

ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES
SCHOOL OF LAW



**Regulation of Initial Public Offering of Shares in Ethiopia: Critical Issues and
Challenges**

By: Tikikile Kumulachew

January, 2011

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Challenges**

**A Thesis submitted to Addis Ababa University, the school of Graduate
Studies, School of Law in Partial fulfillment of the Requirements for the
Degree of Master of Laws (LL.M) in Business Law**

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January, 2011

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Declaration

I, the undersigned, declare that this thesis is my original work, has not been presented for a degree in any other University and that all sources of materials used have been appropriately acknowledged.

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Signature _____

Addis Ababa University

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ACKNOWLEDGEMENT

First and for most, I would like to praise the almighty God for giving me all the strength and hope to accomplish my post graduate studies.

I am very thankful to my advisor Ato Tadesse Lencho for his patience in going through the draft of this paper and insightful comments, his effort, unreserved encouragement, professional and technical guidance he offered me during my tenure in the study of this research paper.

I would also like to express my deep gratitude Ato Eshetu Erena, Zerai G/wold, Anteneh Mengistu, Nuredin Muhamed and H/Eyesus Nigatu for their cooperation in conducting interviews and providing materials that help me a lot to accomplish the paper.

I deeply appreciate the support of my brothers and friends Amare Abawa, Desalew, Muluken, Fitsum, Dawit, Engineer Eyasu, and Abebe.

The last but by no means the least special thanks to my friends Nega Mirete and Nabia Berhane for their unreserved support not only to the paper but also to my whole time in Addis Ababa University.

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Acronyms

APRA	Australian Prudential Regulation Authority
CSFI	Center for the Study of Financial Innovation
DNB	De Nederlandsche Bank
FD	Full Disclosure
FSA	Financial Service Authority
ICSA	International Council of Securities Associations
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
ISO	International Organization for Standardization
NASD	National Association of Securities Dealers
OECD	Organization for Economic Cooperation and Development
OTC	Over- The-Counter
SEC	Securities and Exchange Commission
SRO	Self Regulatory Organization
UK	United Kingdom
US	United States of America
WB	World Bank

Abstract

An IPO (Initial Public Offering of Shares) is offering stock to the public on an open market for the first time. The IPO is the process in which a company first offers its shares to the public and becomes a publicly traded company. The reason for the regulation of public offering is that members of the public who are subscribed shares in a company are entitled to full disclosure to the nature of what is on that offer before they make a financial commitment, and to provide them with effective remedies to redress any loss incurred as a result of failure on the part of the company to make complete or accurate disclosure.

The paper investigates the issues and challenges in relation to the regulation of initial public offering of shares in Ethiopia. Issues like approval of public offering; regulation of prospectus content, form and distribution; the publication and advertisements of the offer; the market conducts of the participants and their civil and criminal liability as well as the issues associated with the regulatory framework of the securities market are analysed.

The findings of the research show that there are inadequate legal and institutional frameworks to regulate the public offering of shares in Ethiopia. Poor approval of public offering, prospectus regulation, and insufficient registration of intermediaries and regulation of their market conducts and lack of public and self regulatory institutions characterize the process of public offering. Laws governing civil liabilities for misconducts in public offering of shares are flawed in multifarious ways with weaknesses such as ambiguities and short comings in proscribing acts and omissions which entail liability, identifying potentially liable persons, high burden of proof, and problems in enforcement.

Key words: Regulation, Public Offering of shares, issuers liabilities, Regulatory framework, and self regulation

Chapter One

Introduction

1.1. Background of the study

An IPO (Initial Public Offering of Shares) is offering stock to the public on an open market for the first time. The IPO is the process in which a company or a company under formation first offers its shares to the public and becomes a publicly traded company. Raising capital through IPOs plays an important role in corporate finance and enables economic growth.¹

Nowadays, Ethiopia is witnessing the boom of companies which are offering shares for public subscription. After the fall of 'Derg' the existing regime has adopted a free market economy where private investors are expected to play a vital role in the economy. Within the realm of free market economy IPOs as a tool to finance companies has been employed by the public. On the one hand, the boom of capital pulling through equity financing has been undertaken to finance corporations by luring the public to subscribe to the shares. Salivating to the advertised expected profits of the business, thousands of investors are subscribing to these incorporating companies.

On the other hand, securities are complex investment instruments that differ significantly from other things that are traded in commerce to the extent that securities are intangible and are neither produced nor consumed. So in large part because of their nature securities and the securities market have been particularly susceptible to fraud and manipulations. As a result those investors subscribing to the shares are beginning to worry and question about the entire legal system as to whether a proper mechanism is in place to protect their interest in case the promoters deceive and manipulate them, or mismanage the company.

On top of that, the existing legal and regulatory framework does not address the intricate and particular nature of securities market as well as cannot satisfactorily answer the

¹ Ganor, M., "Manipulative Behavior in Auction IPOs", available at, <http://heinonline.org>, visited on Mon May 10 06:38:51 2010

question and worry of investors. In as much as , it is palpable, well developed and efficient security market fuels economic growth, failure to address the problems associated with it highly affects the economy and discourages investors to actively participate in the investment. In general unlike other countries, Ethiopia doesn't have a particular operational and regulatory framework to regulate securities market.

