.

Regarding continuous disclosure documents, however, the Act provides only that financial statements or any other business reports filed or published by an issuer should not contain any misrepresentation. It does not specify the responsible persons. Some academics[69] interpret this Article as meaning that only issuers are responsible persons. Disagreement, however, exists. Theoretically, prospectuses and continuous disclosure documents share the same function — providing investors with information about the corporate financial and business position. By inference, if persons signing prospectuses are liable, they should be held liable when they sign continuous disclosure documents. Issuers (usually, companies) themselves cannot draft any documents because they are not natural persons. All their business is run by directors and employees. Therefore, it is submitted that any persons who make such misrepresentation should be liable.[70] Since continuous disclosure documents do not go through underwriters, underwriters are outside the scope of regulation in this case.

As noticed earlier, whether the liability for compensation in continuous disclosure documents is a negligence liability or more than that is uncertain. Here is revealed another possible line of thought on the question. It may be helpful to characterise this liability as a negligence or gross negligence one and limit the liability on the basis of the frequency of published documents. Prospectuses are published only when public issues of securities are concerned, while the continuous disclosure documents are published

---

[69] Yin-chao Lai , supra note 19, Vol. 4, 1991, p. 109.
[70] *Cf.* American Securities Exchange Act 1934, § 18(a).

monthly, quarterly, half-yearly, and annually. If such a heavy liability is imposed on every occasion, costs may be too high and the liability may be too great. Accordingly, a new standard could be propounded. It is proposed that the criteria be based on whether the said document is audited. An audited document is always prepared more carefully, thus persons who draft it know the importance of the documents. Making them liable if they are at fault is not too burdensome. On the other hand, if a document is not audited, it is usually a monthly, quarterly, or immediate report. Persons who make it cannot be expected to exercise such a high standard of care because the work is urgent or more routine. Unless guilty of wilful conduct or gross negligence is found, they should not be condemned.

b. to whom they are liable

If the UK POS Regulations and the FSA 1986 are compared with the Taiwanese SEL, it is easy to see that in Taiwanese law the term "bona fide" accompanies the word denoting the counterparty all the time. At the stage where prospectuses should be delivered to investors, only a bona fide counterparty can bring an action for damages; when misrepresentation in prospectuses is in question, only bona fide counterparties have a right of action for damages; in continuous disclosure, bona fide buyers and sellers are investors being protected; and in the case of insider dealing, bona fide counterparties exclusively have a right for compensation.

The substantive meaning of such wording relates to the burden of proof laid on plaintiffs as part of the normal civil procedure rules. Generally, in provisions regarding civil liabilities the bona fides of plaintiffs is presumed.[71] Defendants cannot dispose of liabilities unless they can prove that plaintiffs knew the true information. This is to protect plaintiffs by means of shifting the burden of proof. Even though it is only a

[71] *Cf.* §§ 11, 12(2) of the Securities Act 1933 (the USA).

procedural change and has nothing to do with the substance of liabilities, it does have a certain effect on the latter.

By using the term expressly, however, the statute means that good faith is not presumed; plaintiffs have to prove that they did not know the true position (where the delivery of prospectuses and insider dealing are concerned) or that they were unaware that there was any misrepresentation in prospectuses or continuous disclosure documents when they entered into the transactions. This, doubtlessly, weakens the function of the civil liability provision and should be amended.

The next problem which arises from the provisions is the scope of "counterparties". This problem does not arise where the continuous disclosure obligation and insider dealing are taken into account. Because in these situations, any buyers or sellers during the period when information is misrepresented or omitted fall into the scope of protection, and are all named as counterparties. However, if prospectuses are considered, the scope needs to be clarified.

Does the word counterparty mean subscribers or broader acquirers? Academics interpret the term "counterparties" as being subscribers who subscribe directly from issuers or underwriters.[72] According to Article 31, the persons who are entitled to obtain prospectuses are subscribers. When the liability directly comes from the contravention of this requirement, to interpret the scope of protected investors as being only these persons is not unsound. However, to restrict the civil liability to the above mentioned persons when misrepresentation is committed in prospectuses shows the policy is still quite conservative in this field, and academics do not wish to extend it. Unfortunately, the courts have not yet come across this problem and have had no opportunity to interpret the law.

---

[72] Yin-chao Lai, supra note 19, Vol. 2, p. 252.

6.3.3 Conclusion

The comparison between English and Taiwanese law shows that Taiwanese law generally provides more comprehensive protection for investors as regards misrepresentation in securities transactions and insider dealing. Taiwanese law imposes civil liability on responsible persons regarding continuous disclosure and insider dealing, while the UK in this respect lags behind.

However, Taiwanese law does not shift the burden of proof concerning the mental condition of plaintiffs (bona fide or not); moreover, Taiwanese law, unlike the UK, which extends protection to acquirers, also limits the scope of investors to those subscribers who subscribe directly from issuers and underwriters. If the consistent policy of Taiwanese law is to extend the scope of protection, it should extend the scope of protected investors to cover any purchasers who rely on the prospectus in question. If it is true that the UK government wishes to enhance the protection of investors as it has often proclaimed, it may have to amend its current law with respect to continuous disclosure as well as insider dealing.

6.4 Causation

So far as misrepresentation is concerned, a plaintiff's subjective state of mind, reliance, is required to establish the liability for damages. Nonetheless, it seems that English law opts for presuming its existence whenever there is a misrepresentation and reverses the burden of proof to a defendant. In contrast, Taiwanese law does not take such a position; a plaintiff needs to prove his reliance. On the other hand, reliance could also be shown by having recourse to "the fraud on the market theory" and accordingly, the defendant would not be able to get rid of his liability by showing that the plaintiff did not read the misrepresented documents. Such a new theory could possibly find its applicability in the UK, but possibly not in Taiwan. Besides the element of reliance, a

further examination of the causal links between the wrong and reliance and reliance and investment is called for. The fact that a specific plaintiff relies on the misrepresentation could not by itself predict that the same result would occur to other people. A causal connection that a reasonable person would normally rely on the same statement should also be demonstrated in the meantime. It is submitted that English law follows the foreseeability theory in the case of negligence while taking the directness theory in fraudulent situations. Taiwanese law applies the adequacy theory in all events.

6.4.1 Introduction

Causation serves two functions in civil liability for damages: being an element of establishing liability and helping to decide the extent of liability (the measure of damages). At this stage, where establishing civil liability is the subject, the first function of causation will be examined. The second is left to the section which deals with measure of damages.

In misrepresentation, causation as an element required on the part of the plaintiff is referred mainly to the problem of "reliance". Because of the misrepresentation, the plaintiff put his faith in it; because of such reliance, the plaintiff made the investment decision. Causation as an element required generally in establishing liability for compensation is related to the causal theories. These two problems are separately dealt with in sections 6.4.2 and 6.4.4.

6.4.2 The Fraud on the Market Theory

The requirement of reliance in fraudulent securities transactions cases is as tricky as it normally is in other fraudulent cases. Normally, no plaintiff in front of the courts would admit that he did not read or rely on the information documents. But the question

could also be presented in the way that as most investors do not read these disclosure documents, reliance has become an insurmountable burden for the plaintiff to prove. Either way, reliance relates to a plaintiff's subjective state of mind which by no means is easy to prove or overturn.

In the United States as the class action is permitted in securities cases, one further difficulty arises. Class action is allowed in the USA because it helps to simplify the complicated situation of actions which involve too many plaintiffs. But if every plaintiff is required to prove his state of mind, individual issues would then have overwhelmed common ones which are the prerequisite of the class action. Accordingly, some courts have developed the "fraud on the market" theory to resolve this problem,[73] and the Supreme Court in *Basic Inc. v. Levinson*[74] for the first time adopted this theory.

The tenor of "the fraud on the market theory" is that even if investors have not read the documents in question, this will not bar them from compensation. When they purchase or sell securities, they rely on the securities prices which fully reflect all available information in the market, including the wrong one. Hence, investors rely on the information in the form of relying on securities prices. Reliance is thus established

[73] The strongest support for a generalised fraud-on-the-market theory comes from the Ninth Circuit. See case *Blackie v. Barrack* 524 F. 2d 891 (9th cir. 1975). About this theory, see Daniel R. Fischel, "Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities", in 38 *The Business Lawyer*, 1-20, 1982; Note, "Fraud-on-the-Market Theory", 95 *Harvard L. R.*, 1143-61, 1982; Bradford Cornell and R. Gregory Morgan, "Using Finance Theory to Measure Damages in Fraud on the Market Cases", 37 *U.C.L.A. L. R.*, 883-924, 1990. As regards the opinion against this theory, see Paul G. Mahoney, supra note 24. It is said that the fraud on the market theory has no application in the primary public distribution of securities since in the USA the burden of proof regarding reliance has been shifted to the defendant. However, this does not seem to be right. Because even if the burden has been shifted, the problem whether the defendant can get rid of his liability by proving that the plaintiff did not read any documents still remains unresolved. Also, in the case where the burden of proof has not been shifted to the defendant, whether the plaintiff can prove his reliance simply by referring to the fact that he is a price-taker merits discussion.

[74] 485 U.S. 224 (1988). The facts of the case in brief are as follows. Some one-time shareholders in Basic, a publicly held firm whose shares were traded on the New York Stock Exchange, brought a suit against the officers and directors for fraudulently denying the on-going merger negotiation of 1977 and 1978. Because in 1978 Basic announced that its board of directors had approved a tender offer by Combustion Engineering for all of Basic's outstanding shares. These shareholders had sold their shares between the denial and the announcement date and thus suffered the loss.

by showing the fact that transactions were made and the information was material. In other words, the Supreme Court substituted the reliance on market integrity for the actual reliance on disclosed information and the plaintiff had to demonstrate that the market was efficient.

The argument developed by the Supreme Court has been criticised by the academics that it misplaced the emphasis on an efficient market although the academics agree with the theory itself.[75] They correctly point out:

> "This focus on efficiency unnecessarily complicates the inquiry. The Court erred by confusing reliance on the efficiency of the market in pricing certain securities with reliance on the fact that important news will be incorporated quickly into the prices of affected securities."[76]

> "Thus, plaintiffs must prove to courts applying the fraud-on-the-market theory ... that the particular misrepresentation or omission pertained to the kind of information that the market find worthwhile to decode."[77]

Therefore, even if a market is efficient in general terms, a specific security is not necessarily efficient unless many and constant transactions are made in the market. It is also true that even if a security is hotly traded, a specific piece of information may not be reflected in the price efficiently. For example, according to the method of event study, the information concerning a stock split is always quickly reflected in the price of the securities in question while the quarterly earnings announcement is not so reflected.[78] Accordingly, the "efficiency" which should be taken into account is not the efficiency of the whole market; it is rather, the efficiency of a specific piece of information regarding a specific kind of securities.

---

[75] See Jonathan R. Macey and Geoffrey P. Miller, "Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory", in 42 *Stanford L.R.*, 1059-92, 1990; Jonathan R. Macey, Geoffrey P. Miller, Mark L. Mitchell, and Jeffry M. Netter, "Lessons from Financial Economics: Materiality, Reliance, and extending the Reach of *Basic v. Levinson*", in 77 *Virginia L. R.*, 1017-49, 1991.
[76] See Macey, Miller, Mitchell, and Netter, id., p. 1021.
[77] See Macey and Miller, supra note 75, p. 1084.
[78] Id., pp. 1083-5.

Would this theory have its application in the UK or Taiwan, especially when the application of reliance meets some difficulties? In principle, two issues are taken into account here. First, the problem of the burden of proof; second, whether defendants can be freed from liabilities by means of showing that plaintiffs did not read any misstated documents.

(1) the United Kingdom

First of all, it is obscure whether the burden of proof regarding reliance has been shifted from plaintiffs to defendants. Section 150(1) of the FSA 1986 states that persons responsible for listing particulars are liable to pay compensation to any acquirers who suffer loss "as a result of" any untrue or misleading statement in the particulars or the omission from them. The section does not manifestly allocate the burden of proof concerning reliance on either side. However, the term "as a result of" does imply that misrepresentation in listing particulars is the cause, while the loss is the consequence. In between them, reliance is the connection. The question is who bears the obligation to prove it.

Section 151(5) of the FSA 1986 (also reg. 15(5) of the POS Regulations) states that the defendant can dispose of his liability if he can prove that at the time of transaction the plaintiff knew the truth. Supposing that the burden of proof is on the plaintiff, then in which case the general rule that the defendant can prove otherwise is self-evident; s.151(5) looks redundant. On the contrary, if the defendant, rather than the plaintiff, bears the burden, the plaintiff is presumed to put his faith in the documents and the defendant cannot be exonerated unless the contrary is shown; s. 151(5) in this situation makes sense. Hence, once there was a material misrepresentation in listing particulars and the plaintiff suffered loss, the reliance of the

plaintiff was presumed.[79] However, this does not imply that the plaintiff has no obligation to prove the causation. It is submitted that "the requisite causation will be established if the price at which he (the plaintiff) acquired the securities was materially affected by the defect of the failure to correct it".[80] Such reasoning seems to support the fraud on the market theory discussed above.

Second, it is questionable whether the defendant can free himself by proving that the plaintiff never read the document. As a general rule, that the plaintiff does not know the truth arises from two situations: he reads the documents and believes them, or he never reads the documents and is unaware of anything. In the latter case, there is in effect no reliance and in the normal legal sense, no causation exists. Even though the plaintiff "need not establish that he relied on the particular defect in the sense that he observed it and took it into account or that he even read the particulars containing the defect",[81] it is uncertain if the causal connection could be broken by evidencing the actual non-reliance.

According to the Efficient Capital Market Hypothesis and the fraud on the market theory analysed above, prices fully reflect all available information, misleading or not. It follows, persons who purchase or sell securities from the market might claim that they rely on securities prices even though they do not read any documents (the fraud on the market theory).

Such an argument can be supported when that particular misleading disclosure or omission has been efficiently reflected in the securities prices. Thus, it may not be

---

[79] It is argued that the statute has in fact changed the common law rule evolved by *Smith v. Land and House Property Corporation* (1884) 28 Ch.D. 7, p. 16. "... I cannot quite agree with the remark of the late Master of Rolls in *Redgrave v. Hurd*, that if a material representation calculated to induce a person to enter into a contract is made to him it is an inference of law that he was induced by the representations to enter into it..." *per* Bowen L.J.

[80] See E.Z. Lomnicka and J.L. Powell, *Encyclopedia of Financial Services Law*, 1987, Vol. 1, p. 2-537.

[81] Id.

necessary to require plaintiffs to read the disclosure documents; their purchase and sale will prove their reliance on prices, and indirectly on the documents provided that they can prove that concerning that information, the market is efficient. In consequence, it is for the defendant to prove that the plaintiff knew the information to be misleading, i.e. no reliance on securities prices, or the market itself is not in fact efficient.

Nonetheless, difficulties may arise when the primary market is concerned. In some situations, there may be no market prices upon which investors can rely. For instance, there are no market prices formed yet at the time of first public distribution of securities. It is also possible that the subscribing or purchasing price is not the same as the price of the same securities in the market. The latter situation happens often as companies usually discount securities prices at initial public offer.[82] Thus, it is hard to say that plaintiffs rely on any market "prices". It is the selling price in which they put faith; unfortunately, such a price could be arbitrary and has no direct connection with information. In addition, s. 151(5) of the FSA 1986 does not mention that defendants can dispose of liabilities by proving the plaintiffs did not read disclosure documents. Therefore, if the point of view that plaintiffs need not put reliance on information by reading documents is taken in a situation where the application of the fraud on the market theory has difficulties, the reason supporting this view may be that the legislature intends to maintain the integrity of the market.[83]

In insider dealing or misleading information in continuous disclosure documents, plaintiffs should be entitled to claim that they rely on securities prices. No civil liability so far on insider dealing has been introduced, and only in very limited situations will the liability as regards continuous disclosure documents be admitted. Consequently, the fraud on the market theory deriving from the ECMH has limited effect on English law.

---

[82] See T.J. Jenkinson, *Initial Public Offerings in the UK, USA, and Japan*, 1990; Saul Levmore "Efficient Markets and Puzzling Intermediaries", 70 *Virginia L. R.*, 645-67, 1984.

[83] See Louis Loss, *Fundamentals of Securities Regulation*, 1988, p. 961. This can be shown by comparing s. 150(5) of the FSA 1986 with § 11 of the USA Securities Act 1933.

(2) Taiwan

The Taiwanese SEL does not shift to the defendant the burden of proof concerning reliance. Plaintiffs have to show that they rely on misleading information at the time of transactions. The problem is whether investors in Taiwan can apply the fraud on the market theory in actions for damages arising from prospectuses, misleading continuous disclosure documents and insider dealing, and thus discharge the onus of proof by merely proving that the securities price has reflected the misleading information efficiently.

As a general proposition, manipulation is widely spread in the market; any trivial rumors can affect the market seriously.[84] This could be interpreted as that the market is not efficient because the securities prices are not driven to the level where they would reflect the securities value. This, however, also demonstrates that the Taiwanese markets are highly sensitive in some situations. Thus, it fully depends on whether the plaintiff can prove that the particular misleading information or omission was incorporated into securities prices at the time the plaintiff traded in the market. If the plaintiff can, there is no reason why the plaintiff could not rely on "the fraud on the market theory". Neither is it reasonable to allow the defendant to prove that the plaintiff in fact did not read the documents. The defendant has to demonstrate either

[84] On October 6, 1994, the stock index slumped by 291.27 points, dropping further by 674.17 points in the succeeding three days to 5982.15. This was caused mainly for two reasons: the rumor that the Chinese leader, Xiaoping Deng, was dead, and a securities broker (Hong Fu) controlled by the Hualon Group failing to honour a $200m cheque. The latter incident "highlights the fragility of the financial system's regulatory framework and its ability to cope with the underground financial markets". See *Financial Times*, October 10, 1994. The Taiwanese financial market is easily manipulated; therefore, a minor default of payment by one broker could greatly affect the stock market. Since the broker Hong Fu is controlled by the Hualon Group, and the controller of Hualon in turn is a very famous player on the Stock Exchange, his default would easily cause investors to over react and lead the stock index to slump. This is only one example among numerous events; hence, the writer cannot agree that Taiwanese Stock Exchange has been an efficient market. However, the fraud on the market theory is not necessarily inapplicable.

that the plaintiff knew the truth or that the specific piece of information was not efficiently reflected in the securities price at the time the plaintiff traded in the market.