Especially Initial Public Offering of Shares is a complex process that needs extensive regulation. The principles regarding securities market requires that full and fair disclosure in connection with public offering of shares should be made. In some countries a due diligence report is required as to the nature and prospectus of the offer whether the offer is worthy of distribution to the public.²

Mandatory disclosure duties reduce the cost of searching for information and the risk involved in detecting price value deviations.³ The more information that is disclosed, the lower the risks associated with both insider trading and estimating the fundamental value of the firm.⁴ Market manipulation, which also violates the principles of full, true and plain disclosure as well as the principle that all investors must share equally in the risk and the opportunity, occurs when traders intentionally cause the trading price of shares to take place at a price which is not reflective of fair market value and the securities offered. In a market manipulation, investors are deceived or defrauded by those who artificially distort the value of the offering. It is usually brought about by a combination of false information and deceptive trading activity.⁵

Insider trading is also one area where investors have a concern. Trading on the insider information that is information which is not disclosed to the public violates the principle of full, true and plain disclosure, as well as the principle that all investors must share equally in the risk and opportunity. Another area for the concern of the investors is the conduct of the securities industry or businesses. The securities dealers, brokers,

² International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*: (May 2003), p. 5

³ Ibid

⁴ Ibid

⁵ Ibid

investment advisors, auditing firms, lawyers, and others aren't sufficiently regulated. Hence the public investor lacks confidence to participate in the public offering process.

The securities market sector is regulated for the protection of individual investors (investor protection regulation) and to maintain the stability of the financial system as a whole, which is also called prudential regulation.⁶ Regulation of the agents who control securities industries performs both an investor protection and a prudential function, i.e., supervising those who run financial firms should help protect investors from being defrauded or otherwise damaged by the failings of those to whom they have entrusted their capital; and it should also help to filter out those would seek to use their controlling position to operate their business in a way that would threaten the soundness of the industry.⁷ Besides the establishment of regulatory frameworks, i.e. Public Authority or Self Regulatory Organizations are also areas of priority that the experiences of other countries reveal.

1.2. Statement of the Problem

1.2.1. General Problem

As can be observed in other countries, Initial Public offering of shares is a complex process subject to extensive legal requirements. However in Ethiopia, even though initial public offering shares to the public has been undertaken to finance investment, there is no sufficient legal regime as well as organizational structure to regulate the market. The absence adequate regulation of public offering of shares will adversely affect the interests of the investing public and the efficiency of the securities market which ultimately hinders the growth of the economy as a whole. So the paper studies the legal and regulatory problems associated with the initial public offering of shares in Ethiopia.

1.2.2. Specific Problem

The specific problems that the research is trying to address are the following;

⁶ Goodhart, C., Ferra, E., *Regulating Financial Services and Markets in the Twenty First Century: An Overview*, Published in North America (US and Canada) by Hart Publishing, 2001), p. 23

⁷ Ibid

1. Prospectuses Regulation i.e. the problem of content and disclosure of material information, due diligence report from issuers and other experts, and regulation of the distribution of the prospectuses and dissemination of information;
2. The problems associated with regulating the intermediaries like; underwriters, if any, brokers, dealers, auditors, investment and legal advisors;
3. The problems of market misconducts like the misstatement and omission of material facts, selective disclosure and insider trading, market manipulation, and fraud.
4. The problem of regulatory framework both as public authority and self-regulatory institutions; and
5. The problems associated with remedies whenever violation of rules occurs are the issues that the research will attempt to address.

1.3. Research Questions

The questions that the research is going to answer are the following:

1. Does the legal regime effectively regulate the content and disclosure of prospectuses, distribution of prospectuses, dissemination of information, and due diligence report?
2. Are intermediaries like underwriters, auditors, brokers, legal advisors, dealers, and investment advisors sufficiently regulated?
3. Does the law regulate market misconducts like misstatement and omission of material facts, selective disclosure and insider trading, market manipulation, and fraud?
4. Are public authority and self-regulatory organizations established to regulate the Initial Public Offering of shares?
5. Are there sufficient remedies available to the investors and other intermediaries in case the law is violated and issuers don't act properly?

1.4. Objective of the Research

The general objective of the study is to analyze the operational and regulatory framework of the Ethiopian legal regime in regulating Initial Public Offering of shares in Ethiopia.

The specific objectives of the research are:

1. To critically examine the regulation of prospectuses rule in connection with content and disclosure, due diligence report, distribution of the prospectuses and dissemination of information.
2. To analyze the regulation of intermediaries like underwriters, if any, auditors, brokers, dealers, investment advisors, legal advisors, and the like;
3. To investigate whether the existing legal system regulates misstatement and omission of material facts, selective disclosure and insider trading;
4. To identify and analyze whether the country sets up regulatory framework and institutions to regulate the Initial Public Offering of shares; and
5. To explore whether the existing legal remedies are sufficient to achieve the goals of initial public offering of shares.

1.5. Scope of the Research

The research basically limits itself to the regulation of Initial Public offering of shares in Ethiopia. The issues raised in the research are those which are directly related to the regulation of initial public offering of shares. The operational and regulatory framework and market infrastructures which are directly related to IPOs will be addressed in by research. The research tries to incorporate the practice of companies going public and the experiences of participants in connection to the initial public offering process. Even if the interviews and discussions with the concerned parties mainly focus on Addis Ababa, the situation of the public offering process out side of the metropolis will also be considered whenever necessary.

1.6. Significance of the Research

In general the research has paramount importance to understand the principles and practices of Initial Public offering of shares in Ethiopia. The research will be an input for

the legislature to enact appropriate securities law and consolidate the regulation and supervision of securities market, initiates further research, helps students and instructors in teaching and learning process, and creates awareness to the issuers, investors and other securities market intermediaries about the problems of initial public offering of shares in Ethiopia.