6.4.3 Theories on Causation

The theories of causation require discussion at this point for two reasons: (1) to complete the examination of causation in establishing liability; (2) more important, at the stage of deciding the extent of liability (measure of damages), such theories provide the tests for remoteness of damages. Damage regarded as too remote will not be compensated. Therefore, the theories of causation and remoteness of damages diffuse into the problem of measuring damages, and play a very important role.

To analyse these theories will help to identify the conflicts between the method currently well appreciated by the courts regarding the measure of damages in securities transactions cases and the theories adopted by the courts as regards the remoteness of damages in other cases. Therefore, it is justifiable to analyse these theories here because they have been developed under the title of causation and remoteness of damages.

The five main theories (notions may be a preferable term in common law countries[85]) of causation have been advanced; they are "condition", "adequacy", "foreseeability", "directness", and "statutory purpose" theory (or notion).

[85] One prominent distinction between civil law and common law is that the former usually tries to construct a scientific theory for causation, while the latter entrusts causation to common sense and the normal "notions" of judges. See H.L.A. Hart and Tony Honoré, *Causation in the Law*, 2nd ed., 1985, pp. 1, 432.

6.4.3.1 The Theory of Conditions and the Adequacy Theory — the Civil Law System Approach

(1) the theory of conditions

The theory of conditions was first expounded by the Austrian writer Glaser in 1858; von Buri in Germany adopted a similar view later on.[86] Any factors which contribute to the incidence of damage are all treated as the "conditions" of damage in question. Nonetheless, not every condition is necessarily a cause. Only those conditions which cannot be eliminated in thought without eliminating the consequence also, are equivalent and therefore regarded as causes of the consequence (*conditio sine qua non*).[87]

According to the theory of conditions, any person who is responsible for any condition (cause) should be held liable for the final damage entailed, no matter how remote it may be. The threshold of this theory is too low and the extent of liability is too broad. It causes people to feel unsafe because they may have to compensate some victims not yet imagined. Thus, this theory has been abandoned as the only test of causation, at least in Germany and Taiwan regarding civil cases.

It has become customary for English law to analyze the question of causation in two stages.[88] The first, factual causation, is essentially concerned with whether the defendant's fault was a necessary "condition" of the loss occurring.[89] The test used is the 'but-for" cause: would the loss have been suffered but for the relevant act or omission of the defendant? If the answer is negative, then factual causation is established. So far as this stage is concerned, the condition theory is decisive.

---

[86] H.L.A. Hart and Tony Honoré, id., pp. 442-3.
[87] By Tarnowski, in id., p. 444.
[88] Markesinis and Deakin, supra note 2, p. 163.
[89] Id.

However, the second stage, legal cause, shows that English law is not satisfied with the condition theory; any factual causation which cannot pass the test of legal cause is left as "mere condition" and liability will not be attached. As regards legal cause, it will be discussed below.

(2) the adequacy theory

In 1886 German scholar J. von Kries propounded that any given contingency would not be regarded as the adequate cause of damage unless it was a *sine qua non* of the damage and it increased the objective probability of the damage (one of the probability theories).[90] Put another way, the defendant is held liable if his act or omission is the adequate cause of the damage. This theory immediately became the leading authority in civil cases in Germany thereafter until it was amended in the middle of 20th century.[91]

Like other theories of causation, this theory is too obscure and abstract. First, the meaning of increasing the objective probability of the damage is unclear. It has been suggested that whether the probability of the damage has been increased depends on whether a most prudent man who has a very sound knowledge of law and generalisations, both before and after the wrong act, would predict the increase in probability.[92] This is abstract. Second, in certain situations, for justice, there must be some exceptions when the theory is applied. For example, A negligently left the hole he dug on the road uncovered. B intentionally pushed C down the hole. According to a most prudent man's knowledge, A has increased the probability of C's injury. But it would be too severe if A is held liable for C's harm. Third, the judgment of increasing the probability may turn on the judge's subjective impression. Sometimes, sympathizing

---

[90] Hart and Honoré, supra note 85, p. 469. See also Shih-hsiong Tseng, *The Principles on Damages (Sun Hai P'ei Ch'ang Fa Yüan Li)*, 1986 (reprinted), p. 63.
[91] See Tseng, id.
[92] A.M. Honoré, "Causation and Remoteness of Damage", in *International Encyclopedia of Comparative Law, Torts*, André Tunc (ed.), 1981, pp. 48-52.

with the plaintiff will give judges the impression that the wrongdoing adequately caused the damage.

6.4.3.2 Foreseeability and the Direct Consequences Theory — English Law Approach

(1) the foreseeability theory

The traditional standard for determining legal causation in English law is whether the defendant can reasonably foresee the ensuing damage in question, i.e. the foreseeability theory (it is also one of the probability theories). Interestingly, the foreseeability theory sprang from French law; the French Civil Code, Article 1150 provides:

> "A debtor is held only to damages which are foreseen or which could have been foreseen at the time of the contract, when it is not by his willfulness that the obligation is not executed."[93]

Nonetheless, Article 1151 adds:

> "Even in the case where the inexecution of the agreement results from the willfulness of the debtor, damages are to include with regard to the loss incurred by the creditor and the gain of which he has deprived, only what is an immediate and direct consequence of the inexecution of the agreement."

This shows that French law imposes stricter liability on those with greater fault and adopts the direct consequences theory in the situation of wilful breach of contract (and torts as well by extension).[94]

In English law, this theory was first formulated in a case involving breach of contract. *Hadley v. Baxendale*[95] firmly stated that liability for damages in breach of

---

[93] The English translation, see *The French Civil Code*, translated by John H. Crabb, 1995.
[94] A.M. Honoré, supra note 92, p. 43.

contract would be established only when the damage was within the reasonable contemplation of the defendant at the time of the contract being made. The court stated such an objective standard regarding causation:

> "Where two parties have made a contract, which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may *fairly and reasonably* be considered either arising naturally, i.e. *according to the usual course of things*, from such breach of contract itself, or such as may *reasonably be supposed to have been in the contemplation of both parties* at the time they made the contract, as the probable result of the breach of it." (emphasis added)

Since the loss of profits in this case could not be reasonably foreseen by the defendants, the defendants were not liable to this special damage. Unlike the French Civil Code, the English courts did not distinguish willful from negligent breach of contract. Causation in both situations was judged by foreseeability.

What degree of likelihood of the loss occurring was required to have been reasonably contemplated by the defendant at the time of the contract was clarified in *Heron II*[96] to some extent. It was ruled that a higher degree of likelihood than required in tort should be required. And in *Parsons v. Uttley Ingham*,[97] Orr L.J. and Scarman L.J. made it clear that a serious possibility was required in breach of contract.

The reason for emphasizing the likelihood degree of foresight is because for a long time, the foreseeability theory was believed to apply in both cases of torts and breach of contract. In between *Re Polemis*[98] and *Overseas Tankship (UK) Ltd. v. Morts Dock & Engineering Co. Ltd.*, the *Wagon Mound (No. 1)*,[99] the direct consequences theory was propounded and some change was made, which will be

---

[95] (1854) 9 Exch. 341.
[96] [1969] 1 A.C. 350.
[97] [1978] 1 All E.R. 525.
[98] [1921] 3 K.B. 560.
[99] [1961] A.C. 388.

discussed below. Here it is sufficient to state that the rule in *Re Polemis* for torts of negligence was overruled by the *Wagon Mound (No. 1)*. It was held by the court that the liability of the defendant in negligence turns on whether the damage in question can be reasonably foreseen by him at the time of wrongdoing. Moreover, only a slight possibility of foreseeability is required. This case left the courts great discretion as to the judgment on the possibility of foreseeability. Therefore in the *Wagon Mound (No. 2)*,[100] the Privy Council exercised such discretion (based on further evidence) and ruled that the defendant should be able to foresee the possibility of fire.

Both the *Wagon Mound (No. 1)* and *(No. 2)* were concerned with the same event. While an oil-burning vessel, of which the defendants were the charterers, was taking in bunkering oil in Sydney Harbour a large quantity of the oil was, through the carelessness of the defendants' servants, allowed to spill into the harbour. The escaped furnace oil fouled the wharf of the plaintiffs of the first case. The defendants told such plaintiffs that the oil could not be ignited. The plaintiffs thus continued their welding work on two ships owned by the plaintiffs of the second case. But the oil was ignited by a piece of molten metal and the wharf and the two ships were consumed in the resulting fire.

In the *Wagon Mound, (No. 1)*, the Privy Council held that the defendants could only reasonably foresee the result of fouling the wharf, not the fire; therefore, they were not liable; while in the *Wagon Mound, (No. 2)*, the Privy Council instead ruled that the defendants could reasonably foresee the fire which destroyed the two ships and then judged in favor of the plaintiffs, the owners of the two ships.

Here a question is raised: why could the so-called "objective test" (the requisite foresight being that of a reasonable man) be judged in such a different way in the two cases which bore the same story? The reason for this is that in the *Wagon Mound (No.*

[100] [1967] 1 A.C. 617.

2), the foreseeability of the fire was thought by the Privy Council to be sufficiently established, while in the *Wagon Mound (No. 1)* it was not. But still, since Walsh J. in the *Wagon Mound (No. 2)* (who based his judgment on the same evidence as that of the Privy Council) held that there was no foreseeability of fire, while the Privy Council treated the evidence as sufficient to prove the foreseeability. It was revealed that the objective test was influenced by judges' subjective notions.[101] This unearths part of the puzzle which is brought about by the concept of "causation"; its obscurity and uncertainty. The term "foreseeability" is not exactly objective. On the contrary, it is vague.[102] The vagueness of this criterion partly springs from the fact that it is not only a causal test but also a theory where legal policy and justice come into play.[103] Therefore, based on policy choice, the courts may in some cases hold that there is foreseeability but not in other situations.[104]

The vagueness may also result from the fact that the courts sometimes mingle the practical foreseeability with the theoretical foreseeability when they simply refer to the term "foreseeability". In some situations, the defendant has no foreseeability about certain damage until the wrong has happened. In this situation, there is no foreseeability in a practical sense; but the foreseeability may exist in a theoretical sense.[105] For example, in *Re Guardian Casualty Co.*,[106] a taxi-cab was forced across the pavement and against the stone stoop of a home due to the defendant's negligence. While the cab was being removed, without any negligence on the part of those helping, a stone which had been loosened by the impact of the cab fell and struck the deceased who was standing 20 feet away. The defendant was held liable because he must have

---

[101] See R.W.M. Dias, "Trouble on Oiled Waters: Problems of the Wagon Mound (No. 2)", in *C.L.J.* 62-82, 1967, p. 63.
[102] See K.M. Stanton, *The Modern Law of Tort* , 1994, p. 96; Nicholas J. Mullany, "Common Sense Causation - an Australian View", in 12 *O.J.L.S.*, 431-9, 1992.
[103] Lord Denning M.R. in *Lamb v. Camden London Borough Council* [1981] 1 Q.B. 625, p. 637 et esq.; *March v. Stramare*, [1991] 171 C.L.R. 506, pp. 531, 533.
[104] *Lamb*, id.
[105] See Hart and Honoré, supra note 85, p. 266.
[106] (1938) 253 App. Div. 360, 2 N.Y.S. 2d. 232.

foreseen the removal of the vehicle and he in turn might reasonably have anticipated the drop of the stone.

In fact, the defendant could not foresee all these until the accident really happened. Thus, his foreseeability was constructed in a theoretical sense rather than in a practical sense. Accordingly, if the courts follow the theoretical foreseeability, the liability will be extended;[107] on the contrary, if the practical foreseeability is adhered to, the extent of liability would be limited.[108] This causes the term "foreseeability" to be unclear and subjective because of the different usage of the courts. The English court in *Cambridge Water Co. v. Eastern Counties Leather plc.*[109] seems to suggest that the Wagon Mound rule should also be applied to strict liability torts.

As such it is submitted that the foreseeability theory is now used in both breach of contract and non-intentional torts (negligence torts and strict liability), but with a different standard of foreseeability. In breach of contract, a higher standard is required, while in the latter situation, the law is more generous to the plaintiff.

(2) the direct consequences theory

The direct consequences theory seems to be applied in tort cases, especially in deceit and probably other intentional tort probably.[110] It was established by the leading case *Re Polemis,*[111] where the defendant was held to be liable for all damage directly coming from his wrongdoing.

Literally, this theory is very favorable to a tortfeasor because it suggests that the tortfeasor be only liable for his own conduct. However, the English courts extended it

[107] *Chapman v. Hearse* [1961] 106 C.L.R. 112.
[108] *Woods v. Duncan* [1946] A.C. 401, 431, *per* Lord MacMillan.
[109] [1994] 1 All E.R. 53.
[110] Andrew Burrows, *Remedies for Tort and Breach of Contract*, 2nd ed., 1994, p. 45.
[111] [1921] 3 K.B. 560.

to a great extent in *Re Polemis*. Thus, this standard of liability becomes quite strict for the defendant, seeing that he has to make all damage good even if it is not within his expectation. The justification of the theory lies in the distribution of risks and loss. Neither party can predict the incidence of damage, so it may be just to order the party who has greater fault, or in another way, who initiated the trouble (especially, in deceit and other intentional tort, the tortfeasor must have been willful when he committed the tort) to bear the ensuing consequences of his own fault rather than to leave it with the innocent party, who suffered loss but had no chance to prevent it in advance.

In *Re Polemis*, the direct consequences theory was not limited to deceit and other intentional torts; it was supposed to be applied to negligence torts as well because *Re Polemis* itself was a negligence case. It was not until the *Wagon Mound (No. 1)*[112] that the courts overruled it. As indicated above, the *Wagon Mound (No. 1)* insisted that the foreseeability theory should be used instead of the direct consequences theory.

It is, however, unclear whether in the *Wagon Mound (No. 1)* it was thought that all torts should be treated in the same way. As the *Wagon Mound (No. 1)* is a negligence case, it was fair to say that at least it re-established the test of causation for negligence torts. In the later case, *Doyle v. Olby* (a case of deceit),[113] the *Re Polemis* rule was employed by the court as follows:

> "That the proper measure of damages for deceit, ... was all the damage directly flowing from the tortious act of fraudulent inducement which was not rendered too remote by the plaintiff's own conduct, whether or not the defendants could have foreseen such consequential loss."

Therefore, the direct consequences theory has not been wholly abolished; at least, in the case of deceit, it is still the effective rule.

---

[112] [1961] A.C. 388.
[113] [1969] 2 Q.B. 158.

6.4.3.3 The Statutory Purpose Theory (The Scope of Rule Theory)

In Germany, the statutory purpose theory has become increasingly popular used by the courts to supplement the adequacy theory.[114] It was first propounded by Ernst Rabel and further interpreted by von Caemmerer.[115] Its tenor is that causation should be determined from the meaning and purpose of the tort statute in question, especially the interest which the statute intends to protect.

The real purpose of this theory is to break free from the conceptual puzzles. The real function of causation is to "limit" liability, both as to its establishment and as to its scope. If all the theories about causation cannot provide a satisfactory solution, it may be more appropriate to embark on this problem "by deploying the meaning and range of the particular rule, not by applying the general causal formulae."[116]

According to the statutory purpose theory, compensation will not go to the extreme of all or nothing. For instance, if A negligently hurts B, A's liability is concerned with B's injury; should B have committed suicide therefrom, A's liability for this later damage is not established because from the point of view of the tort statute, there is no liability. The tort statute which imposes liability on A regarding his wrongdoing of injuring B is to protect any person from being unlawfully injured by another, not from getting hurt by himself. It is fair to claim that this theory is not a "causal" test but a policy choice.

---

[114] See Hart and Honoré, supra note 85, p. 476.

[115] See Tseng, supra note 90, p. 79. The other title of this theory is the "scope of the rule" theory, which can be found in English law, e.g. *Gorris v. Scott* (1874) L.R. 9 Ex. 125 and *Close v. Steel Company of Wales* [1962] A.C. 367. See F.H. Lawson and B.S. Markesinis, *Tortious liability for unintentional harm in the Common law and the Civil law*, Vol. 1, 1982, pp. 123-5.

[116] See E. Rabel, "Die Grundzüge des Rechts der unerlaubten Handlungen", Deutsche Ref. Int. Kong. Rechtsvergl, 1932. In Hart and Honoré, supra note 85, p. 476.

It is well accepted that in principle a cause must be a *conditio sine qua non*. From that point, however, different jurisdictions adopt different legal causal theories, such as the direct consequences theory, the adequacy theory, or the foreseeability theory. But all these legal causal theories are no longer purely "causal" tests. Legal policy and justice have been the real subject matter of judgments when the extent of liability has been decided under the guise of "causation" and "remoteness of damages", or "the breaking of the chain of causation". That is why some academics suggest adopting the scope of rule theory instead continuing the confusion of causation with legal policy or justice. Since most of the types of civil liability in securities misrepresentation cases have been introduced by statute, to decide the extent of liability the statutory purpose theory would be very helpful.

6.4.4 Causation on Non-Disclosure and Untrue Statements

(1) the United Kingdom

In *Doyle v. Olby*, the direct consequences theory in *Re Polemis* was followed. In other words, the establishment of liability regarding causation will depend on whether the harm in question has a direct relationship with the event.[117] Coming to the substance of "directness", it is an unclear word. In this context, "directness" is limited to the meaning of not being too remote. The defendant in a deceit case is exposed to a greater scope of liability because of his malice. Therefore, in a case of intentional misrepresentation, whenever a plaintiff's reliance is the direct consequence of a defendant's misrepresentation and the investment decision is the direct consequence of the reliance, there is sufficient causation.

On the other hand, in case of negligent misrepresentation and issuers' absolute liability (in listing particulars) the *Wagon Mound (No. 1)* will be followed, i.e. the

[117] See also *East v. Maurer* [1991] 1 W.L.R. 461; *Davis v. Churchward* (May 6, 1993) (unreported); P.A. Chandler, "Fraud: Damages and Opportunity Costs", in 110 *L.Q.R.*, 35-8, 1994.

general rule of causation for torts of negligence. That is, causation would be established if a defendant can reasonably foresee that a plaintiff will make an investment decision in reliance on the misrepresentation he made. Only a slight possibility of damage needs to be foreseen.

(2) Taiwan

The situation in Taiwan is simpler. Only one standard of causation is adopted, the adequacy theory. Therefore, willful and negligent conduct is all judged by the same test. If a defendant's conduct is the adequate cause of a plaintiff's reliance and the investment decision therefrom, i.e. the conduct increasing the objective probability of the occurrence of reliance and investment, there is causation.

6.5 Damage

Whether there is damage and to the extent to which there should be compensation for it are closely related to the definition of damage. If damage is defined as the difference between the position of the injured party as it is and what it should have been had the wrong not been committed, this inevitably will take many supervening events into account (denominated as the subjective standard). If damage is defined so as only to focus on the objective loss of assets (denominated as the objective standard), this will exclude many supervening events. As regards damages in securities transactions cases, the English courts have constantly followed the objective standard while Taiwanese law inclines to the subjective test. An inevitable contradiction (which will be addressed in section 6.6) between the objective test taken by the English courts in securities cases and the rules adopted by the same courts in respect of foreseeability and directness of other forms of tortious damage is revealed. On the other hand, the subjective test in Taiwanese law also possesses its drawbacks. All these problems may end up with

better solutions if the statutory purpose of securities damages is taken into consideration and this again is analysed in section 6.6.

6.5.1 The Kind of Damage discussed in this Chapter

The final element of civil liability is damage. Damage, as noticed above, is common to all three sources of civil liability, torts, breach of contract, and statutory liability. After fault and causation are established, if there is no damage, no civil liability will ensue though sometimes nominal damages will be available in English law. Hence, damage is indispensable in establishing civil liability. However, to define and identify it are by no means easy.

Damage is generally classified as pecuniary and non-pecuniary. Pecuniary damage ordinarily arises from property damage or financial loss, but it is not unusual to see it in personal injury cases. For example, medical expenses and loss of earning ability both stem from personal injury.

Non-pecuniary damage, on the other hand, is not physical and cannot be measured by any objective standard, for example, pain, mental distress, and discomfort. It always accompanies physical or psychological harm. In the English law of contract and tort, non-pecuniary damage may be redressed on the basis of deceit or breach of contract.[118] This is quite different from Taiwanese law; the Taiwanese Civil Code enumerates all situations where non-pecuniary damage is recoverable,[119] namely injuries to rights of personality, name, life, body, health, freedom, and reputation. Following this, any non-pecuniary damage resulting from financial loss is not protected by law. In other words, even if financial loss is inflicted by deceit, no non-pecuniary damage such as mental distress is remedied.

---

[118] *Shelley v. Paddock* [1980] Q.B. 348; *Saunders v. Edwards* [1987] 1 W.L.R. 1116; *Hobbs v. L.S.W. Ry* (1875) L.R. 10 Q.B. 111; *Bailey v. Bullock* [1950] 2 All E.R. 1167.
[119] Articles 18, 19, 194, and 195.

Therefore, for the sake of clarity, this thesis deals only with the problem of pecuniary damage in actions for compensation on the basis of securities misrepresentation and leaves out non-pecuniary damage which may be available under English law but is definitely not allowed in Taiwanese law.

6.5.2 The Meaning of Damage

Damage exists, it is said, in two forms: (1) the reduction of a plaintiff's total amount of wealth, and (2) the increase that should have, but did not, take place to the total amount of a plaintiff's wealth. In *Twycross v. Grant*,[120] the plaintiff was induced to purchase shares which were overpriced. The damage incurred by the plaintiff was the reduction of his total wealth (the first form): money was spent in exchange for much less valuable shares. By contrast, if the defendant bragged that the price would double within a short period of time, then the plaintiff also suffered the expectation damage (the second form).

This general description is not new to English law; common law usually refers to the terms "expenses", "cost of repair or replacement",[121] and "loss of business profits".[122] The expenses caused by torts are usually for keeping the damage within reasonable bounds;[123] for example, when a plaintiff's motor car is destroyed, he may have to hire or buy one in its place. Or, when the plaintiff is injured, he may have to take medical care to prevent infection. Both of these cause the reduction in the plaintiff's total wealth. A plaintiff may also suffer the loss of business profits. For instance, the plaintiff's factory was burned; the plaintiff lost the business profits which

---

[120] (1877) 2 C.P.D. 469.
[121] See *Lim Poh Choo v. Camden and Islington Area Health Authority* [1980] A.C. 174; *Tate & Lyle Food and Distribution v. Greater London Council* [1982] 1 W.L.R. 149.
[122] See *The Kate* (1899) 15 T.L.R. 309; *Liesbosch Dredger v. S.S. Edison* [1933] A.C. 449; *The Soya* [1956] 1 W.L.R. 714.
[123] See Harvey McGregor, *McGregor on Damages*, 15th ed., 1988, p. 75.

he should have made if the wrong had not been committed.[124] It is, however, true that a general and comprehensive definition of damage has never be found in either the English or Taiwanese jurisdictions. Even so, three possible ways of describing damage are suggested.

First, damage represents an "interested relationship" between the victim and the incident. That is, damage is a lost "interest" suffered by the victim because of the incident in question (damage = interest). The so-called "interest" is the difference of the total amount of wealth that the victim has after the incident and what he should have had if the incident had not happened.[125]

For example, A has a book worth £10, B likes it very much and offers £20 to buy it. If C destroys A's book, the interest A loses is £20, not £10, because A's interest in the book is £20. The difference of A's total wealth before and after C's wrong is £20. By contrast, A's house is going to be demolished in a few days. If B sets fire to the house, A's lost interest is not great at all, seeing that his interest in the house is trivial. Thus, A is entitled to the difference between his position as it is and as it would have been had the wrong not occurred.

Accordingly, in actions for compensation for securities misrepresentation, a plaintiff's lost interest will be the difference between the total wealth that he has after the transaction and what he would have had if the transaction had never been carried out. Therefore, if a plaintiff finally sells the securities at a good price resulting from other economic factors, there is no damage at all. If, on the contrary, the price falls further due to reasons other than the misrepresentation, the defendant is liable for all consequential loss. The difference between the purchase price and the sale price

[124] Some academics interpret loss as being that the plaintiff has to purchase a substitute or the plaintiff would have been wealthier if the wrong had not been committed. See S.M. Waddams, *The Law of Damages*, 2nd., 1991, p. 1.

[125] This is called the theory of interest or the theory of difference in Germany, first propounded by F. Mommsen, Zur Lehre von dem Interesse, 1855. See Tseng, supra note 90, pp. 27 et seq.

provides a good reference for measure of damages. If the plaintiff does not sell his securities at the time of judgment, the value of the securities is decided by the price at that time. This definition of damage conceptually can be understood as a **"subjective" test** of damage. To call it subjective is because all the plaintiff's special circumstances are taken into account, not only the market price at the time and place of the wrong. It is possible to argue that this description is an "objective" test; however, such an argument is only meaningful in the sense of evidence and proof.

Such description of damage has its shortcomings. A defendant may need to account for any unexpected fall of the price; he may also dispose of liability due to the thereafter prosperous market. To define damage in this way may cause difficulties where measure of damages is concerned because of unfairness in certain situations.

Second, damage can be described as a harm done to an injured party's specific assets. The victim is entitled to the value of his assets at the time and place when damage was incurred.[126] This description thus solves the problem mentioned above. For example, A negligently destroyed B's stamps which B had collected for many years. B's sadness was disclosed by newspapers; as a result, hundreds of stamps were sent to B by sympathisers. If the difference of B's wealth before and after the wrong is calculated, B suffered no loss. But, if the damage is measured as what the "objective asset test" describes, B's damage is what he lost at the time and place of destruction. Consequently, the second description excludes the special situation of B (i.e. people gave him stamps). Given the examples about the book and house mentioned above, the damage to the book is £10 and the damage to the house is its objective market value. Based on this description, the fact that the injured party sold the securities at a good price should be excluded when damage is assessed. According to the tenor of this

[126] This is called the "objective asset test" (or the theory of items) in Germany, advanced by P. Oertmann, in Die Vorteilsausgleichung beim Schadensersatzanspruch, and R. Neuner, Interesse und Vermögensschaden. See Tseng, supra note 90, pp. 35 et seq; A.M. Honoré, "Causation and Remoteness of Damages" in International Encyclopedia of Comparative Law, Torts, André Tunc (ed.), 1981, p. 81.

description, it is appropriate to call it an "objective" test, because it does not take cognisance of the plaintiff's special circumstances.

Third, if the right of compensation has been introduced into the statute (or in common law, established by cases) it may be apposite to look into each statutory provision (or in common law, the rules developed by cases) to define damage.[127] For example, in torts, no one should harm others; thus damage caused by wrongful conduct covers medical expenses because in ordinary situations, the victim needs medical treatment. It also includes the loss of earning ability if the victim has normal work; the pain and discomfort sustained are also within the scope of the statute (common law rule) because it is the natural result of this kind of harm.

In securities transactions, the statutes intend to prohibit any fraud or negligent misrepresentation which naturally results in financial loss to plaintiffs. Therefore, financial loss is the damage defined in this situation. As regards its scope, statutory purpose should also be resorted to. This will be discussed later.

Accordingly, if the first and second descriptions cannot provide a good guideline in securities cases, it would be more just to define damage by means of analysing the purpose of statutes than by applying the traditional definition of damage which fits traditional civil actions for damages, but not securities cases.

The English courts, as noticed above, adopt the direct consequences theory and foreseeability theory in deceit and negligence torts respectively. Under these two theories, whether a plaintiff's special circumstances should be taken into account depends on whether the harm resulting from such circumstances is the direct consequence of the defendant's wrong or could have been reasonably foreseen by the defendant. Comparatively, the foreseeability theory is a more "objective" test, seeing

[127] See supra notes 114, 115.

that it stresses a reasonable man's foreseeability. The harm coming from the wrong will be compensated provided that it is foreseeable. As regards securities misrepresentation cases, English law adopts the second description of damage (the objective asset test) revealing a possible contradiction between the theories employed by the English courts in normal cases (the direct consequences and foreseeability theories) and the measure of damages where the second description of damage is followed; this will be analysed in due course below.

In Taiwan, the objective test in principle is not adopted.[128] Therefore, in securities actions, what one needs to consider is whether the first description of damage can solve the problem and whether there are any other criteria that should be taken into account.

Finally, one has to bear in mind that damage is changeable as time passes. In securities transactions, especially as listed securities, prices of securities are changeable every minute. After the plaintiff purchases or sells the securities in question, the price will go up or down quickly; therefore, the plaintiff may sell the securities at a good price and in consequence suffer no loss at all. It is also possible that after the purchase, the price keeps falling which exaggerates the loss. Because of such a characteristic of price movements, the question of how to identify damage becomes very difficult, and in fact this may turn on a policy choice.

If the plaintiff finally gets a handsome return, will the loss previously existing at the time of transaction be remitted? On the other hand, if the loss is aggravated by other factors, should the defendant be liable for it as well? These questions relate to two issues: (1) the time of measuring damages; and (2) the intervening events. Damage

[128] See Tseng, supra note 90, p. 44. Only in exceptional cases, is the theory of items adopted. For example, Article 638 of the Civil Code provides that in carriage, damage coming from loss, injury, or delay of goods shall be calculated in accordance with the value which the goods would have had at the place of destination and at the time when delivery was due.

varies from time to time; the use of different times leads to different measures of damages. Damage is also affected by factors other than the wrong. Hence the statutory purpose may be very helpful in this aspect.

6.6 Measure of Damages

Once a defendant's liability is established, that is, all elements such as fault, causation, and damage present, the measure of damages is the sequential problem remaining to be discussed.

First, as mentioned above, causation serves two functions: one of them concerns the establishment of liability, which has been analysed in section 6.4; the other is to provide criteria for judging the extent of liability, which is focused on in this section. Second, section 6.5 has dealt with the problem of defining and identifying "damage". Several issues were left to this section, i.e. the time for measuring damages and the effects of supervening events, i.e. those occurred between the date of the transaction and the date of judgment. These combined with the theories of remoteness of damages mentioned above are discussed here to resolve the problem of measuring damages. Third, the extent of damage varies from person to person as noticed above in section 6.5 concerning the definition of damage; this is also closely connected with measure of damages.

If all damage directly flowing from the wrong is what the law intends to compensate, then the scope of liability may be extended to cover the damage that the defendant cannot foresee at the time of the wrong (the subjective test). On the other hand, should the law emphasise its deterrent function, it may not order the defendant to compensate for damage which the defendant cannot reasonably foresee in advance (the objective test). In securities cases, the capital sources of purchasing securities, the purpose of purchasing securities, and the proportion of investment in securities to the

total wealth of the plaintiff are all special circumstances to an investor that outsiders cannot fully perceive. Only if the subjective test is adopted would these heads of damage be considered. Therefore, the choice of different standards to measure damages fully lies in the policy of risk distribution and the nature of compensation. No choice is absolutely correct.

According to English law, damages in securities cases are measured by calculating the difference between the price paid by the plaintiff for the securities and the "real" value of the securities at the time of allotment or transaction plus interest (the out-of-the-pocket method) (an objective standard). It will be argued that this simple formula deserves criticism. Following the distinction between normal damage and consequential damage made by the thesis and the proposed specific characteristics of securities transactions, the time for measuring damages should be set at the time for judgment. Only in this way can the hypothetical concept of the real value of securities be estimated more reasonably, and contradictions between this rule and the theories of foreseeability and directness can be addressed.

In addition, even though English law may maintain its objective test, it is due to the specific characteristics of securities transactions rather than due to the concept that economic loss is less important than physical loss. Taiwanese law adopts the subjective standard for measuring damages by calculating the difference between the price paid and the selling price or the market price (if not yet sold) of the securities at the time of judgment. This rule obviously suggests a lack of understanding of the characteristics of securities transactions and signals a need to cut out supervening events when measuring damages.

It is submitted that in light of the statutory purpose of compensation provisions, for both jurisdictions, consequential loss should be ruled out from the scene as much as possible on the one hand, and based on the causation theories (i.e. in the UK, the

directness and foreseeability theory; in Taiwan, the adequacy theory) and characteristics of securities transactions, damages are estimated in the sense that we do put the plaintiff back into the position that he would have been in had the wrong not happened on the other hand.

6.6.1 The Effective Law

Unlike the American Securities Act 1933 which codifies the measure of damages in relation to false registration statements,[129] the UK POS Regulations 1995, FSA 1986, and Taiwanese SEL do not specify the methods to measure damages. In such a situation, the general rules of measuring damages prevail.

(1) the United Kingdom

As discussed in section 6.2, securities cases about misrepresentation are characterised either as common law or statutory torts. Therefore, the tortious measure of damages is adopted by the courts. Compensation is aimed at putting the plaintiff into the position that he would have been in if the misrepresentation had not been made to him. And generally the courts calculate the difference between the price paid by the plaintiff for the securities and the "real" value of the securities at the time of allotment (or transaction) (price paid less value received) plus interest as the damages.[130] It is called the out-of-pocket method.

---

[129] § 11(e) of the Securities Act 1933. It provides that a plaintiff may recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less then the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought. But a defendant need not account for the depreciation of securities prices not resulting from his false statements provided that he can prove this.

[130] *Davidson v. Tulloch* (1860) 3 Macq. 783; *Twycross v. Grant* (1877) 2 C.P.D. 469; *Edgington v. Fitzmaurice* (1885) 29 Ch.D. 459; *Cockett v. Keswick* [1902] 2 Ch. 456; *McConnel v. Wright* [1903] 1 Ch. 546; *Clark v. Urquhart* [1930] A.C. 28; *Doyle v. Olby* [1969] 2 Q.B. 158; *Smith New Court Securities Ltd. v. Scrimgeour Vickers (Asset Management) Ltd. and Another* [1994] 4 All E.R. 225.

As a general rule, English cases in respect of securities transactions choose the time of the transaction as the time for calculating damages. This rule, however, is valid only in the context of "normal damage". The English courts sometimes also take into account the events happening after the transaction date and other losses, i.e. consequential damage. Nonetheless, in securities transactions cases, regarding price movement losses, it is not practical to distinguish consequential damage by price movement from normal damage by price movement because: (1) the real value of securities at the time of transaction could not be assessed unless events occurring later are considered; (2) all losses resulting from price movement are "normal" if there is a causal connection between the misrepresentation and the price movement; (3) the English courts have never specifically segregated part of the price movement loss as consequential loss. For the sake of clarity, we therefore define all price movement losses which have a causal connection with the misrepresentation as normal damage; and we classify the non-price movement losses and abnormal price-movement as consequential damage. The subsequent discussion of time for measuring damages is based on such a definition.