1.7. Methodology

The research mainly depends on field research, interviews, and discussions. In addition, the experiences and legal documents of other countries, library work and literature review will be employed. The existing legal documents of the country will also be analyzed. Interview of concerned bodies and market participants will be made from Addis Ababa and regional cities.

1.8. Limitation of the Research

Absence of prior researches in relation to securities market regulation in the country limits the research not to deal with specific issues of public offering of shares. Besides shortage of materials on the topic along with the unfamiliarity of most of the issues of the initial public offering of shares will also be a challenge to the research. The inaccessibility of promoters and founders for interview and weak information registration of the public offices will be another limitation to the research.

The paper contains five chapters. The second chapter discusses the basic concepts and practices in relation to the regulation of public offering of shares. The conceptual underpinnings of securities, securities market, securities regulation, the goals of securities regulation, and the process of initial public offering of shares will be discussed. The third chapter elucidates the regulatory framework and instruments of securities regulation. The fourth chapter concerned with the issues and challenges of the initial public offering of shares in Ethiopia. The significance of the regulation of securities market, the issues of approval of public offering, disclosure rule, market misconducts of the participants of securities market, and their liability as well as the regulatory framework will be addressed. The last chapter dwells itself to the conclusion and possible recommendations of the paper.

Chapter Two

Conceptual Underpinnings of Regulation of Initial Public Offering of Shares

2.1. The Concept of Securities, Securities Market and Securities Regulation

2.1.1. Understanding Securities

The dictionary defines securities as “(a) document held by a creditor as a guarantee of his right to payment. Hence any particular kind of stock, shares or other form of investment guaranteed by such documents.”⁸ The USA Federal Securities Act of 1933 broadly defines security as including notes, stocks, treasury stocks, bonds, debentures, certificates of interest or participation in profit-sharing agreements, collateral-trust certificates, preorganization certificates or subscriptions, transferable shares, investment contracts, voting-trust certificates, certificates of deposit for a security, and a fractional undivided interest in gas, oil, or other mineral rights.⁹

The absence of any specific securities law in Ethiopia makes difficult to determine what constitutes securities. A definition which seems similar to the US Securities Act is provided by the Law of Negotiable instruments. Article 715(1) of Ethiopian Commercial Code of 1960 defines the term negotiable instruments as any document incorporating a right to an entitlement in such a manner that it is not possible to enforce or transfer the right separately from the instrument.¹⁰ The rights that could be incorporated in negotiable instruments may be rights for payment of money arising out of various contracts such as the contract of loan, sale, lease, or any other contract performed by payment of a certain amount of money; or ownership in companies or loan made to the government or to a share company; or the rights may be to receive goods under voyage or deposited in a warehouse.¹¹ Article 715(2) of the Commercial Code categorizes

⁸ Oxford English Dictionary (2d ed. 1989)

⁹ US Federal Securities Act Section 12

¹⁰ Article 715(1) Commercial Code of the Empire of Ethiopia of 1960, Nagaret Gazeta, Extra ordinary issue, No. 3 of 1960 (henceforth Commercial Code)

¹¹ Fasil Alemayehu and Merhatbeb Teklemedhn, A Course Material on Law of Banking and Negotiable Instruments, and Insurance, Sponsored by Justice and Legal Systems Research Institute, Addis Ababa Ethiopia (unpublished), 2008, p. 81

negotiable instruments into three main types, i.e., Commercial Instruments, [Transferable] Securities and Documents of Title to Goods. Commercial instruments are negotiable instruments setting out an entitlement consisting in the payment of a sum of money.¹² Bills of exchange, promissory notes, checks, travelers' checks and warehouse goods deposit certificates are deemed to be commercial instruments under the Commercial Code.¹³

Documents of title to goods are negotiable instruments containing rights of ownership over goods that are being transported or goods which are warehoused and which enable their holders to receive such goods.¹⁴

The sources of the rights of transferable securities may be investments made in companies or loans provided to the government or its subdivisions through purchase of government bonds and treasury bills or to companies through the purchase of debentures.¹⁵ A person who invests in a company has the right to receive dividends from the profits of the company and to share in the assets of the company where the company is dissolved.¹⁶ On the other hand, the person who has purchased a government bond or a treasury bill or a company bond, also called a debenture, acquires the right to receive repayment of the money he has given on loan plus interest.¹⁷ In general, these instruments represent the financial rights and in some case the power to control the corporations.¹⁸ They are the instruments through which business entities and governmental entities raise a substantial part of the funds with which to finance new capital construction¹⁹

¹² Art 732(1) of the Ethiopian Commercial Code of 1960

¹³ Ibid, Art 732(2)

¹⁴ See Arts 571-576 and 610-619 of the Commercial Code of Ethiopia regarding documents of title to goods under voyage and Arts 2814-2824 of the Civil Code of regarding documents of title to goods warehoused.

¹⁵ Supra note at 11

¹⁶ Supra note at 2, Art 345

¹⁷ Ibid, Art 433. Refer also to the provisions of Arts 2490-2511 of the Civil Code of the Empire of Ethiopia.