Moreover, in normal cases of tortious misrepresentation, the English courts distinguished two methods of assessing loss: (1) no-transaction method; and (2) successful-transaction method. The first method refers to cases where, if misrepresentation had not been made, there would have been no transaction. The second method applies in cases where, if misrepresentation had not been made, there would have been a transaction but on different terms. The courts order the defendant to compensate the plaintiff for all the loss he has suffered if the case falls within the category of the no-transaction method, i.e. market fluctuation is included (the subjective test). According to the successful-transaction method, the loss is assessed at the date of the transaction (the objective test).[131] However, it is of great interest to notice that in securities transactions cases, such a distinction has never been mentioned

[131] See *Hayes v. James & Charles Dodd* [1990] 2 All E.R. 815 (*per* Staughton LJ, at pp. 818-9); *Banque Bruxelles Lambert SA v. Eagle Star Insurance Co. Ltd.* [1995] 2 All E.R. 769.

by the courts in the context of measuring damages even though the courts sometimes have had to consider the contention that the plaintiff would not have entered into the transactions but for the defendant's wrong.[132]

The real difficulties that the courts have not in fact tried to solve are: (1) What is the "real" value?; (2) Why have the courts chosen the time of allotment (or transaction) as the time for measuring damages?;[133] (3) What is the effect of events happening later but affecting the price of securities?; (4) How about the plaintiff's personal special circumstances which may enlarge or reduce the amount of damage?

In an early securities case, the courts dealt with the first question by saying that the market value of securities was only evidence of value, not proof of it, and if the jury thought that the quotation on the Stock Exchange did not show a real, but only an illusion, value caused by the fraudulent nature of the prospectuses, the jury should ignore it.[134] It is true that market value can be influenced by all publicly available information, including a false one, so that the "price" is not reliable in this sense. The courts also state that events happening later such as the insolvency of the company can be taken into account when the "real" value is measured[135] because it helps to prove that at the time of allotment or transaction the shares were in effect valueless. However, the courts still do not provide clearer criteria as regards estimating the "real" value. As the Court of Appeal in *Smith New Court Securities Ltd. v. Scrimgeour Vickers*[136] admitted, information would be quickly reflected in securities prices. In other words, the court implicitly accepted the ECMH. Then, the "real" value of securities should be the price the shares would fetch in the market if the truth was

---

[132] Comparing *Banque Bruxelles* with *Smith New Court* ([1994] 4 All E.R. 225, CA) demonstrates this strange phenomenon. In *Banque*, the court held that "it seems clear on English authority that effect will be given to the restitutionary principle by awarding the buyer all he has paid out less what he has recovered" and this includes the *later fluctuations in the market*. On the other hand, in *Smith New Court* the later market fluctuations were excluded.

[133] "...in practice, as a matter of convenience, the date is taken to be that of the day after the posting of the notice of allotment." See *Stevens v. Hoare* [1904] 20 T.L.R. 407, p. 409.

[134] *Twycross v. Grant*, supra note 130, pp. 489-90.

[135] *Peek v. Derry* (1887) 37 Ch.D. 541, p. 592.

[136] [1994] 4 All E.R. 225.

revealed and all the facts were known. The problem is what is the best date to see the effect the true information would have had on securities prices if it had been disclosed at the time of the transaction or allotment.

Would this be the day of disclosure of the real information? or several days after disclosure? Theoretically, the court may use the day of disclosure or several days after the disclosure as the time of deciding the real value of the securities. What the court should consider is market efficiency, i.e. in the specific case how long it takes for the market to react and for the price to reflect the information. This may vary from case to case but the fundamental rule is the same.

What would happen if there is no "exact" disclosure day? For instance, if a company has been under merger negotiations for a long time and instead of releasing such information, when asked about the negotiation, it denies that there is any meeting about the merger. Nonetheless, one day the company suddenly declares that it has entered into the merger agreement and the securities price goes up substantially. B is an investor who sells his shares at the time the company denies the merger information. The real value of the securities at the time of transaction cannot be known, because at the time of disclosure there is an agreement, while at the time of transaction there is only a possibility to merge.

Another example may be given. An oil company publicly declares that its oil well has an 80% possibility of striking oil. Later the company is informed by some experts that there is only a 30% chance, but the company chooses to keep silent. B buys the shares at the time the company knows the true information. The oil well finally turns out to be barren and the price of shares falls to zero. What is the real value of securities at the date of transaction? it is not susceptible of proof. Clearly, real value itself is a very artificial concept.

The more difficult problem is: how can one be sure that there are no other factors which cause the price to fall further? How can these factors be determined?[137] This is why the English courts have chosen the date of allotment or transaction as the basis of measuring real value in order to exclude all other factors which affect securities prices but have no bearing on the false statement. This, nonetheless, reveals that the courts have ignored a very important problem, namely that the real value is quite hypothetical and cannot be measured unless the prices at the time of disclosure, or even before or after it are taken into account, and the real challenge here should be to find a more rational way to exclude the non-false-statement factors.[138]

Another questionable position adopted by the English courts is why the date of allotment or transaction is taken as the date for calculating damages. As noticed above, damage is changeable perpetually, especially in securities markets. The implication of this position is that the courts treat damages in securities transactions in a way analogous to the valuation of physical goods without allowing for the much greater price fluctuation in securities markets. Can this be challenged on the bases of the characteristics of securities transactions which will be examined below? This point also relates to the third and fourth questions proposed above; that is, will supervening events and a plaintiff's personal special circumstances affect the measure of damages?

---

[137] In American law, a suggested method for the estimation of real value is by applying the "market model". Since that there are two lines: a value line and a market line; before the false statement is made, two lines coincide. However, the market prices are inflated because of the misrepresentation. Based on the ECMH, when the real information is disclosed, these two lines will converge. Then, in between this period, to subtract the real value from the market price at the date of purchase will be the damage. Hence, how to calculate a value line is a clue to the measure of damage. A value line is not estimated based on either the assets value or the earning data of the company; it is, rather, drawn by calculating securities prices data adjusted for movement in the market and industry, which can be done by financial experts. Sneed J. in *Green v. Occidental Petroleum Corporation* (541 F.2d 1335 (1976)) advocated this method. See also Philip J. Leas, "The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities", in 26 *Stanford L. R.*, 371-98, 1974, pp. 386 et seq.; Jared Tobin Finkelstein, "Rules 10b-5 Damage Computation: Application of Financial Theory to Determine Net Economic Loss", in 51 *Fordham L. R.*, 838-70, 1983.

[138] Id.

(2) Taiwan

The Taiwanese Civil Code provides: "Unless otherwise provided by law or by contract, damages should be limited to compensation for the losses incurred and gains foregone."[139] Despite the word of limitation, it seems that Taiwanese law aims to compensate the whole damage suffered by the plaintiff,[140] including loss accruing from his special circumstances. This is very different from that of English law. Taiwanese law does not specify the time for measuring damages, but it is obvious that it would not be the date of transaction or allotment. Moreover, if the law had intended to exclude loss arising from the special plaintiff's circumstances, it would have specifically spelt this out.[141]

Therefore, it is uncertain as to how the courts would measure damages in securities cases. As a matter of principle, the time of the conclusion of the oral proceedings in the last appeal where facts of cases are allowed to be considered by the courts (in Taiwan, this generally is the end of the oral proceedings in the court of appeal) is the proper time for the calculation of damages. Therefore, if plaintiffs have sold securities by this date, the selling prices provide good criteria; if not, then the market prices at that time will be considered.[142]

The courts will not consider whether the market price is a real one; nor will they take into account the ECMH and observe the price fluctuation during the period in question[143]. Accordingly, the defendant may not be liable to pay any damages at all if at the proper date the price of the securities is higher than the purchasing price; the

[139] Article 216(1).
[140] See Tseng, supra note 90.
[141] Article 638 as mentioned above (supra note 128) is a good example.
[142] In case *Hsin Po (74 nien tu su tzu ti 15521 hao*, 21.4.1986), the court measured the damage by subtracting the sold price from the purchasing price and then added interest since the last day of the oral proceedings. From a comparative point of view, this kind of method was also seen in American cases. See *Chasins v. Smith Barney & Co.* (438 F.2d 1167 (2d Cir. 1970)). Thomas J. Mullaney, "Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability", in 46 *Fordham L. R.*, 277-94, 1977, p. 287.
[143] See *Hsin Po*, id.

defendant also may have to account for more damages if other factors come into play. Whether the defendant can prove that there is no causal connection between a further drop in the price and the original wrong is unclear. But since he may be relieved of liability for compensation when the price goes up, by inference, he should not be allowed to avoid the full liability when the price goes down further.

6.6.2 The Characteristics of Securities Transactions

Three characteristics that we suggest here are discussed sequentially below.

(1) parties to securities transactions are uncertain and sometimes numerous

In transactions where many people become involved, it is impossible to know the background of the opposite party and the special circumstances surrounding him. This emerges even more clearly when the parties are uncertain. For instance, for purchasers of tickets in cinemas or railway stations, identity is not usually the concern of the seller. If tickets are lost, there is no remedy. The same characteristic is found in securities transactions. The public distribution of securities always attracts a great number of investors to take part. Further, transactions on the stock exchange are made by unspecified investors (in the sense that computers do the "match"). These factors will influence the relationship between the transaction parties; that is, no one has any specific knowledge about the other; the only connection between them is the exchange of securities and money. Therefore, one party's personal circumstance such as capital sources and purpose of investment are outside the other party's knowledge.

(2) the objects of securities transactions are "intangible"

Although certificates of securities are pieces of paper and are tangible, the main objects transferred are the "rights" attached to the certificates and a right is intangible. Shareholders and debenture holders on the bases of these rights can claim dividends

(given a declaration of dividends) and interest payment; they can also vote if the rights so provide.

The importance of securities certificates in the modern world is decreasing. In particular, the highly developed technology permits electronic transactions without any necessity for the parties to hand over securities certificates. This emphasises more than ever the conceptual difference between damage to the value of securities and damage to tangible property. Consequently, it would be surprising that the same method is used to measure financial loss in securities transactions and loss flowing from physical damage.

(3) securities flow like water

Although not negotiable instruments, securities do share certain characteristics with the former. First, securities, especially as they are traded on the stock exchange, are expected to transfer often like negotiable instruments in commercial usage. Hence, for the sake of enhancing such "movements", damages in principle should be measured by way of focusing on the value of securities. Any intention to recover the consequential damage will be an obstacle to constant movements of securities.

Second, civil law countries, for example Germany and Taiwan, treat these transactions (the transactions of negotiable instruments and securities) as "juristic acts regardless of their cause". Therefore, the legal reason which leads the holder to possess the instruments is not taken into account when the question of whether the holder owns the legal title of the instrument is decided. Based on such a characteristic, holders who obtain securities in good faith will get a good title. This device is intended mainly to help the flow of securities. Consequently, where measure of damages is concerned in securities cases, it may be appropriate, from the policy point of view, to exclude any consequential losses from the transactions in question.

As mentioned earlier, English law in most cases is inclined to use the objective standard (foreseeability) to measure damages. According to the three characteristics examined above, in securities transactions, individuals' special circumstances cannot be appreciated by opposite parties to the transactions. Hence, although financial loss is always connected with the change to the whole wealth of a plaintiff, it would be more appropriate to exclude those personal special circumstances which in normal situation cannot be foreseen by defendants in these transactions.

6.6.3 Specific Problems regarding Measure of damages

Based on the analyses of the characteristics of securities transactions and the problems identified in section 6.6.1, it is now appropriate to consider the inter-relationship of all these problems and propose certain solutions.

(1) subjective circumstances v. objective standard

Damage in securities misrepresentation cases can be classified into two groups: 1. damage flowing from non-price movements losses (for example, for the purpose of obtaining capital to purchase securities, the interest payment of the loan or the loss of selling a house at a lower price suffered by the plaintiff); 2. damage flowing from price movements losses; this in turn can be divided into two classes: a. loss caused by misrepresentation and b. loss caused by supervening events (e.g. economic depression, the intentional or negligent conduct of third parties). The first group of damage will be analysed (consequential damages springing from the personal specific circumstances).

a. the United Kingdom

First, the second function of causation is to govern the measure of damages. Securities transactions are rapid and often involve substantial amounts and the damage they entail is "pure economic" loss. Therefore, it has been long established that the defendant

must take the plaintiff as he finds him[144] in physical damage cases is not applicable when pure economic loss is in issue. This results from the *Liesbosch*[145] case which was decided before the rule in *Re Polemis* (1921) was overruled by the *Wagon Mound* (1961); this explains why the concept of "reasonable foreseeability" did not form part of the court's reasoning. It was, however, obvious that the court distinguished *Re Polemis* on the ground that in *Liesbosch* the economic loss suffered by the plaintiff was an extraneous matter (personal financial weakness) which was not covered by *Re Polemis* where the causation problem was concerned with immediate physical consequences.

This attitude was criticised in the *Wagon Mound (No. 1)*, where it was reasoned by the court that such distinction has no justification. Nonetheless, in *H. Parsons Ltd. v Uttley Ingham & Co. Ltd.*, Lord Denning intended to establish a standard for causation not based on whether the event was a breach of contract or a tort, but rather on whether the damage was physical or economic.

This raises a further problem. Lord Denning drew a distinction between physical damage and pure economic loss in breach of contract. He held that in relation to physical damage, both in breach of contract and in tort the same test of remoteness applied, that is, the tort test; the defendant was liable for all damage which could reasonably have been foreseen at the time of the breach as a possible consequence of the breach even if the possibility was only slight. For economic loss, on the other hand a stricter test was substituted; the defendant was liable only if the damage was such that at the time of the contract he could reasonably have contemplated it as a serious possibility in the event of a breach occurring. Lord Denning did not make it clear what

---

[144] This is the eggshell skull rule. In *Smith v. Leech Brain & Co. Ltd.* ([1962] 2 Q.B. 405) the court reached a position that it was sufficient to establish liability so far as the defendant could foresee the type of damage, the extent of which did not need to be foreseen, if physical damage was taken into account. In this case, the plaintiff was burned on the lip by molten metal, inducing a cancer from which the plaintiff died. The court made the defendant responsible for the plaintiff's death.

[145] [1933] A.C. 499.

standard he would apply if damages for pure economic were claimed in tort. But he appears to envisage a stricter criterion of causation in pure economic loss cases. One academic suggests that from Lord Denning's point of view, in the case of pure economic loss, the stricter standard of contract should be applied, or, if there is any contractual or like relationship between the parties and economic loss is involved, the contract standard should be preferred.[146]

The point made by Lord Denning seems difficult to justify. First, why should it be more difficult to obtain compensation for pure economic loss than for physical damage if they are both "normal" forms of damage? The missing point in Lord Denning's opinion and the *Liesbosch* case is that the real problem is not whether the damage is physical or economic; the real problem is whether the damage is normal or consequential. In most cases, pure economic loss or financial loss is consequential damage, which may not be foreseen by the defendant at the time of the wrong because it usually relates to the plaintiff's special circumstances. Hence, the reason for non-compensation is not because the damage is economic, the real reason being that it is too remote.

But in securities transactions, pure economic loss is the normal form of damage, and physical damage is the exception, in contrast to ordinary cases. What a subscriber or purchaser loses is the higher price he paid for the securities; thus, he suffers pure economic loss which can easily be reasonably foreseen by the persons who made the misrepresentation. The plaintiff should be compensated as far as this damage is concerned. On the other hand, supposing that the victim got his capital, for the sake of purchasing securities, from a "loan shark" and as a result of default, he was injured by the creditor's "enforcers", the damage he suffered from personal injury would be consequential damage. The defendant should not be liable for this, even though it was a form of physical damage.

---

[146] See Andrew Burrows, supra note 110, pp. 48-53.

Second, in the 20th century, pure economic loss is in no sense less significant than physical damage. It could be argued that to apply the eggshell skull rule to physical damage but not to pure economic loss is reasonable (the eggshell skull rule itself is intended to give greater protection to personal injuries plaintiffs) because maintaining respect for human life has a special meaning, especially when machines and technology replace human labour. Highly developed society makes human beings distinct, and human beings sometimes wonder about the value of personal existence. Thus imposing such liability is in reality to remind people that the moral value is not yet lost. But if such a distinction is further employed to decide the remoteness of damages, it is to ignore the real world where financial loss becomes widespread following the development of financial markets and industry.

It is submitted that when the extent of liability is measured, the law regarding causation should apply the same standard to both pure economic loss and physical damage. After this principle has been established, the characteristics of securities transactions come into play. Capital resources and the proportion of investment to the whole wealth of the plaintiff are both special circumstances and thus any loss incurred of this kind is consequential. For example, the plaintiff borrowed money with high interest to purchase securities, then the interest he suffered would be special damage. The plaintiff sold another kind of investment, e.g. a house, and used that amount of money to buy securities; however, the house price increased dramatically after he sold it, then the expected profits he lost would also be consequential damage.

The most important point accompanying the above characteristics of securities is that all such consequential damage should be excluded in principle. According to the foreseeability theory in this kind of case, they (consequential damages) are excluded because there is not the slightest possibility that the defendant could foresee them. However, in the situation where the direct consequences theory applies, all direct

consequences flowing from the wrong should be compensated. The courts, in this situation, should bear in mind the characteristics of securities transactions and interpret some damage as so remote as to sever the causal relationship in order to meet the special characteristics of securities transactions.

If the statutory purpose is observed here as opposed to the directness theory and the foreseeability theory, the answer may be more straightforward.

First, English law has extended the scope of persons who are entitled to ask for compensation when misrepresentation in listing particulars is involved. When the scope of protected persons is enlarged, it may be inferred that the extent of liability to each individual person is to be reduced. An example of this tendency is the compensation in public transportation cases (e.g. aircraft accidents) today.

Second, the Companies Act 1985 allows shareholders to sue the company for compensation without rescinding the contract first. Any investors who are induced to subscribe for the securities by fraudulent misrepresentation can now sue the company (the issuer) for compensation. This was not possible before 1989[147] because of the rule in *Houldsworth v. City of Glasgow Bank*.[148] In that case, the plaintiff was barred from compensation based on the fact that he did not rescind the contract of sale, and to allow a shareholder to bring an action against the company was inconsistent with his membership and interest in the company.[149]

So, an increasing number of persons are now entitled to seek compensation in securities cases. Therefore, to exclude damage which comes from the plaintiff's special

---

[147] The Companies Act 1989, s. 131(1) amended the Companies Act 1985, s. 111A.
[148] (1880) 5 A.C. 317.
[149] See Louis G. Doyle, "Liability for Listing Particulars", Part II in *Law for Business*, 3[3], 124-6, 1991, p. 125.

circumstance is justifiable in light of the statutory purpose (e.g. the FSA 1986, s. 150(1)).

b. Taiwan

In Taiwan, the second function of causation, i.e. in measuring damages, appears to have been ignored. This does not mean that academics or the courts have claimed no such function in causation. It is, instead, due to the fact that the law of damages is not fully developed in Taiwan. Therefore, people may be interested in how damages is measured. The answer is that Taiwanese law generally adopts the first description of damage mentioned above (the theory of interest), i.e. special circumstances of the plaintiff are taken into account. Thus in practice the time for measuring damages is at the end of the oral proceedings in the last factual appeal; consequently, all factors occurring in between the wrong and judgment are relevant.

Therefore, the price paid by the plaintiff for the securities less their market value at the end of the oral proceedings in the court of appeal represents the damage suffered by the plaintiff. Should the calculation prove zero or negative, the damage is nil and the case is dismissed.

So far, only a few judgments have been delivered. In the *Hsin Po*[150] case, the plaintiffs did not claim special financial loss; therefore, it is hard to conclude at this moment that all consequential damages which relate to the plaintiff's special circumstance will be excluded. However, the special financial loss obviously should not be redressed if the characteristics of securities transactions are acknowledged.

It is thus clear that although special circumstances may be considered in physical damages cases (e.g. the eggshell skull rule), they should be disregarded in securities

[150] See supra note 142.

misrepresentation cases. This is not based on the concept that economic harm is less important than physical harm; rather, it is based on a policy choice which closely relates to the characteristics of securities transactions.

(2) time for measuring damages

According to the characteristics that securities flow like water and that their prices change constantly, the later the date on which damages are calculated, the more factors the prices reflect. English law fixes the date of allotment or transaction as the time for measuring damages; it aims to exclude all factors other than the false information when measure of damages is at issue.

First, as examined earlier, English law adopts the directness theory of causation in respect of intentional tort. This may bring about an anomaly. For instance, a company fraudulently published that its oil well had an 80% possibility of striking oil; this not only induced the plaintiffs to subscribe for its securities but also induced a bank to promise to honour the company's overdraft cheques. Later, the true information was released, and the securities price fell. In addition, the price dropped further because the bank stopped honouring cheques.

Based on the directness theory, the further drop in the price is the direct consequence of the wrong and should be redressed. Yet if the date for measuring damages, as the courts have held, is the time of the transaction, it seems that such damage should not be compensated because the real value of the securities at the time of the transaction was the price that securities would have had if the misrepresentation had not been committed.

Second, in negligence cases, the defendant is liable for damage that he can reasonably foresee at the time of wrong. Supposing that the defendants disclosed the

earning of this quarter to increase by 30% over the same period last year and predicted (without reasonable ground) that this would happen over the remaining fiscal year. However, if the defendants had not been negligent, they would have foreseen that the whole industry would decline substantially for the second half of the year. The securities price went up from £10 to £15 (per share) because of the information. B bought shares at £15. Towards the beginning of the second half of the year, the coming depression became known to the public, and the price dropped to £12. It appears reasonable to presume that the real value of securities at the time of the transaction would only have reflected part of the depression if it had been disclosed, and thus the possible price would have been £14. Therefore, if the courts follow the securities cases rule, the defendants only have to compensate B for £1 (£15-£14) per share. However, according to the foreseeability theory, the difference should be £3 (£15-£12) per share.

Third, in section 6.5 it was suggested that the real value of securities cannot be decided unless the price movements in the later stage are taken into account. Fourth, damage is constantly changing.

For all these reasons, it is argued that although setting the time for measuring damages as the time of allotment or transaction may meet the objective standard preferred by English law, the inconsistency between this choice and the theories mentioned above, the ignoring of the nature of damage, and overlooking the importance of the later events to the measure of real value, are not acceptable. Therefore, for the purpose of taking these factors into account, it would be better for the English courts to calculate the measure of damages as at the end of the trial.[151]

[151] In reality, the attitude of the English courts is not inflexible. In cases other than securities transactions, the courts have suggested that the time of loss is not the only timing available to the measure of damage; other timing such as the time of judgment may be adopted in certain situations. *Wroth v. Tyler* [1974] Ch. 30; *Johnson v. Agnew* [1980] A.C. 367; *Dodd Properties v. Canterbury City Council* [1980] 1 All E.R. 928.

(3) supervening events

English law excludes supervening events when the damages for misrepresentation in relation to securities transactions are calculated, while Taiwanese law still encompasses them in this case. Here two steps of reasoning are proposed. First, based on the characteristics of securities transactions, it should be appreciated that there is a "moderate" way of measuring damages which is different from the current law both in the UK and Taiwan.

deceit

In English law, following the ordinary theories of remoteness, if the remoteness of damage is judged based on the direct consequences theory, then the defendant should be responsible for the damage that he cannot reasonably foresee at the time of wrong but which directly flows from the wrong. Therefore, in intentional tort cases, if the damage is not too remote, the defendant has to answer for them. In securities transactions, if the price further drops because of some other factors, the defendant may have to compensate this damage unless it is too remote. However, there is no objective standard for judging whether a specific item of damage is too remote. On the other hand, should the price go up, can the defendant allege that no damage is entailed in fact? From common notions of fairness and justice, it seems appropriate to suggest that the defendant should not be freed from the liability because harm has already occurred, even though it is mitigated by other factors. In particular, on the basis that the price is changeable, no one can ensure that the plaintiff secures more benefits until he sells them.

negligent misrepresentation

By way of contrast, when the foreseeability theory is in use, the defendant will not be held liable for the damage that he could not reasonably foresee in advance. Hence if the real value of securities at the time of judgment is lower than what the defendant can

reasonably foresee in advance, that unforeseeable part of the damage should be excluded from calculation. Market risks are thus borne by the plaintiff. However, if the price goes up, the plaintiff can still claim full compensation, unaffected by other factors; the reason is the same as mentioned above.

In Taiwan, under the current law, supervening events are not excluded; and the adequacy theory has not yet been analysed by the courts. However, because of the characteristics of securities transactions, a line should be drawn to limit the defendant's liability. The solution should be similar to what has been suggested above as a desirable change in English law, except that the misrepresentation must be the "adequate" cause of the supervening events, and when "adequacy" is decided, the courts must bear in mind that liabilities cannot be extended to the extent they ordinarily do in normal cases.

Secondly, if the analysis above is correct, it is more just to measure damages by calculating the difference between the price paid and the real value of securities at the time of judgment than to calculate it as at the time of the transaction. According, in cases of intentional torts (such as deceit), it seems just to allocate the risk of market fluctuation to the defendant and ask him to compensate the further damage; whereas in cases of negligent misrepresentation, the defendant is not required to make such damage good. However, for two reasons, any supervening events which affect securities price but are not related to the false statement, as a general rule, should be excluded. First, the scope of liability in relation to listing particulars and prospectuses has been extended in English law by the enactment of the FSA 1986 (s. 150) and the POS Regulations (reg. 14); therefore the limitation of damages by excluding supervening events can be justified. Second, Investment always is accompanied by risks, a moderate obligation to look after the investment may be imposed on investors. Nonetheless, between the transaction and the date of judgment, there may arise complex or unusual sets of circumstances in the market, which justice would require to be taken into account in assessing the plaintiff's damage. But by their very nature and

unpredictability, such cases will be the rare, though necessary, exceptions to the general rule.

This proposal intends to adjust the current English rule which exclude all supervening events in relation to misrepresentation in securities transactions. Undoubtedly, it may not be easy for the English courts to make such change.

In Taiwan, how should the normal damage be assessed if the statutory purpose rather than the theory of interest is considered? First, respecting prospectuses, the SEL provides that only bona fide counterparties are under protection, and the academics interpret this as being that only the persons directly subscribing to the company or through underwriter are within the protection of the law.[152] If the courts also take this position, then Taiwanese law will not extend the scope of protected persons; accordingly, damage that results from non-misrepresentation factors may not be required to be excluded. The current doctrine (i.e. supervening events are not excluded) does not contradict to the statute.

On the other hand, if one day the statute is amended (as suggested above) to include subsequent acquirers of securities, the courts may have to adjust the measure; to say the least, the extent of liability to individual investors would have to be reduced and accordingly the price at the time of judgment would not the only criterion of measuring damages. The events happening in between the period of the transaction and judgment also need to be assessed.

Second, where there is misrepresentation in continuous disclosure documents, the Law[153] empowers any buyer or seller to claim compensation. These are investors who buy or sell in the market, not necessarily trading with the defendant. Therefore, in

[152] Article 32. of the SEL.
[153] Article 20(2) of the SEL.

this situation, the scope of protected persons is extended and the courts should follow the principle of excluding consequential damage as discussed above when they deal with such cases.

The Taiwanese legislature must realise that the law is not intended to protect investors from all risks and investors must understand that they themselves have certain obligations. Therefore a moderate distribution of risks in such a situation is welcomed.

Finally, it is difficult to understand why the courts have held that in the case of actions brought under the Misrepresentation Act 1967, s. 2(1), the direct consequences theory should be the standard for judging causation.[154] It may be a misunderstanding of the Act.[155] The purpose of the section in question should be read as to make negligent misrepresentation actionable by statute, not only under case law. In all negligence cases the same standard should be employed; it is hard to find any justification for this deviation.

6.7 Insider dealing

In English law, no liability for damage to individual investors is imposed on insiders when they embark on insider dealing. There are criminal liabilities;[156] there are also civil liabilities imposed on an "authorised person" if it violates the Core Conduct of Business Rule of the SIB which requires authorised persons to comply with the Criminal Justice Act 1993.[157] That is, if the authorised person, its associate, or an employee of either effects for itself or himself, or for a client, a transaction which the

---

[154] *Royscot Trust Ltd. v. Rogerson* [1991] 3 All E.R. 294.
[155] Professor Treitel argues that the fiction of fraud in s. 2(1) may be misconceived. See G.H. Treitel, Law *of Contract*, 9th ed., 1995, pp. 325-6.
[156] Criminal Justice Act 1993, Part V.
[157] s. 62 of the FSA 1986 and the Core Rule 28. See Michael Blair, *Financial Services: The New Core Rules*, 1991, pp. 121-4.

authorised person knows would be an offence under the Criminal Justice Act 1993, the authorised person is liable to pay compensation to persons who suffer loss because of insider dealing. However, these liabilities are beyond the scope of this thesis.

On the other hand, in Taiwan, insiders face a severe civil liability if they make use of inside information to sell or purchase listed corporate shares or shares traded in the over-the-counter market. This section concentrates on the measure of damages regarding insider dealing. Unfortunately, despite the general belief that insider dealing is common in the market, not a single civil case dealing with this question has been reported.

According to Article 157-1 of the Taiwanese SEL, the amount of compensation is limited as follows:

(selling price less the average of the last reported selling price for ten business days after disclosure) x (number of shares)
or,
(the average of the last reported selling price for ten business days after disclosure less purchasing price) x (number of shares)

Upon the application of the bona fide counterparties, the court may in its discretion increase the compensation up to treble the limit should the violation be very serious.

This formula sets out only the maximum extent of compensation that the defendant has to pay; it does not provide a means of measuring the plaintiff's damage. Therefore, the measure of damages still follows the method used in the other cases as discussed above: price paid less the market value at the time of judgment, or, if the plaintiff has sold the securities, the selling price.

If one hundred plaintiffs sue and the total amount of their damages exceeds the limit of the defendant's liability, how should the court act? It is obvious from the

provision that the law wishes to make the defendant disgorge his benefits rather than compensate the plaintiffs.[158] Stated otherwise, insider dealing liability is not like the normal actions for damages where the defendant is ordered to make the damage good. The provision shifts the focus from compensating the plaintiffs to depriving the defendant of an improper benefit; this is a deviation from the normal nature of damages (the general principle for the assessment of damages is compensatory). Consequently, when the money available for compensation cannot satisfy all claims, it may be fair to distribute it pro rata to all plaintiffs.[159]

There is a serious defect here. Class actions are not allowed in Taiwan; there is no provision to force all plaintiffs to bring suit together. In other words, the action of an investor has no effect on the position of others; the latter can initiate proceedings at some other time. Thus, in the practical sense the court has no chance to distribute the money pro rata to all investors. Therefore, if the money can only satisfy ten victims, how about the eleventh investor who brings action one year later?

Why does the statute adopt such a formula? The most probable reason is that the opposite parties to the transactions are not identifiable. Securities transactions carried out on the stock exchange or in the over-the-counter market are not face to face. The computer system arranges the transactions automatically. Grounded on this fact, any investors who trade during the period of insider dealing are the possible sellers or buyers of the insiders. Since no one can prove that he or she is the person who trades with insiders, the law allows all of them to claim their rights.

As a result, a director who buys or sells only one time may end up facing hundreds of "counterparties". It seems unfair to order him to fully compensate all

[158] The same thinking exists in the USA, see Donald C. Langevoort, "Fraud and Insider Trading in American Securities Regulation: Its Scope and Philosophy in a Global Marketplace", in 16 *Hastings International and Comparative L. R.*, 175-87, Winter, 1993, p. 181.

[159] See Arnold A. Jacobs, "The Measure of Damages in Rule 10b-5 Cases", in 65 *Georgetown L. J.*, 1093-169, 1977, pp. 1130-7.

investors; hence the law shifts its focus from "damage" to "benefit", taking the point of view of the defendant. The law, however, does not step into the face to face transactions, which as discussed in Chapter Three will not impose on insiders any liability.

The last point made here is that the ECMH is seen in Article 157-1. Even though the reasoning of the ECMH can be seen in this provision, this does not mean that the Taiwanese SEC has really adopted this theory; nor is the theory diffused into the judicial thinking of the courts or academics. No case has ever mentioned this theory so far. Therefore, Article 157-1 can be treated only as an incidental case; it cannot be inferred from this Article that Taiwanese law holds faith in the ECMH.

6.8 Conclusion

English law characterises actions for compensation in securities misrepresentation as torts (common law or statutory torts); while Taiwanese law leaves it undecided. Based on the facts that to define cases of this kind as torts or breaches of contract may not be apposite in certain situations, it is suggested that these liabilities should be characterised as statutory liabilities in Taiwan. However, no matter what the nature of these cases is, they have to meet certain elements before liabilities are established. Here three elements are focused on: the duty of care, causation, and damage.

More than thirty years after *Hedley Byrne* English law continues to show a reluctance to admit the existence of a duty of care in relation to misrepresentation in securities transactions cases. This causes a serious defect when the protection of investors is concerned. Securities holders are quite often injured in the trading market, which may result from the fraudulent information of the provider, but it may also come from its negligence. Since the statutes (e.g. the FSA 1986) do not impose any such liability on these providers, the only help investors can resort to is common law.

Therefore, the reluctance of common law to establish this duty in reality has barred investors from compensation.[160]

Admittedly, whether to impose this duty is a policy choice. It is, however, suggested that the English legislature should reconsider this problem. Seeing that the trading market is no less important than the issuing market, why cannot investors be given the same protection as they have in the issuing market? Moreover, it can be seen from existing legislation that the trend is to enhance investors' protection (acquirers substituting for subscribers in listing particulars and prospectuses cases).

After the problem of the duty of care is solved, the ensuing problems of causation and damage occur. Unlike the traditional civil liability in misrepresentation where the plaintiff has to prove his reliance on the false statement, in securities cases this kind of reliance may be presumed. Especially, if there is an efficient market, such a requirement may even be remitted unless the plaintiff knew the truth when the transaction was made. First, the legislature can choose to shift to defendants the burden of proof based on a policy choice.

Second, if the ECMH is adopted, then whether investors have read the misleading documents is not relevant because prices have fully reflected all information. But the problem is that in the cases where no market prices are available or they are reliable such as in the initial public offering, the ECMH cannot be alleged. Accordingly, if the legislature wishes to omit this requirement, the maintenance of market integrity would provide a good reason.

Although the Taiwanese market is not very efficient, given widespread manipulation and insider dealing, it seems possible to abolish the requirement of

---

[160] The recent development in *Possfund* (see supra note 41) seems very encouraging to the argument of this thesis because Lightman J. suggested a broader scope of duty of care.

proving reliance provided that a specific piece of information concerning a specific kind of securities has been efficiently reflected in the securities price.

Since to define the concept of "damage" is by no means easy, it is wise to look at the statutory purpose when the definition is made. Obviously, the statutes (the English POS Regulations and FSA 1986, and the Taiwanese SEL) require defendants to compensate financial loss suffered by investors. The statutes also extend the scope of persons being protected. It is thus argued that the extent of liability should be limited.

Furthermore, the characteristics of securities have to be weighed. The parties in securities transactions are numerous and uncertain, and securities are designed to be traded frequently; consequently, all special circumstances surrounding a plaintiff which result in consequential losses should be excluded from the scope of compensation. As a general rule, any damage flowing from securities price movements but not relating to the misrepresentation should be excluded from compensation to a great extent. The exclusion of these various factors cannot be explained by the theories of remoteness of damages; the only argument advanced is a policy choice. In addition, damage is not necessarily fixed at an arbitrary date such as the date of the transaction; to measure damages at the time of judgment may be more just and compatible with the characteristics of securities transactions.

However, events happening in between the period of a transaction and judgment had better be excluded as far as possible in the UK even though the direct consequences or foreseeability theory is taken into account. It is the same in Taiwanese law. If one day more investors are within protection, it has to adjust its standard and exclude supervening events unrelated to the misrepresentation concerning the compensation for misleading prospectuses.