¹⁸ Hazen, T., *Securities Regulation Cases and Material*, (6th ed, USA, West Group Co. 2003) p. 2

¹⁹ Ibid

It is quite misleading to view securities as documents which gives its owner some tangible rights, that is not usually the case, at least with regard to shares of a company.²⁰ The only tangible rights to property that result from stock ownership exist in the event that the company is dissolved and liquidated.²¹ For example, Art 345 of the Commercial Code states that every share shall confer a right to participation in the annual net profits and to a share in the net proceeds on a winding-up.²² Hence securities have no intrinsic value in themselves but represent rights in something else whose value depends on the financial condition of the securities issuer, the profitability or future prospects of the corporation or other entity which issued it.²³

2.1.2. Securities Market

Securities markets are facilities through which securities are traded.²⁴ These markets may have physical locations but in many cases are simply formal or informal systems of communication through which buyers and sellers make their interests known and consummate transactions.²⁵ Securities are bought and sold in two principal setups, i.e. issuers transactions and trading transactions.²⁶ Issuers transactions (primary markets) are those involving the sales of securities to investors in order companies, governments and other groups obtain financing through debt or equity based securities.²⁷ Primary markets are facilitated by underwriting groups, which consist of investment banks that will set a beginning price range for a given security and then oversee its sale directly to investors.²⁸ In Ethiopia the offering of shares to the public, however, is not facilitated by the underwriters.

²⁰ Ratner, D., *Securities Regulation Material for a Basic Course*, (2nd Ed, USA, West Publishing Co. 1980), p. 1

²¹ Ibid

²² Art.345 of the Ethiopian Commercial Code of 1960

²³ Supra note at 20, p. 2

²⁴ Ibid

²⁵ Ibid

²⁶ James D. Cox, Robert W. Hillem, Donald C. Langevoort, *Securities Regulation Cases and Materials*, (4th ed, 1991) p. 2.

²⁷ Id, p. 3.

²⁸ Ibid

The primary markets are where investors can get first access to newly issued securities.²⁹ The issuing company or group receives cash proceeds from the sale, which is then used to fund operations or expand the business.³⁰ These are the means by which businesses raise capital to develop, to grow, or simply to survive. Primary markets are characterized by their unpredictability because it is difficult to accurately measure investor demand for a new security.³¹

On the other hand, trading transactions (Secondary markets) are the purchasing and selling of outstanding securities among investors.³² Once the initial sale is completed, further trading is conducted on the secondary market, which is where the bulk of exchange trading occurs each day in developed economies.³³

Stocks are traded in two stock markets; “exchanges” and “over-the-counter markets”. An “exchange market” operates in a physical facility with a trading floor to which all transactions in a particular security are supposed to be directed³⁴ and traditionally exchanges operated in a structured manner prescribing the number of members and what functions each member must undertake.³⁵ On the other hand, the “over-the-counter (OTC) markets” traditionally operates in unstructured manner without any physical facility and with any qualified firm being free to engage in any types of activities with respect to any securities.³⁶ Both the “exchange market” and the “over-the-counter” markets are not yet functional in Ethiopia.

2.1.3. Securities Regulation

In this paper securities regulation is used to refer to the set of rules, controls and processes, established by state authorities, with the aim to shape or prohibit certain behavior, decision making and transactions in the public offering of shares and securities

²⁹ Duke University School of Law, “Securities Regulation: Legislative and Administrative Treatment of the “Hot Issue”,” *Duke Law Journal*, Vol. 1968, No. 6 (Dec., 1968), p. 1138.

³⁰ Supra note at 20, p. 2.

³¹ Ibid

³² Ibid

³³ Ibid

³⁴ Ibid

³⁵ Id, p. 3

³⁶ Ibid

firms.³⁷ Thus securities regulation is a wide concept, which encompasses the regulation and supervision of securities markets and firms.

Securities regulation is a field that covers the interaction between the law and the securities industry.³⁸ In some countries securities law governing the issuance of and trading in securities is a mix of public laws and regulations, requirements of private industry organizations, industry custom and private contractual arrangements.³⁹ And the principal concern of the law is fraud, deception and manipulation in securities markets.⁴⁰ As a result in several countries security markets and industries are subject to some level of supervision and control by a public authority or commission.⁴¹

The distinctive features of securities entail a different approach to regulate it. The first feature of securities is that they are created rather than produced.⁴² They can be issued in unlimited amounts, virtually without cost, since they are nothing in themselves but represent only an interest in something else.⁴³ An important focus of securities regulation, therefore, is assuring that, when securities are created and offered to the public, investors have an accurate idea of what that “something else” is and how much of an interest in it the particular security represents.⁴⁴

The second is that they become a kind of currency, traded in the secondary market at fluctuating prices and these transactions far outweigh, in number and volume, the offerings of newly-created securities.⁴⁵ Hence, continuous flow of information about the

³⁷ Llewellyn, David, , “*Institutional Structure of Financial Regulation: The Basic Issues*”, paper presented at the World Bank and IMF conference Aligning Supervisory Structures with Country Needs, Washington DC, June 5-6, (2006), P. 4

³⁸ Edmund W. Kitch (1999), Regulation of the Securities Market, University of Virginia Law School, available at, <http://www.law.virginia.edu/lawweb/faculty.nsf/FHPbI/1180712?OpenDocument&ExpandSection=1>, accessed on June 17, 2010

³⁹ Supra note at 20, p. 815

⁴⁰ Ibid

⁴¹ Ibid

⁴² Supra note at 20, p. 1

⁴³ Ibid

⁴⁴ Id, p. 2

⁴⁵ Ibid

corporation or “something else” which is represented by securities being actively traded in the secondary markets should be disclosed and ensured.”⁴⁶

Third, securities are complex investment instruments that differ significantly from other things that are traded in commerce to the extent that securities are intangible and are neither produced nor consumed.⁴⁷ So, due to this nature, securities and the securities market have been particularly susceptible to fraud and manipulations. The securities law deters a variety of fraudulent, misleading or deceptive practices.⁴⁸

Finally, securities market involves intermediaries who buy and sell securities for investors and traders. Hence securities regulation is concerned with the regulation of people and firms engaged in that business, to assure that they do not take advantage of their superior experience and access to overreach their non-professional customers.⁴⁹

2.2. The Concept of IPOs

An initial public offering (IPO) occurs when a firm for the first time sells securities to the public.⁵⁰ Firms going public can be promising start-ups or old, established corporations engaged in restructuring programs requiring new capital injection.⁵¹ First and foremost, a public offering of shares has traditionally served primary functions for the company under formation as a means for raising capital in substantial amounts from the public at large.⁵² Second, initial public offering of shares is also employed to raise substantial amounts of equity capital for the already established companies.⁵³ The primary purpose of public offering of shares by the company which is already formed is generally to raise substantial amounts of equity capital for the corporation's use in the expansion and betterment of its business.⁵⁴ In addition a company which is already established may also go public to raise money to increase market value, to acquire other companies, to attract

⁴⁶ Ibid

⁴⁷ Ibid

⁴⁸ Ibid

⁴⁹ Ibid

⁵⁰ Ritter, J., “Initial Public Offerings”, *Contemporary Finance Digest Vol. 2, No. 1* (Spring 1998), p. 6

⁵¹ Ibid

⁵² Brown, B., Roe, C., and Jr. and Crooks, S., “The Public Offering and a Quest for Alternatives”, *23 Vand. L. Rev. (1969-1970)*, p.41

⁵³ Ibid

⁵⁴ Ibid

and retain employees, to diversify and liquefy personal holdings, to provide liquidity for shareholders, to implement an estate tax planning strategy and to enhance the companies' reputation.⁵⁵

A business can raise capital for its enterprise through the sale of shares. When a company (which henceforth also refers to a company under formation) proceeds to issue shares, it is called 'offering'. But this offering may be 'private' or 'public'. In several jurisdictions the distinction is drawn between 'private' and 'public' offering which entails different treatment by securities law. For example in some jurisdictions a private offering is made to a limited number of persons who are well informed about the affairs of the company that the company doesn't need to file registration statements and disclose information.⁵⁶ In contrast a 'public offering' is made to the public and is subject to extensive securities regulation. However, what constitutes a public offering does not have the same meaning across countries.

For example, the Securities Exchange Commission of USA in determining what constitutes 'public offering' set four principal factors for guidance. The first is the number of offerees and their relationship to each other and to the issuer.⁵⁷ Regarding this factor there is no formula precise enough to answer what constitutes a substantial number of offerees.⁵⁸ But the basis on which the offerees are selected is a factor of major significance in determining whether a 'public offer' exists or not. Consequently an offering to a given number of persons recruited at random from the general populace on the basis that they are possible purchasers may be considered a public offering even though an offering to a much larger group of persons who are all the members of a particular class, i.e., employees of a large corporation, might be considered a private offering.⁵⁹ The relation between the issuer and the prospective purchasers is also a matter to be given due weight.⁶⁰ Concretely, an offering to persons of a group who should have

⁵⁵ Ibid

⁵⁶ Ibid

⁵⁷ Mehler, I. M., "The Securities Act of 1933: "Private" or "Public" Offering," *Dicta. Vol. 32* (1955), p. 361

⁵⁸ Id, p. 362

⁵⁹ Ibid

⁶⁰ Ibid

special knowledge of the issuers is less likely to be a ‘public offering’.⁶¹ The second criterion is the number of units offered.⁶² Even though, the offering of unsubstantial number of units might presumably be an indication that no public offering would be involved, the offering of many units in small denominations might indicate that the issuer recognizes the probability of a distribution of the security to the public at large.⁶³ In addition, the offering of a substantial number of units along with large offerings and the utilization of those means normally used for purposes of public sale and distribution are also the indication of the existence of public offering.⁶⁴

Some countries define the public offering in terms of the number of persons who buy the shares and the value of the offering. For example, in South Korea an offering will be classified as a public offering if solicitation regarding the offered securities have been received by 50 or more persons (not including institutional investors) with in any given six month period.⁶⁵ If the aggregate value of the type of securities offered by the issuer within one year is twenty (20) billion Korean dollars still the solicitation is a public offering.⁶⁶

The Ethiopian Commercial Code allows companies to be formed among founders or by offering shares for public subscription. So one can equate ‘private offering’ with companies formed among founders and ‘public offering’ with public companies. Share companies which are formed among the founders are exempt from the requirements of permission by the Office of Commercial Register, prospectus and subscribers meeting.⁶⁷ The definition of founders provided in the commercial code is not clear. Those persons who sign the memorandum of association and subscribe the whole of the capital, persons who sign the prospectus, bring in contribution in kind, who are to be allocated a special

⁶¹ Omuck, A., “Some Observations on the Administration of the Securities Laws”, *Minn. L. Rev. Vol. 42* (1957-1958), p. 33

⁶² Ibid

⁶³ Ibid

⁶⁴ Ibid

⁶⁵ Han, W., Lee, W., “Public and Private Securities Offerings in Korea: An Overview of Public and Private Offering Classification Rules and Related Registration and Other Requirements,” *Journal of Korean Law Vol. 2* (2002), p. 197