Changing the time for measuring damages to the time of judgment is justified for four reasons: (1) this thesis never suggests that supervening events should be excluded entirely, but only as a general rule; (2) this new time solves the contradiction between the old time and causation theories; (3) only by this change, there will be a possibility of considering subsequent events even though this may be a rare case; (4) the new time reflects the fact that damage in securities transactions changes constantly.[161]

Finally, English law has not ordered insiders to account to individual investors, but Taiwanese law has done so even though it may have some problems. Greater importance has been attached to depriving insiders of the benefits of their illegal transactions than to compensate their victims. This deviation from the traditional principle of compensation reflects a dilemma that to compensate investors in full may be unfair to insiders. Therefore, such a compromise is concluded.

[161] Securities prices are affected by many factors, such as the perceptions of stock market analysts, financial commentators, business journalists, etc. (see *Lonrho plc and others v. Fayed and others* (No 5) [1994] 1 All E.R. 188, 196) By inference, prices always fluctuate.

Chapter Seven

Conclusion

This thesis, grounded on the examination of the substantive laws of the UK and Taiwan, analyses step by step the justification for mandatory disclosure regulation, the principles on which the content of mandatory disclosure are designed, and civil liability for breach of mandatory disclosure requirements. In the course of comparison, the merits and shortcomings of both English and Taiwanese law have been identified and possible improvements have been suggested.

The results of the research suggest that even though legal academics and economists continue to debate the necessity of mandatory disclosure, this practice gains its justification from the inadequacy of the general law, thus marginalising the arguments propounded by each side. Under the definition of mandatory disclosure put forward in the thesis, mandatory disclosure regulation is a set of rules added to the general law and in the context of the work comprises the Companies Act 1985, the FSA 1986, the POS Regulations 1995, the Yellow Book, and the Code on Takeovers and Mergers in the UK, and the Securities and Exchange Law and various regulations promulgated by the SEC in Taiwan. It has been demonstrated that without mandatory disclosure requirements, investors cannot obtain sufficient information on the basis of the law of contract or tort. This problem, moreover, is manifested in highly developed financial markets because more information is required in those markets following the emergence of numerous new financial products.

Taking the UK as an example, although in accordance with their fiduciary duties, directors must make full disclosure to the company in the case of self-representation and both-side representation, and are not allowed to profit from their position by

making use of corporate information. Yet, individual shareholders or potential investors have no right to ask information from the company concerning either the company itself or its directors, since the fiduciary relationship exists only between the director and the company. Daily information is not available to shareholders. Under the general law, their only source is that of annual accounts and reports. This illustrates the defects of the general law. On the other hand, in Taiwan where there is no legal concept of fiduciary relationship, Taiwanese investors are worse off than their counterparts in the UK. As a result, it is submitted in the thesis that before economists are able to provide more persuasive evidence regarding cost-benefit analysis, mandatory disclosure should surely be accepted. Even if some day such evidence is produced, whether cost-benefit analysis could be relied upon as the only basis negating mandatory disclosure is not beyond doubt.

Nonetheless, it is undeniable that the existing disclosure regulations are defective in the light of the content of mandatory disclosure, the method of disclosure, and its timing, making the goals of mandatory disclosure (the protection of investors and the achievement of market efficiency) partially unachievable. The content of mandatory disclosure, for a long time, has been excessively concerned with reporting historical facts, triggering serious criticism from opponents of mandatory disclosure. The reason for regulators to adopt this conservative stance discouraging the disclosure of soft information was to protect investors from being misled because of the natural uncertainty of this kind of information. The opponents, on the other hand, maintained that what investors need was soft information rather than historical reports. In addition, since the contents of disclosure are complicated and far from easy for laymen to understand, the practical effect of a pile of documents aimed at helping investors make investment judgments becomes increasingly questionable and worth re-consideration. The most sensitive issue has been the timing of disclosure. The timing of disclosure not only affects investors' investment interests but is also closely connected with corporate business interests. For instance, in the process of merger negotiation, if

information is disseminated prematurely, on the one hand bidder's costs increase, while on the other hand shareholders of the target company as a whole might suffer loss should the bidder withdraw its offer owing to the market reaction. Also, supposing a company finds new mines, immediate disclosure of this information may increase the cost to the company of purchasing adjacent land.

Therefore, the thesis argues that the law should not be encumbered with details of the concrete items to be disclosed but instead, should concentrate on identifying the fundamental guiding principles for the design of the necessary content of disclosure. Accordingly, materiality has been proposed as the supreme guiding rule. Because of the abstractness of materiality and its lack of unanimous definition, however, users' needs and corporate circumstances must, in practice, serve as guidelines. Where legal regulation should intervene is in the situation where investors need information and given due consideration to the corporate environment disclosure is permissible. As regards other information, it should be left to the company and its accountants to decide whether to make it public. However, the law must ensure that material information is clearly described in a prominent position in the disclosure document lest it be buried in a mass of less important information. If material information is not presented properly, it should be deemed to be non-compliance with disclosure requirements.

The most difficult problem is that as financial statements contain more information, they become more complicated. It seems that in reality it is impossible to combine "simple presentation" with "full disclosure". Even though currently all regulations emphasise the importance of simplicity of information disclosure, it remains a remote ideal. The only solution to this dilemma is to simplify the financial statement to the maximum possible extent on the one hand, and to encourage and supervise the establishment and operation of investment consulting companies and professional investors on the other. If individual investors could have recourse to these experts for

help in analysing financial and business reports, they would be more capable of reaching informed decisions. The popularity of professional investors will contribute to the improvement of market efficiency seeing that they have the skill to select better securities for investment; this in turn, enables securities prices to fully reflect all available information and reach their fair prices, as a consequence of which individual investors will benefit from trading at fair prices.

There is a specific phenomenon in Taiwanese society which demands the attention of regulators, that is, the improvement and supervision of accountants. The reliability of any financial statements entirely depends on the proper function of a company's internal accounting system and auditors' fair and independent investigation. If any of them is inadequately regulated, disclosure of more information would only be to the detriment of investors, for financial statements might contain misleading information.

Finally, any regulation, no matter how strict it is, requires a comprehensive set of enforcement rules; among these, civil liability is highly important. Traditionally, theories concerning civil liability for tort, contract, and other statutory liability have been well developed; however, such theories may not fit properly into securities cases and thus are unable to resolve the whole range of problems. For instance, in England, the courts are used to taking a conservative attitude towards the tort of negligence, and accordingly they often rule out the possibility of civil liability at the first stage of enquiry, namely, the existence of the duty of care. However, legislation has constantly expanded the scope of protection, especially in the public offer of securities in the primary market. As a result, there is a gap between the different levels of protection in the primary market and the secondary market. The thesis disagrees with such discriminatory treatment. Setting aside the legal inconsistency for a moment, there is no convincing reason even from the perspective of policy choice as to why the courts

opt for this position, it being commonly accepted that the secondary market is as important as the primary market.

A more obvious defect of English law appears in measuring damages. The rules for normal cases are that the foreseeability theory deals with the issues of breach of contract and the tort of negligence, while the direct consequences theory decides the scope of liability in intentional tort, such as deceit. Now, if these rules are applied to securities cases and identify the extent of damages, it is found that the result would conflict with the principles developed by securities cases; that is, damage is measured based on the difference between the price paid and the real value of the securities at the time of allotment of securities or transactions. It is clear that if the time for measuring damages is fixed at the time of transactions, all supervening events and specific circumstances of the plaintiff must be wholly excluded from the consideration, but if the foreseeability or direct consequences theory is followed, these events may be included in the scope of liability.

The thesis, thus, concludes that the time for calculating damages should be changed to a later stage, i.e. immediately before judgment (in Taiwan, it is generally before judgment of the court of appeal). If the new time is adopted, the contradiction between the traditional rules and the securities cases principles would be avoided. The suggested time also reflects the fact that securities prices change constantly and this risk should not be borne solely by the victim. Nonetheless, based on the characteristics of securities transactions, it is proposed that in assessing damages personal circumstances of plaintiffs should be entirely excluded from consideration and that supervening events should be ignored as much as possible by the court.

Taiwanese law, on the other hand, makes the diametrically opposite error of over emphasising the subjective aspect of damage and thus possibly over- or under-compensating the plaintiff. In other words, the defendant bears all the market risks.

Consequently, if the current time for measuring damages in Taiwanese law is retained, the courts should endeavour to distinguish misrepresentation factors from non-misrepresentation factors, and fairly distribute market risk to both parties; only in this way, will a just compensation system be established.

When civil liability is examined, the concept of damage plays a key role regarding the later discussion about the measure of damages. The thesis points out that both English and Taiwanese law lack an in-depth theoretical structure for defining the concept. The thesis tries to clarify its concept and help understand the close relationship between these two issues. The fraud on the market theory is also introduced with the aim of mitigating the difficulties stemming from the proof of reliance when civil liability is established. This is an example of a financial economic theory which may shed useful light on legal thinking.

Finally, to revert to the point mentioned at the very beginning of the introduction, namely that the topic could be researched by financial economists, accountants, and corporate finance experts, it is expected, here, that these experts in the future could provide more inspiration for legal studies. Even more, the theories of regulation, the role of competent authorities, and other enforcement methods such as criminal liability for non-compliance are all relevant subjects of the topic and are worth researching. Academics could analyse the efficacy of the enforcement methods and then propose some innovative ideas or embark on how to strengthen administrative powers in such a way as to bring the market into order. It is hoped that all these possibilities will encourage researcher to further develop the subject.

Bibliography

Abrams, Charles, "The Public Offers of Securities Regulations 1995: non-UK issuers", in *European Financial Services Law*, 2(8), 238-40, 1995.

Akerlof, George A., "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", in 84 *Quarterly J. of Economics*, 488-500, 1970.

Allen, David K., *Misrepresentation*, 1988, London, Sweet & Maxwell.

Allen & Overy, "Disclosure of Interests in Shares", in *In-House Lawyer* (IHL), 36-7, July/Aug., 1993.

Arden, M.H., "Accounting Standards Board, The True and Fair Requirement — Opinion" in *Current Accounting Law and Practice*, Robert Willott (ed.), 1988, London, Sweet & Maxwell.

Barc, Stephen and Nicholas Bowen (eds), *Tolley's Company Law*, 1993, Croydon, Tolley Publishing Company.

Barlev, Benzion, "On the Measurement of Materiality", in *Accounting and Business Research*, 194-7, Summer, 1972.

Bates, Chris, "The New UK Prospectus Rules", in *Butterworths J. of International Banking and Financial Law*, Part I, 10(7), 296-303, 1995; Part II, 10(9), 426-31, 1995.

Bates, Homer L., Robert W. Ingram and Philip M.J. Reckers, "Auditor-Client Affiliation: The Impact on 'Materiality'", in *J. of Acct.*, 60-3, April.

Beales, Howard, Richard Craswell, and Steven C. Salop, "The Efficient Regulation of Consumer Information", in 24 *J. of Law and Economics*, 491-539, 1981.

Beaver, William H., "The Nature of Mandated Disclosure", in *Economics of Corporation Law and Securities Regulation,* Richard A. Posner and Kenneth E. Scott (eds.), 1980, Boston, Little, Brown and Company.

Benston, George J., *Corporate Financial Disclosure in the UK and USA*, 1976, Farnborough, Hants, Saxon House.

Benston, George J., "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934", 63 *American Economic Review*, 133-55, 1973.

Berle, Adolf A. and Gardiner C. Means, *The Modern Corporation and Private Property*, revised ed., 1968, New York, Harcourt, Brace & World.

Besorai, Ahal, "Disclosure of Tentative Information by Listed Companies", in *The Company Lawyer*, Part I, 16(8), 236-42, Sept., 1995; Part II, 16(9), 263-70, Oct., 1995.

Bird, P., "What is 'A True and Fair View?'", in *J. of Bus. Law*, 480-5, 1984.

Bird, P., "After Argyll Foods what is 'a true and fair view'?", in *Accountancy*, 80-1, June, 1982.

Birks, Peter, *An Introduction to the Law of Restitution*, 1989, Oxford, Clarendon Press.

Bishop, William, "Negligent misrepresentation: an economic reformation", in *The Economic Approach to Law*, Paul Burrows and C.G. Veljanovski (eds.), 1981, London, Butterworths.

Blair, Michael C., *Financial Services: The New Core Rules*, 1991, London, Blackstone Press.

Bowles, Roger A., *Law and Economy*, 1982, Oxford, Martin Robertson.

Brealey, Richard A and Stewart C. Myers, *Principles of Corporate Finance*, 5th ed., 1996, New York, McGraw-Hill.

Bressand, Albert, "Wealth Creation and the Role of Financial Markets in the Early Twenty-First Century", in *Finance and the International Economy*, John Calverley and Richard O'Brien (eds.), 1987, Oxford, Oxford University Press.

Breyer, Stephen, *Regulation and its Reform*, 1982, Cambridge, Mass., Harvard University Press.

Buckley, M., G.B. Parker, and Sir Raymond Walton, *Buckley on the Companies Acts*, 1981, London, Butterworths.

Burgess, Robert, *Corporate Finance Law*, 1992, London, Sweet & Maxwell.

Burrows, Andrew, *Remedies for Tort and Breach of Contract*, 2nd ed., 1994, London, Butterworths.

Buxbaum, R. M., Marina Hertig, Alain Hirsch, and Klaus J. Hopt, *European Business Law*, 1991, Berlin, Walter de Gruyter.

Chandler, P.A., "Fraud: Damages and Opportunity Costs", in 110 *L.Q.R.*, 35-8, Jan.,1994.

Chang, Y. and W. Chen, "The Current Analyses of the Structure of Taiwanese Securities Investors" (Tang Ch'ien Wo Kuo Chêng Chüan T'ou Tzu Jên Chih Fên Hsi), in 401 *Materials on Securities Transactions (*Chêng Chüan *Tzu Liao)*, 14-23, 1995.

Chapman, Colin, *How the Stock Markets Work*, 4th ed.,1994, London, Century Business.

Cheng, Yu-po, *The General Principles of the Law of Obligations (Min Fa Chai P'ien Tsung Lun)*, 1985, Taipei, San Ming Co. Ltd.

Cheng, Yuan, *Taiwan's Legal Framework for Foreign Investment: What Can the PRC Learn from it?*, Working Paper No. 9, SOAS Law Department, University of London, March 1996, London.

Clark, Robert Charles, *Corporate Law*, 1986, Boston, Little, Brown and Company.

Coffee, John C. Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System", in 70 *Virginia L. R.*, 717-53, 1984.

Cohen, Manuel F. and George J. Stigler, *Can Regulatory Agencies Protect Consumers? Rational Debate Seminars*, 1971, American Enterprise Institute for Public Policy Research, Washington.

Cohen, Milton H., "Regulation through Disclosure" in *J. of Acct.*, 52-62, 1981.

Comany Law Monitor, 2(8), 3-4, 1994.

Commission of the EC, *A Business Guide to the Single Financial Market*, 1992, Luxembourg, Office for Official Publications of the European Communities.

Company Accounting and Disclosure, A Consultative Document (Green Paper), Cmnd. 7654, 1979, London, HMSO.

Company Law Reform, Cmnd. 5391, 1973, London, HMSO.

Consultative Committee of Accountancy Bodies, *The Making of Accounting Standards Report (Dealing Report)*, 1988, London, Institute of Chartered Accountants in England and Wales.

Cooke, John, *Law of Tort*, 2nd ed., 1995, London, Pitman.

Cornell, Bradford and R. Gregory Morgan, "Using Finance Theory to Measure Damages in Fraud on the Market Cases", in 37 *U.C.L.A. L. R.*, 883-924, 1990.

Cowan, T.K., "Are Truth and Fairness Generally Acceptable?", in *Accounting Rev.*, 788-94, Oct., 1965.

Crabb, John H., *The French Civil Code*, 1995, Deventer, Holland, Kluwer Law and Taxation.

Craig, P.P., "Sovereignty of the United Kingdom", in *Year Book of European Law 1991*, 221-55, 1992.

Cranston, R. (ed.), *The Single Market and the Law of Banking*, 2nd ed., 1995, London, Lloyd's of London Press.

Cseh-Menczer, Judith, "The Public Offers of Securities Regulations 1995", in *European Financial Services Law*, 2(6), 174-5, 1995.

D'Sa, Rose M., *European Community Law and Civil Remedies in England and Wales*, 1994, London, Sweet & Maxwell.

Dashwood, A., "The Principle of Direct Effect in European Community Law", in 16 *J. of Common Market Studies*, 229-45, 1978.

Davies, Paul L., "Directors' Fiduciary Duties and Individual Shareholders", in *Commercial Aspects of Trusts and Fiduciary Obligations*, Ewan McKendrick (ed.), 1992, Oxford, Clarendon Press.

Dennis, Roger J., "Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix", in 25 *William and Mary L. R.*, 373-419, 1984.

Department of Statistics, Ministry of Finance, The Republic of China, *Monthly Statistics of Financial*, Oct., 1991, Taipei, Ministry of Finance.

Dias, R.W.M., "Trouble on Oiled Waters: Problems of the Wagon Moung (No. 2)", in *C.L.J.*, 62-82, 1967.

Dine, Janet, "Implementation of the Acquired Rights Directive", in *Corporate Briefing*, 15(5), 143-4, 1994.

Dine, Janet, "The Harmonisation of Company Law in the European Community", in *Yearbook of European Law 1989*, 93-119, 1990.

Doyle, Louis G., "Liability for Listing Particulars, Part I" in *Law for Business*, 3[2], 70-2, 1991.

Doyle, Louis G., "Liability for Listing Particulars, Part II" in *Law for Business*, 3[3], 124-6, 1991.

DTI, *Listing Particulars and Public Offer Prospectuses, Consultative Document*, July, 1990, London, DTI.

DTI, *Accounting and Audit Requirements for Small Firms, A Consultative Document*, 1985, London, DTI.

DTI, *Financial Services in the United Kingdom, A new framework for investor protection* (generally called *the White Paper* 1985), Cmnd. 9432, 1985, London, HMSO.

Easterbrook, Frank H. and Daniel R. Fischel, *The Economic Structure of Corporate Law*, 1991, Cambridge, Mass., Harvard University Press.

Easterbrook, Frank H. and Daniel R. Fischel, "Optimal Damage in Securities Cases", in 52 *U. of Chicago L. R.*, 1985.