⁶⁶ Ibid

⁶⁷ See Art. 12(5) of Commercial Registration and Business Licensing Proclamation No. 686/2010 and Article 318 and 320 of the Commercial Code of the Empire of Ethiopia

share in the profits, or who have initiated or facilitated the formation of the company are considered as founders.⁶⁸ For example if a company offers shares ,which confers a special profit, to the general public, no matter how their participation in the company, investors who buy such shares are considered as founders as per Art. 307(3) of the Commercial Code.⁶⁹

The ambiguity of who the founders are might open a gap for the issuers to manipulate the investors by offering a special share to the public and exposing them to liability in which the public has nothing to do with it. Art. 308 and Art. 309 hold founders jointly and severally liable to the commitments and expenses incurred before the formation of the company. In addition to that the freedom of issuers to compete in the securities market by offering a better incentive, i.e. by offering special share in the profits, is restricted in case the public refrains from buying those shares due to fear of responsibility. The failure of the Commercial Code to clearly delineate what constitutes a public offering might hamper the development of securities market in Ethiopia by discouraging investors, who might subscribe a share which confers a special profit, by holding them liable even if they don't involve in the formation and incorporation of the company.

2.3. Goals of Securities Regulation

The regulation of securities market is common in several countries. The ultimate goal of securities regulation is quite different across countries and unique due to the difference in the concrete situations of those countries. However the IOSCO identifies three goals of securities regulation which are implemented in some countries.⁷⁰ These are investor protection, market efficiency and reduction of systemic risk.

2.3.1. The Protection of Investors

Investors in the securities market refer to the general public who buys securities either from the primary or secondary securities market.⁷¹ These investors should be protected

⁶⁸ Id, Art. 307

⁶⁹ Id, Art. 307(3)

⁷⁰ International Organization of Securities Commissions (“IOSCO”), *Objectives and Principles of Securities Regulation* (2003), p. 5. See also, Weinstein, S., “Securities Law in Canada: Quebec A Case Study”, *International Law* Vol. 21 (1987), p. 170

⁷¹ Id, p. 4

from misleading, manipulative or fraudulent practices by dishonest promoters, worthless securities, including insider trading, front running or trading ahead of the general public and the misuse of client assets.⁷² In some countries, especially the western countries, the role of securities regulation is to, amongst other things, promote market confidence and to ensure the development of a transparent and well-informed securities market where every market participant has equal access to information and participates on a level playing field.⁷³ The regulation of the securities market does not seek to ensure that all investors make a return on their investment, nor does it seek to guarantee a specified yield.⁷⁴ The ultimate purpose is to build the confidence of the public to actively participate in the securities markets which as researches have shown fuels economic growth.⁷⁵

The main theme of investor protection is to protect investors in order to help issuers and securities salesman sell securities to the public.⁷⁶ However, what this protection constitutes is never clearly explained and could be studied contextually in different countries. The public may resist buying securities because of fears that any particular issue may be fraudulent or worthless. Potential buyers have to invest real resources to protect themselves against fraud which increases the cost of accurate information and in some cases investors may refrain from buying shares.⁷⁷ Nevertheless, securities regulation reduces this cost for buyers and makes it possible to buy securities at market prices and help issuers and the securities industry to finance their projects.⁷⁸

In some countries full disclosure of information material to decisions of inventors is the most important means for ensuring investor protection.⁷⁹ Investors are, thereby, better able to assess the potential risks and rewards of their investment and, thus, to protect their

⁷² Glocker, W. T., "Protecting Investors in Securities", *Annals of the American Academy of Political and Social Science*, Vol. 206, *Government Expansion in the Economic Sphere* (Nov., 1939), p.69

⁷³ Lawrence, J., "The Economics of Market Confidence: (Ac) Costing Securities Market Regulations", *Centre for Corporate Law & Securities Regulation, The University of Melbourne*, pp. 2-3

⁷⁴ Ibid

⁷⁵ Ibid

⁷⁶ Supra note at 38

⁷⁷ Ibid

⁷⁸ Ibid

⁷⁹ Ibid

own interest. As key components of disclosure requirements, accounting and auditing standards should be in place and they should be of a high and internationally acceptable quality.⁸⁰ In other countries a concerned public authority to regulate the securities market may evaluate the merit of the public offering to verify that it does not expose the public to loss.⁸¹

The IOSCO suggests that only duly licensed or authorized persons should be permitted to hold themselves out to the public as providing investment services, for example, as market intermediaries or the operators of exchanges.⁸² Initial and ongoing capital requirements imposed up on those license holders and authorized persons should be designed to achieve an environment in which securities firm can meet the current demands of its counter parties and, if necessary, wind down its business without loss to its customers.⁸³

Supervision of market intermediaries should achieve investor protection by setting minimum standards for market participants.⁸⁴ Investors should be treated in a just and equitable manner by market intermediaries according to standards which should be set out in rules of business conduct.⁸⁵

Effective supervision of the intermediaries, access to neutral courts or dispute resolution, effective means of compensational and effective enforcement of regal rules are critical in protecting investors.⁸⁶

2.3.2. Market Efficiency

The second goal of securities regulation is to ensure market efficiency. Efficient capital markets are generally beneficial to a society. Prices in an efficient market more closely reflect underlying value than in an inefficient market, and scarce resources are therefore

⁸⁰ Supra note at 70, p. 7

⁸¹ Sethsathira, P., "Securities Regulation in Thailand: Laws and Policies", *4 Pac. Rim L. & Pol'y J.* (1995), p. 788

⁸² Supra note at 70, p. 8

⁸³ Ibid

⁸⁴ Ibid

⁸⁵ Ibid

⁸⁶ Id, p. 9

allocated more efficiently among competing uses.⁸⁷ In general, the more complete and accurate the information used by buyers and sellers in an efficient market, the more prices reflect the underlying values and the more efficient is the allocation of resources to uses that result in the highest benefit to the society as a whole.⁸⁸ If capital markets are efficient, financial accounting and financial statements can contribute to more efficient resource allocation in the economy by providing complete and accurate information on which to base investment decisions.⁸⁹

In principle, economic theory implies that the most efficient market structure is when agents can compete freely, without government interference.⁹⁰ There are, however, exceptional circumstances where governments intervene to rectify the market problems.⁹¹ For securities markets, most of these potential economic problems are based on the existence of asymmetric information, public goods, and different forms of externalities or market power.⁹² So the existence of information asymmetry between the issuers or the promoters and the investors usually invites the government to interfere and address the market problem (market inefficiency).⁹³

The statement that securities markets should be efficient raises further questions as to what is meant by 'efficiency' and even within one meaning there are degrees of efficiency⁹⁴. A workable definition of an efficient market focuses on the relationship between price and information.⁹⁵ A securities price can be seen as being established in an

⁸⁷ Ross, L., and Zervos, S., "Stock Markets, Banks, and Economic growth", *American Economic Review* Vol.88, (1998), p. 539

⁸⁸ Naceur, S., and Ghazouani, S., "Stock, markets, banks, and economic growth: Empirical evidence from the MENA region", *Research in International Business and Finance* 21 (2007), pp. 297–315. See also, Singh, A., "Financial liberalization, stock markets and economic development". *Econ.J.*107, (1997), pp. 771–782.

⁸⁹ Ibid. See also, VanNieuwerburgh, S., Buelens, F., Cuyvers, L., "Stock market development and economic growth in Belgium", *Explor. Econ. Hist.*43, (2006), p. 13–38.

⁹⁰ Niemeyer, J., "An Economic Analysis of Securities Regulation and Supervision: Where to go after the Lamfalussy Report?:" *SSE/EFI Working Paper Series in Economics and Finance; No. 482*, December 14, 2001, p. 3.

⁹¹ Paul, M., "Mandatory Disclosure as a Solution to Agency Problems", *University of Chicago Law Review* Vol. 62, (1995), p. 1048.

⁹² Ibid

⁹³ Ibid

⁹⁴ Supra note at 26, p. 1

⁹⁵ Ibid, See also, Danils, F. J., "Comparing U.S. and Hong Kong Public Offering Regulation: How Cost Effective is China's Primary Capital Market?", *S. Cal. L. Rev. Vol. 69*1821 (1995-1996), p. 1828.

efficient market if, with respect to specific information, the price that exists for the security is the same as the price it would have if everyone had the same information.⁹⁶ An efficient market is one in which the interaction of a large number of buyers and sellers results in prices that fully reflect publicly available information about the goods traded and that react virtually instantaneously to reflect new information as it becomes available.⁹⁷ The security investors may face difficulty to value the price of the offering unless full, fair and plain information is disclosed either about the history of the security's market price or about the enterprise that issued the security.⁹⁸

The efficient market hypothesis is a description of the market as a whole and doesn't necessarily apply to individual securities or individual investors.⁹⁹ Thus accepting it does not completely rule out the possibility of obtaining returns higher than the market in general by analyzing public information.¹⁰⁰

Therefore, the governments intervene in the securities market to ensure the securities market is efficient to fuel economic growth and ensure an efficient allocation of resources.

2.3.3. Reduction of Systemic Risk

The other goal of securities regulation is the mitigation of systemic risk, if not to avoid it for it is impossible to do so. In finance, systemic risk is the risk of collapse of an entire financial system or entire market, as opposed to risk associated with any one individual entity, group or component of a system.¹⁰¹ It can be defined as "financial system instability, potentially catastrophic, caused or exacerbated by idiosyncratic events or conditions in financial intermediaries"¹⁰². Systemic risk refers to the risks imposed by

⁹⁶ Ibid

⁹⁷ Newkirk, G. R., "Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context", *The University of Chicago Law Review*, Vol. 58, No. 4 (Autumn, 1991), p. 1397.

⁹⁸ Ibid

⁹⁹ Ibid

¹⁰⁰ Ibid

¹⁰¹ Bank for International Settlements, *64th Annual Report*, Basel Switzerland (1994), p. 177

¹⁰² Kupiec, P., Nickerson, D., "Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation," *48 J. Real Est. Fin. & Econ. 123 (2004)*, P. 123, cited in , Anand, I. A., "Is System Risk Relevant to Securities Regulation?", Faculty of Law, University of Toronto, p. 3

interlinkages and interdependencies in a system or market, where the failure of a single entity or cluster of entities can cause a cascading, which could potentially bankrupt or bring down the entire system or market.¹⁰³

Where securities firms' failure nonetheless does occur, regulation should seek to reduce the impact of that failure, and, in particular, attempt to isolate the risk to the failing institution.¹⁰⁴ Hence, securities regulation promotes and allows for the effective management of risk and ensures that capital and other prudential requirements are sufficient to address appropriate risk taking, allow the absorption of some losses and check excessive risk taking.¹⁰⁵

2.4. Initial Public Offering Process

Different countries have different legal as well as practical steps in the process of public offering. In this subsection, the paper mainly takes in to consideration the US system to understand and analyze the public offering process. This is because, first, the US securities law is the most comprehensive and developed system in the world so that it's possible to learn and adapt to the local laws.¹⁰⁶ Second, the US system influences the securities law and practice of several countries which in one way or another adopts the US system in the process of implementing their securities regulation.¹⁰⁷ To compare and contrast with different approaches, the experience of other countries will also be raised whenever necessary.