Eccles, George W. and Jenny Cox (eds), *Tolley's Companies Act 1981*, 1982, Croydon, Tolley Publishing Company.

Economic Daily News, *Finance and Securities Yearbook of the Republic of China 1995*, 1995, Taipei, Economic Daily News.

Evans, L. Worthington and F. Shewell Cooper, *Notes on the Companies Act 1907*, 1907, London, Sweet & Maxwell.

Fama, Eugene, "Efficient Capital Markets: A Review of Theory and Empirical Work", in 25 *J. of Fin.*, 383-417, 1970.

Fama, Eugene, "The Behavior of Stock-Market Prices", in 38 *J. of Bus.*, 34-105, 1965.

Fedders, John M. and L. Glenn Perry, "Policing Financial Disclosure Fraud: the SEC's Top Priority", in *J. of Acct.*, 58-64, July, 1984.

Financial Times Conference Organisation, *European Securities Markets in the 90s*, 1991, London, Financial Times Conference Organisation.

Finkelstein, Jared Tobin, "Rules 10b-5 Damage Computation: Application of Financial Theory to Determine Net Economic Loss", in 51 *Fordham L. R.*, 838-70, 1983.

Fischel, Daniel R., "Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities", in 38 *The Business Lawyer*, 1-20, 1982.

Folkerts-Landau, David, Takatoshi Ito, et al., *International Capital Markets Developments, Prospects, and Policy Issues*, Aug., 1995, Washington DC, International Monetary Fund.

Franks, Julian and Colin Mayer, *Risk, Regulation, and Investor Protection: The Case of Investment Management*, 1989, Oxford, Clarendon Press.

Fraser, I. and P. Mortimer-Lee, "The EC Single Market in Financial Services", in 33 *Bank England Quarterly Bulletin*, 92-7, 1993.

Frost, Carol A. and Grace Pownall, "Accounting Disclosure Practices in the United States and the United Kingdom", in *J. of Accounting Research*, 32(1), 75-102, Spring, 1994.

Furey, Nigel, *The Companies of 1989, A Practitioners' Guide*, 1990, Bristol, Jordans.

Gafford, W. Wade and D.R. Carmichael, "Materiality, Audit Risk and Sampling: A Nuts-and-Bolts Approach", in *J. of Acct.*, Part I, 109-18, Oct., 1984; Part II, 125-38, Nov., 1984

Galgano, Francisco, "The Allocation of Power and the Public Company in Europe", in *European Company Laws, A Comparative Approach*, Robert R. Drury, and Peter G. Xuereb (eds.), 1991, Aldershot, Dartmouth.

Gart, Alan, *Regulation, Deregulation, Reregulation, The Future of the Banking, Insurance, and Securities Industries*, 1994, New York, Wiley.

Gellis, Ann Judith, "Mandatory Disclosure for Municipal Securities: A Reevaluation", in 36 *Buffalo L. R.*, 15-73, 1987.

Gibbins, Michael, Alan J. Richardson and John Waterhouse, *The Management of Financial Disclosure: Theory and Perspectives,* 1992, Vancouver, Canadian Certified General Accountants' Research Foundation.

Gilson, Ronald K. and Reinier H. Kraakman, "The Mechanisms of Market Efficiency", in 70 *Virginia L. R.*, 549-644, 1984.

Gladstone report (1844 *B.P.P.*, Vol. VII).

Goodhart, C.A.E. and Arthur Seldon (ed.) *Financial Regulation — or Over-regulation?*, 1988, London, Institute of Economics Affairs.

Gordon, Jeffrey N. and Lewis A. Kornhauser, "Efficient Markets, Costly Information, and Securities Research", in 60 *N.Y.U. L. R.*, 761-849, 1985.

Gower, L.C.B., *Principles of Modern Company Law*, 5th ed., 1992, London, Sweet & Maxwell.

Gower, L.C.B., *Review of Investor Protection, Report: Part: II*, 1985, London, HMSO.

Gower, L.C.B., *Review of Investor Protection, Report: Part I,* Cmnd 9125, 1984, reprinted 1990, London, HMSO.

Gower, L.C.B., *Review of Investor Protection, A Discussion Document,* 1982, London, HMSO.

Griffin, Stephen, "Damages for Misstatements in Company Prospectuses", in *Company Lawyer*, 12(11), 209-12, 1991.

Grossman, Sanford J. and Joseph E. Stiglitz, "On the Impossibility of Informationally Efficient Markets", in 70 *American Economic R.*, 393-408, 1980.

Guest, A.G. (general ed.), *Chitty on Contracts*, 1994, London, Sweet & Maxwell.

Hansen, Jay D., "London Calling?: A Comparison of London and U.S. Stock Exchange Listing Requirement for Foreign Equity Securities", in *Duke J. of Comparative and International Law*, 197-228, Fall, 1995.

Hardcastle, Alan and Michael Renshall (eds.), *The Companies Act 1981 Handbook*, 1985, London, Institute of Chartered Accountants in England and Wales.

Hart, H. L.A. and Tony Honoré, *Causation in the Law*, 2nd ed., 1985, Oxford, Oxford University Press.

Hartley, T.C., *The Foundations of European Community Law*, 3rd ed., 1994, Oxford, Clarendon Press.

Hayek, F.A., *Law, Legislation and Liberty*, 1982, London, Routledge & Kegan Paul.

Heller, Harry, "Disclosure Requirements under Federal Securities Regulation", in *The Business Lawyer*, 300-20, 1961.

Hewitt, James O., "Developing Concepts of Materiality and Disclosure", in 32 *The Business Lawyer*, 887-956, 1977.

Hicks, Ernest L., "Materiality" in *J. of Accounting Research*, 158-71, Spring, 1964.

Hofler, Anthony, "The Company Securities — Misinformation and Litigation", in *The Company Lawyer*, 16(3), 67-71, 1995.

Holdsworth, William, *A History of English Law*, Vol. 15, 1965, London, Methuen & Co. Ltd.

Honoré, A.M., "Causation and Remoteness of Damages" in *International Encyclopedia of Comparative Law, Torts*, André Tunc (ed.), 1981, Tübingen, J.C.B. Mohr.

Horwitz, Robert Britt, *The Irony of Regulatory Reform*, 1989, Oxford, Oxford University Press.

Hsu, Jing-liang, *The Interpretation and Comments on the GAAPs (I Pan Kung Jên K'uai Chi Yüan Tsê Chih Ch'üan Shih)*, 1989, Taipei, San Ming Co. Ltd.

Jacobs, Arnold A., "The Measure of Damages in Rule 10b-5 Cases", in 65 *Georgetown L. J*, 1093-169, 1977.

Jaffe, J.F., "Special Information and Insider Trading", in 47 *J. of Bus.* 410-28, 1974.

Jaffey, A.J.E., *The Duty of Care*, 1992, Aldershot, Dartmouth.

Jenkinson, T.J., *Initial Public Offerings in the UK, USA, and Japan*, 1990, London, Centre for Economic Policy Research.

Jennings, Marianne M., Philip M. Recker, and Daniel C. Kneer, "A Source of Insecurity: A Discussion and an Empirical Examination of Standards of Disclosure and Levels of Materiality in Financial Statements", in *J. of Corporation Law*, 639-88, Spring, 1985.

Jensen, Michael C. and William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure", 3 *J. of Fin. Econ.*, 305-60, 1976.

Jordan, Robert L. and William D. Warren, "Disclosure of Finance Charges: A Rationale", 64 (2) *Michigan L. R.*, 1285-322, 1966.

Ko, Fang-chih, *The Company Law (Kung Ssu Fa Lun)*, 1987, Taipei, San Ming Co. Ltd.

Kenyon-Slade, Stephen and Mads Andenas, *The EC Financial Market Regulation and Company Law*, 1993, London, Sweet & Maxwell.

Kripke, Homer, "The Myth of the Informed Layman", *The Business Lawyer*, 631-8, 1973.

Lai, Yin-chao, *The Interpretation on the Securities and Exchange Act (Chêng Chüan Chiao I Fa Chu T'iao Shih I)*, 5th ed., 1990, Taipei, San Ming Co. Ltd.

Langevoort, Donald C., "Fraud and Insider Trading in American Securities Regulation: Its Scope and Philosophy in a Global Marketplace", in 16 *Hastings International and Comparative L.R.*, 175-87, Winter, 1993.

Large, Andrew, *Regulation for a Global Marketplace*, July, 1995, Paris, Panel on Globalisation of Risks: Cooperation Between Banking and Market Regulators, 20th Annual Conference of International Organisation of Securities Commissions.

Lasok, K.P.E. and Edmond Grace, "Fair Accounting", in *J. of Bus. Law*, 235-9, 1988.

Lawson, F.H. and B.S. Markesinis, *Tortious liability for unintentional harm in the Common law and the Civil law*, 1982, Cambridge, England, Cambridge University Press.

Leas, Philip J., "The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities", in 26 *Stanford L. R.*, 371-98, 1974.

Lee, T. A., *Materiality: A review and analysis of its reporting significance and auditing implications*, 1984, London, Auditing Practices Committee of the Consultative Committee of Accountancy Bodies.

Lee, T.A., "The Evolution and Revolution of Financial Accounting" in 9 *Accounting and Business Research,* 292-9, 1979.

Lev, Baruch, "Toward a Theory of Equitable and Efficient Accounting Policy", in 63 *Accounting Rev.*, 1-22, 1988.

Levmore, Saul, "Efficient Markets and Puzzling Intermediaries", in 70 *Virginia L. R.*, 645-67, 1984.

Lin, Yung-jung, *The New Annotation of Commercial Law (Shang Shih Fa Hsin Ch'üan)*, 4th ed., 1990, Taipei, Wu Nan Co. Ltd.

Llewellyn, David T., "A Competition and the Regulatory Mix", in *National Westminster Bank Quarterly R.*, 4-13, Aug., 1987.

Lomnicka, Eva, "The Internal Financial Market and Investment Services", in *EC Financial Market Regulation and Company Law*, S. Kenyon-Slade and M. Andenas (eds.), 1993, London, Sweet & Maxwell.

Lomnicka, Eva, "Private Damages Claims for Breaches of Securities Regulation Law: the U.S. and U.K. Approaches", in *Legal History and Comparative Law: Essays in honour of Albert Kiralfy*, Richard Plender (ed.), 1990, London, Frank Cass & Co. Ltd.

Lomnicka, Eva and J.L. Powell, *Encyclopedia of Financial Services Law*, 1987, London, Sweet & Maxwell.

Loss, Louis and Joel Seligman, *Securities Regulation*, 3rd. ed., 1993, Boston, Little, Brown and Company.

Loss, Louis, *Fundamentals of Securities Regulation*, 1988, Boston, Little, Brown and Company.

Loss, Louis, "The fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States", in 33 *M. L. R.*, 34-52, 1970.

Macey, Jonathan R., Geoffrey P. Miller, Mark L. Mitchell, and Jeffry M. Netter, "Lessons from Financial Economics: Materiality, Reliance, and extending the Reach of Basic v. Levinson", in 77 *Virginia L. R.*, 1017-49, 1991.

Macey, Jonathan R. and Geoffrey P. Miller, "Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory", in 42 *Stanford L. R.*, 1059-92, 1990.

Macey, Jonathan R., *An Introduction to Modern Financial Theory*, 1991, Santa Monica, CA, The American College of Trust and Estate Counsel Foundation.

MacKie-Mason, Jeffrey K., "Do Firms Care Who Provides Their Financing", in *Asymmetric Information, Corporate Finance and Investment*, R. Glenn Hubbard (ed.), 1990, London, University of Chicago Press.

Magnus, S.W. and M. Estrin, *The Companies Act 1967*, 1967, London, Butterworths.

Mahoney, Paul G., "Precaution costs and the Law of Fraud in Impersonal Markets" in 78 *Virginia L. R.*, 623-70, 1992.

Mandelbrot, Benoit, "Forecasts of Future Prices, Unbiased Markets, and "Martingale" Models", in 39 *J. of Bus.*, 242-55, 1966.

Markesinis, B.S. and S.F. Deakin, *Tort Law*, 3rd ed., 1994, Oxford, Oxford University Press.

Maw, Nigel G. and Michael Craig-Cooper, *Maw on Corporate Governance*, 1994, Aldershot, Dartmouth.

McBarent, Doreen and Christopher Whelan, "International Corporate Finance and the Challenge of Creative Compliance", in *The Internationalisation of Capital Market and the Regulatory Response*, John Fingleton (ed.), 1992, London, Graham & Trotman.

McDonnell, D.L. and J. G. Monroe, *Kerr on the Law of Fraud and Mistake*, 1952, reprinted 1986, London, Sweet and Maxwell.

McGee, Andrew, "The 'True and Fair View' Debate: A Study in the Legal Regulation of Accounting" in 54 *M.L.R.*, 874-88, 1991.

McGregor, Harvey, *McGregor on Damages*, 15th ed., 1988, London, Sweet & Maxwell.

McMonniew, N. Peter, *The Companies Act 1981, a practical guide*, 1982, London, Oyez Publishing Ltd.

McRae, Hamish and Frances Cairncross, *Capital City*, 1991, London, Methuen.

Mercer, Colin, "Disclosure of Interests in Shares: Implementation of EC Major Shareholdings Directive", in *Corporate Briefing*, 7(9), 228-31, 1993.

Mercer, Colin, "Disclosure of Price Sensitive Information: Guidance from the Stock Exchange" in *Corporate Briefing*, 8(2), 2-5, 1993.

Miller, Merton H., "Debt and Taxes", in 32 *J. of Finance*, 261-75, 1977.

Mitchell, Philip L.R., *Insider Dealing and Directors' Duties*, 2nd ed., 1989, London, Butterworths.

Morgan, E. Victor and W.A. Thomas, *The Stock Exchange: Its History and Function*, 1969, London, Elek.

Morris, Simon, *Financial Services: Regulating Investment Business*, 2nd ed., 1995, London, FT Law & Tax.

Morton, Walter A., "Institutional Aspects of Savings and Investment: The Structure of the Capital Market and the Price of Money", in 44 *American Economic R.*, 440-54, 1954.

Mullaney, Thomas J., "Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability", in 46 *Fordham L. R.*, 277-94, 1977.

Mullany, Nicholas J., "Common Sense Causation — an Australian View", in 120 *O.J.L.S.*, 431-9, 1992.

Neate, F.W., *The Developing Global Securities Market*, 1987, London, Graham & Trotman and International Bar Association.

Nicolaides, Phedon, "Globalisation of Services and Developing Countries", in *International Economics and Financial Markets*, Richard O'Brien and Tapan Datta (eds.), 1989, Oxford, Oxford University Press.

Norton, Joseph J., "Foreign Listings on U.S. Securities Exchanges", in *Z.B.B.*, 366-75, 1994.

Note, "Civil Liability for Misstatements Filed under Securities Act and Securities Exchange Act", in 44 *Yale L. J.*, 456-77, 1935.

Note, "Disclosure as a Legislative Device", in 76 *Harvard L. R.*, Vol. 2, 1273-93, 1963.

Note, "Fraud-on-the-Market Theory", in 95 *Harvard L. R.*, 1143-61,1982.

Page, A.C. and R.B. Ferguson, *Investor Protection*, 1992, London, Weidenfeld and Nicolson.

Parker, R.H. and C.W. Nobes, *An International View of True and Fair Accounting*, 1994, London, Routledge.

Parliament Debate, Commons, Vol. 89, 1986, UK.

Parliament Debate, Lords, Vol. 478, 1985-86, UK.

Penman, Stephen H., "Insider Trading and the Dissemination of Firms' Forecase Information", in 55 *J. of Bus.* 479-503, 1979.

Pennington, Robert R., *The Law of Investment Markets*, 1990, Oxford, Blackwell.

Pennington, Robert R., *The Companies Acts 1980 and 1981*, 1983, London, Butterworths.

Popoff, B.,"Some Conceptualizing on the True and Fair View", in *International J. of Accounting*, 43-54, Fall, 1983.

Posner, Richard A., *Economic Analysis of Law*, 4th ed., 1992, London, Little, Brown and Company.

Posner, Richard A., "The Legal Rights of Creditors of Affiliated Corporations: An Economic Approach", in 43 *U. of Chicago L. R.*, 1976.

Prentice, D.D. and P.R.J. Holland (eds), *Contemporary Issues in Corporate Governance*, 1993, Oxford, Clarendon Press.

Prentice, D.D., "Directors, Creditors, and Shareholders" in *Commercial Aspects of Trusts and Fiduciary Obligations*, Ewan McKendrick (ed.), 1992, Oxford, Clarendon Press.

Prentice, D.D., *EEC Directives on Company Law and Financial Markets*, 1991, Oxford, Clarendon Press.

Prentice, D.D., "Creditor's Interests and Director's Duties", in 10 *O.J.L.S.*, 265-77, 1990.

Report of a Group of Experts appointed by the EEC Commission, *The Development of a European Capital Market,* 1966, Luxembourg, Office for Official Publications of the European Communities.

Report on Issues Raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions, Oct., 1994, Technical Committee of the International Organisation of Securities Commissions.

Richards, Hesketh, "What is EC Corporate Law?" in *Corporate Law, The European Dimension*, based on papers given at the Bar European Group Conference, Edinburgh 1991, in conjunction with the Scottish Lawyers European Group and Faculty of Advocates, 1991, London, Butterworths.

Rider, Barry Alexander K., Charles Abrams and Eilis Ferran, *Guide to the Financial Services Act 1986*, 2nd ed., 1989, Bicester, CCH Editions.

Roberts, Richard Y. and Kurt R. Hohl, "Environmental Liability Disclosure and Staff Accounting Bulletin No. 92", in 50 *The Business Lawyer*, 1-17, 1994.

Rockley, L.E., *A Policy for Disclosure*, 1980, London, Associated Business Press.

Rudden, Bernard, "Disclosure in Insurance: The Changing Scene", in *Lectures on the Common Law*, Vol. 3, 1-13, 1991, Deventer, Kluwer Law and Taxation Publishers.

Saari, Christopher P., "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry" in 29 *Stanford L. R.*, 1031-76, 1977.

Schutle, David J., "The Debatable Case for Securities Disclosure Regulation", 13 *J. of Corporation Law*, 535-48, 1988.

Sealy, Leonard, *Cases and Materials in Company Law*, 6th ed., 1996, London, Butterworths.

Sealy, Leonard, "The Disclosure Philosophy and Company Law Reform", in 2 *The Company Lawyer*, 51-6, 1981.

SEC, Ministry of Finance, R.O.C., *1989 SEC Statistics*, Taipei, Ministry of Finance.

SEC, Ministry of Finance, R.O.C., *1991 SEC Statistics*, Taipei, Ministry of Finance.

SEC (R.O.C.), *The Introduction to the Securities and Exchange Commission*, 1991, Taipei, SEC.

SEC (R.O.C.), *The Review and Prospect of the Securities Administration*, 1991, Taipei, SEC.

Securities Management (Jeng Juan Goan Li), 13(4), 1995, Taipei.

Sedgwick, Robert, *The Changing Structure of the UK Financial System*, 1990, Harlow, Longman.

Seligman, Joel, "The Historical Need for a Mandatory Corporate Disclosure System", in 9 *J. of Corporation Law*, 1-61, No. 1, Fall, 1983.

Semkow, Brian Wallace, *Taiwan's Capital Market Reform*, 1994, Oxford, Clarendon Press.

Shih, Chi-yang, *General Principles of the Civil Code (Min Fa Tsung T'sê)*, 1983, Taipei, San Ming Co. Ltd.

SIB, *Regulation of the United Kingdom Equity Markets, Discussion Paper*, Feb., 1994, London, SIB.

SIB, *Regulation of the United Kingdom Equity Markets, Report*, June, 1995, London, SIB.

Slaughter and May, "The Companies Act 1989", in *Corporate Brief*, 4(2), 32-5, 1990.

Spry, I.C.F., *The Principles of Equitable Remedies*, 4th ed., 1990, UK, Sweet & Maxwell.

Stanton, K.M., *The Modern Law of Tort*, 1994, London, Sweet & Maxwell.

Stedman, Graham, *Takeovers*, 1993, London, Longman.

Steil, Benn, Erik Berglöf, et al., *The European Equity Markets: The State of the Union and an Agenda for the Millennium*, 1996, London, Royal Institute of International Affairs (RIIA).

Steinberg, Marc I. and Daryl L. Lansdale, Jr., "Regulations S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market", in 29 *The International Lawyer*, 43-63, No. 1, Spring, 1995.

Steiner, J., "Direct Applicability in EC Law — A Chameleon Concept", in 98 *L. Q. R.*, 229-48, 1982.

Stephen, Frank H., *The Economics of the Law*, 1988, Brighton, Wheatsheaf.

Stevenson, Russell B., Jr., *Corporations and Information: Secrecy, Access, and Disclosure*, 1980, Baltimore, Johns Hopkins University Press.

Stigler, George, "Public Regulation of the Securities Market", in 37 *J. of Bus.*, 117-42, 1964.

Stonham, Paul, *Global Stock Market Reforms*, 1987, Aldershot, Gower.

Swinson, Christopher, *A Guide to the Companies Act 1989*, 1990, London, Butterworths.

The Accountant's Manual, 1990, London, Institute of Chartered Accountants in association with the Centre for Professional Development.

The Cohen Report, Cmnd. 6659, 1945, London, HMSO.

The Jenkins Report, Cmnd. 1749, 1962, London, HMSO.

The White Paper of 1985 (Completing the Internal Market), COM (85)310, 14.6.1985.

Thomas, C. William, "Materiality guidance for auditors", in *J. of Acct.*, 74-7, Feb. 1979.

Trade and Industry Committee, House of Commons, *Takeovers and Mergers, Minutes of Evidence*, 1991, London, HMSO.

Trade and Industry Committee, House of Commons, *Takeovers and Mergers, First Report*, 27 Nov. 1991, London, HMSO.

Treitel, G.H., Law *of Contract*, 9th ed., 1995, London, Sweet & Maxwell.

Triantis, George G., "Secured Debt under Conditions of Imperfect Information", 21 *J. of Legal Studies*, 225-58, 1992.

Tseng, Shih-hsiong, *The Principles on Damages (Sun Hai P'ei Ch'ang Fa Yüan Li)*, 1986 (reprinted), Taipei, San Ming Co. Ltd.

Turner, A. Kingcome and R. John Sutton, *The Law Relating to Actionable Non-Disclosure and Other Breaches of Duty in Relations of Confidence, Influence and Advantage*, 2nd ed., 1990, London, Butterworths.

Tweedie, D. and J. Kellas, "Setting the Accountants' Record Straight", in *Accountancy*, 19-20, Jan., 1988.

United Nations, *Trade and Development Report*, 1990, Report by the secretariat of the United Nations Conference on Trade and Development.

Upex, Robert, *Davies on Contract*, 6th ed., 1991, London, Sweet & Maxwell.

Vagts, Detlev F., *Materials on Basic Corporation Law*, 3rd ed., 1989, New York, Foundation Press.

Varian, Hal R., *Intermediate Microeconomics: A Modern Approach*, 2nd ed., 1992, London, W.W. Norton.

Veljanovski, C.G. *The New Law-and-Economics*, 1982, Oxford, Centre for Social-Legal Studies.

Waddams, S.M., *The Law of Damages*, 2nd., 1991, Toronto, Canada Law Book.

Wai, U Tun, *Economic Essays on Developing Countries*, 1980, Alphen ann den Rijn, Sijithoff and Noordhoff.

Walton, P., "Introduction: the True and Fair View in British Accounting", in *European Accounting R.*, 49-58, May, 1993.

Ward, Bart H., "An Investigation of the Materiality Construct in Auditing", in *J. of Accounting Research*, 138-52, Spring, 1976.

Warren, Carl. S., "Audit Risk", in *J. of Acct.*, 66-74, Aug. 1979.

Whitford, William C., "The Functions of Disclosure Regulation in Consumer Transactions", *Wisconsin L. R.*, 400-70, 1973.

Wu, Ming-hsien, "The Co-existence of Deceit and Tort" (Cha Ch'i Hsing Wei Yü Ch'in Chi'ün Hsing Wei Ping Ts'un), in *The Law Monthly*, 47(3), 147-9, 1995.

Wyatt, D. and A. Dashwood, *European Community Law*, 3rd ed., 1993, London, Sweet and Maxwell.

Yu, Hsueh-ming, *The Securities+ Administration (Chêng Chüan Kuan Li)*, revised ed., 1983, Taipei, Cheng Chung Book Company.

Zuber, George R., Robert K. Elliott, William R. Kinney, Jr., and James J. Leisenring, "Using Materiality in Audit Planning" in *J. of Acc*t., 42-54, March, 1983.

Zweigert, Konrad and Hein Kötz, *An Introduction to Comparative Law*, 2nd ed., 1992, Oxford, Clarendon Press.

Chen, Shu, "Ju Ho Ts'u Shih Fa Hsin Kung Ssu Yu Hsiao Chien Li Nei Pu K'ung Chih Chih Tu", in *Securities Administration (Chêng Chüng Kuan Li)*, 2(2), 41-5, 1984.

Chen, Chun-shan, *The Securities and Exchange Law (Chêng Chüng Chiao Yi Fa Lun)*, 2nd ed., 1991, Taipei, Wu Nan Co. Ltd.

Chen, Sung-hsing, *The Revolution of Information Disclosure in Securities Markets (Chêng Chüng Shih Ch'ang Tzu Hsin Kung Kai T'i Hsi Ko Ming)*, 1990, Taipei, Shih Yung Shui Wu Publisher.

Cheng, James, *Doing Business in Taiwan*, 1986, Taipei, Taiwan Investment & Business Consultants, Inc.

Chiu, Ching-po, "The Development of Foreign Investment in Taiwan Capital Markets" (Wo Kuo Tzu Pên Shih Ch'ang Kai Fang Wai Jên T'ou Tzu Chih T'ou Tung Kuo Ch'êng), in 252 *TSE Monthly Review (Chêng Chiao Tzu Liao)*, 1-4, 1983.

Chu, Huai-tsu, "Information Disclosure and Protection of Investment" (Tzu Hsin Kung Kai Yü Pao Chang T'ou Tzu), in *Securities Administration (Chêng Chüng Kuan Li)*, 5(1), 25-6, 1987.

Cosway, Richard, Herbert H.P Ma, and Warren L. Shattuck (eds.), *Trade and Investment in Taiwan: The Legal and Economic Environment in the Republic of China*, 1973, R.O.C., China Council on Sino-American Cooperation in the Humanities and Social Sciences Academia Sinica.

Hsia, Chu-hui, "The Substantive Meaning the Means of Financial Disclosure" (Ts'ai Wu Kung Kai Tê Shih Chih Yi Yi Yü Tu Ch'in), in *Securities Administration (Chêng Chüng Kuan Li)*, 2(5), 20-2, 1984.

Hsu, Cheng, "Ch'i Yeh Nei Pu K'ung Chih Chih Tu Chih Han Yi", in *Securities Administration (Chêng Chüng Kuan Li)*, 2(2), 37-40, 1984.

Jao, Ku-huai, "The Way to Fully Make Use of Market Function" (Ju Ho Ch'ung Fên Fa Hui Chêng Chüng Shih Ch'ang Kung Nêng), in *Securities Administration (Chêng Chüng Kuan Li)*, 4(4), 15-8, 1986.

Jao, Ku-huai, "The Future Development of Taiwan Securities Markets" (Wo Kuo Chêng Chüng Shih Ch'ang Wei Lai Chih Chan Wang), in *Securities Administration (Chêng Chüng Kuan Li)*, 3(6), 9-14, 1985.

Lai, Yuan-ho, "Chêng Chüng Fa Hsin Shih Ch'ang Tê Kuan Li", in 315 *TSE Monthly Review (Chêng Chiao Tzu Liao)*, 1-4, 1988.

Lai, Yuan-ho, "A Discussion on Wan Yi Case" (Wan Yi Kung Ssu An P'ing Yi), in *Securities Administration (Chêng Chüng Kuan Li)*, 2(4), 43-52, 1984.

Lin, Jih-feng, "Several Suggestions in Relation to Full Disclosure" (Tsai Ch'ung Fên Chieh Lou Shang Pi Hsü K'ao Lü Tê Chi Hsiang Chien Yi), in *Securities Administration (Chêng Chüng Kuan Li)*, 2(4), 17-8, 1984.

Lin, Chiung-kuei, "The Main Problems in Relation to Information Disclosure System in Securities Markets" (Chêng Chüng Shih Ch'ang Tzu Hsin Kung Kai T'i Hsi Tê Chu Yao Yen Chiu Wên T'i), in *Securities Administration (Chêng Chüng Kuan Li)*, Part I, 7(5), 2-8, 1989; Part II, 7(6), 2-7, 1989.

Lin, Kuo-chuan, "A Discussion on Article 157-1 of the Securities and Exchange Law" (Chêng Chiao Fa Ti 157-1 Tiao Nei Pu Jên Chiao Yi Ching Chih Kuei Ting Chih T'an T'ao), in 45 *Chengchi Law Review*, 259-303, 1992.

Lu, Tung-yin, "The Advantages and Disadvantages of the Systems of Approval and Effective Registration" (Ho Chun Chih Tu Yü Shên Pao Chih Tu Chih Li Pi), in *Securities Administration (Chêng Chüng Kuan Li)*, 4(1), 27-30, 1986.

Su, Sung-chin, "The Mixture of the Systems of Approval and Effective Registration" (Mu Chi Yü Fa Hsing Yu Chia Chêng Chüng Chien Ts'an Shên Ho Chih Yü Shê Pao Chih), in *Securities Administration (Chêng Chüng Kuan Li)*, 6(2), 20-4, 1988.

The Seminar on Financial Disclosure (Ts'ai Wu Kung Kai Tso T'an Hui Chi Yao), in *Securities Administration (Chêng Chüng Kuan Li)*, 1(5), 12-26, 1983.

Wu, Tang-chieh, "The Establishment of the System of Financial Forecast Disclosure" (Lun Ts'ai Wu Yü Ts'ê Kung Kai T'i Hsi Chih Chien Li), in *Securities Administration (Chêng Chüng Kuan Li)*, 5(2), 24-32, 1987.

Wu, Ko-chang, "Chi Chung Chiao Yi Shih Ch'ang Pu Fa Ch'ao Tso Chi Nei Hsien Chaio Yi An Chien Ch'a Ho Yeh Wu Chih T'an T'ao", in 408 *TSE Monthly Review (Chêng Chiao Tzu Liao)*, 4-17, 1996.

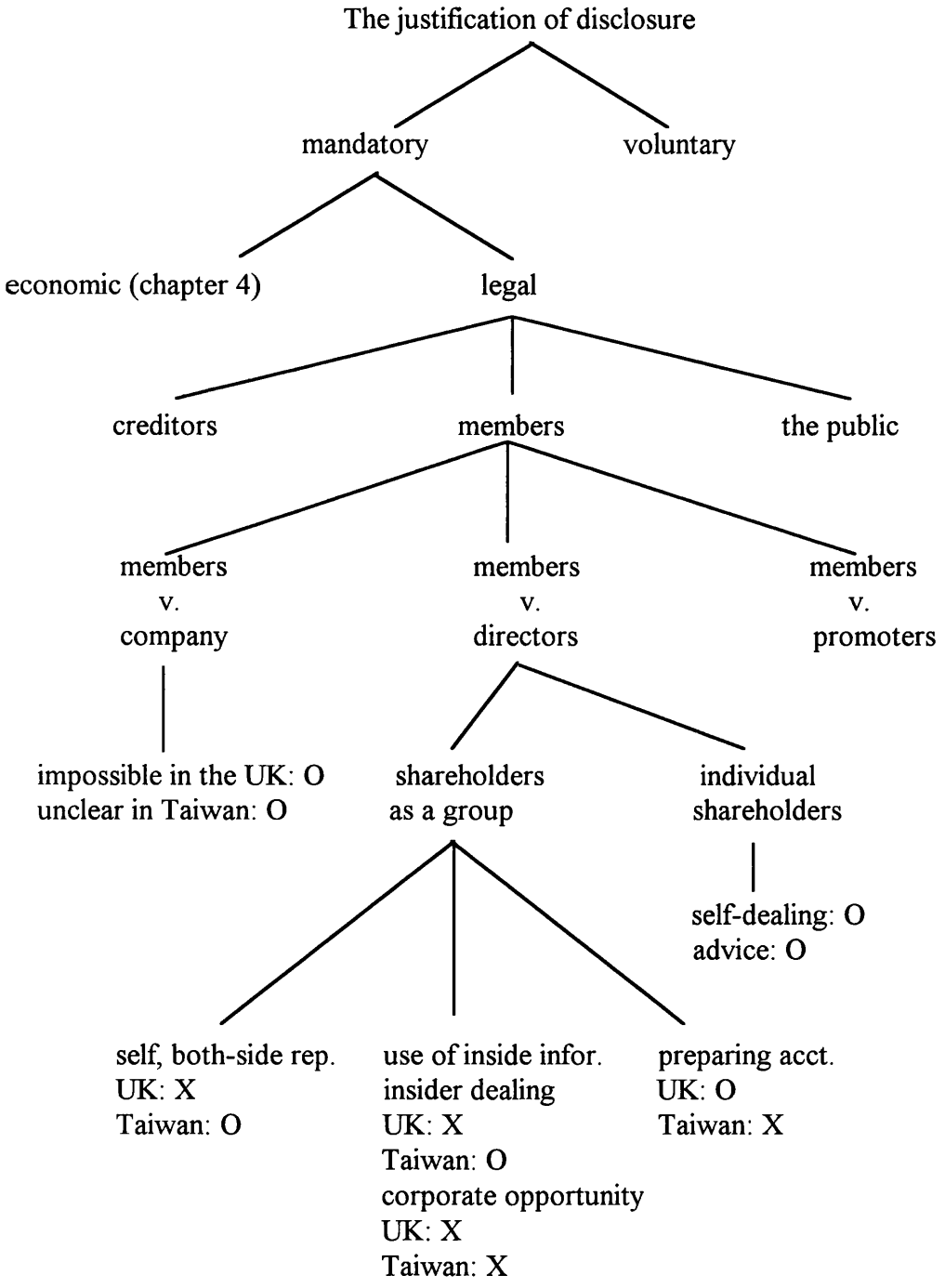
Yang, Kuan-hua, "Chi Kou T'ou Tzu Jên Yü Kung Ssu Kuan Li", in 1992 & 1993 Nien Tu Fa Lü Hsüeh Mên Chuan T'i Chi Hua Yen Chiu Ch'êng Kuo Fa Piao Hui Hui Yi Lun Wên Chi Yao, 227-52, 1995, Taipei.

Yin, Nai-ping, "The Way to Establish Investors' Confidence in Securities Market" (Ju Ho Chien Li Chêng Chüng Shih Ch'ang T'ou Tzu Chê Tê Hsin Hsing), in *Securities Administration (Chêng Chüng Kuan Li)*, 3(4), 10-3, 1985.

Yu, Hsueh-ming, *The Securities and Exchange Law (Chêng Chüng Chiao Yi Fa)*, 1988, Taipei, Chêng Chüng Shih Ch'ang Fa Chang Chi Chin Hui (R.O.C.).

Yu, Hsueh-ming, "The Market Confidence" (Chêng Chüng Shih Ch'ang Tê Hsin Li Chien Shê), in *Securities Administration (Chêng Chüng Kuan Li)*, 1(3), 50-2, 1983.

Appendix



O: denoting the need for mandatory disclosure
X: denoting sufficient disclosure under the general law, and no need for mandatory disclosure