¹⁰³Ibid

¹⁰⁴ IOSCO Public Document No. 98, *Hedge Funds and Other Highly Leveraged Institutions*, IOSCO Technical Committee, November 1999, cited in Supra note at 61, p. 6.

¹⁰⁵ Ibid

¹⁰⁶Bartos, J., "Offering Rules: What the US and Europe can Teach Each Other", *Int'l Finance Law Rev. Vol. 22, (2003)*,p. 16. See also, Kraus, H., "Securities Regulation in Germany? Investors' Remedies for Misleading Statements by Issuers", *International Law Vol.18 (1984)*,p. 109.

¹⁰⁷ Ibid. See also, Guenther, B. D., "The Limited Public Offer in Germany and US Securities Law: A Comparative Analysis of Prospectus Act Section 2(2) and Rule 505 of Regulation D," *Michigan Journal of Int'l Law Vol. 20, (1998-1999)*,p. 928. See also, Danils, F. J., "Comparing U.S. and Hong Kong Public Offering Regulation: How Cost Effective is China's Primary Capital Market?", *S. Cal. L. Rev. Vol. 69 (1995-1996)*,p. 1826. See also, Ishinguro, T., "Issuing Securities: how to do it in Japan", *International Finance Law Review, Vol. 8 (1989)*, P.15.

2.4.1. Steps in Public Offering

The process of offering shares to the public is subject to extensive regulation. The reason for the regulation is that members of the public who are offered shares in a company are entitled to full disclosure to them of the nature of what is on offer before they make a financial commitment, and to provide them with effective remedies to redress any loss incurred as a result of failure on the part of the company to make complete or accurate disclosure.¹⁰⁸

Once a company has decided to go public, the first step in the IPO process is to select an underwriter to act as an intermediary between the company and the capital markets.¹⁰⁹ A large IPO is usually underwritten by a "syndicate" of investment banks led by one or more major investment banks (lead underwriter).¹¹⁰ Upon selling the shares, the underwriters keep a commission based on a percentage of the value of the shares sold (called the gross spread).¹¹¹ Issuers usually select underwriters by accepting proposals from a number of investment banks, then evaluate the bidders on the basis of their reputation, experience with similar offerings, experience in the industry, distribution network, record of post-offering support, type of underwriting arrangement, and the bidders' valuation of the company and recommended share price.¹¹²

There are three basic types of underwriting arrangements.¹¹³ The first is 'best efforts' underwriting arrangement, which means that the investment bank does not commit to buying any shares but agrees to put forth its best effort to sell as many as possible. An underwriter which considers the issue to be risky may choose this type of agreement to shift the risk to the company. Second, 'All or none' underwriting arrangement is similar

¹⁰⁸ Goldring, F. G., "Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation", *Columbia Law Review*, Vol. 81, No. 7 (Nov., 1981), p.1526.

¹⁰⁹ Ibid

¹¹⁰ Ellis, K., R. Michaely, and M. O'Hara. "A Guide to the Initial Public Offering Process", *Corporate Finance Review* Vol. 3 (1999), p. 16.

¹¹¹ Ibid

¹¹² Ibid

¹¹³ Millonzi, R., "Concurrent Regulation of Interstate Securities Issues: The Need for Congressional Reappraisal", *Virginia Law Review*, Vol. 49, No. 8 (Dec., 1963), p. 1484.

to best efforts except that the offering is canceled if all the shares are not sold. Finally, under the 'firm commitment' agreement, the underwriters pledge to buy all of the stock offered in the IPO and resell it to the public. This arrangement offers the company the most security because the owners know they will receive the full sales price of the issue.

The next step in the IPO process is to assemble an underwriting team consisting of attorneys, independent accountants, and a financial printer.¹¹⁴ The accountants issue opinions about the company's financial statements in order to reassure potential investors.¹¹⁵ Then, the lead underwriter prepares a letter of intent in order to ensure that the IPO company will reimburse the investment bank for any expenses should the company withdraw from the IPO process and the IPO company pledges to cooperate in all due diligence efforts.¹¹⁶

The next step is filing a "registration statement" which is required by the concerned public authority. A prospectus must be prepared that will be furnished to every purchaser of the IPO securities. The registration statement must be signed by the principal owners of the firm, its directors, underwriters, and others who assisted in the preparation of the prospectus.¹¹⁷

The next major phase of the process is often referred to as a "road show". This is essentially the marketing stage of the IPO in which officers of the IPO firm make presentations to potential investors.¹¹⁸ The object of these presentations is to determine the amount of interest in these securities in order to help the investment bank in establishing an offering price for the stock.

¹¹⁴ Bragg, S., *Running a Public Company From IPO to SEC Reporting*, (New Jersey John, Wiley & Sons, Inc. 2009), p. 10

¹¹⁴ Ibid

¹¹⁵ Ibid

¹¹⁶ Supra note at 110, P. 16

¹¹⁷ Ibid

¹¹⁸ Ibid

In the last step, the IPO firm and the investment bank set the two most critical aspects of the transaction which are the offer price and the number of shares to be sold.¹¹⁹ Once these final terms are agreed upon, the IPO firm and the investment bank issue a formal underwriting agreement and a final prospectus is prepared.¹²⁰ It is at this point that the shares are actually made available for sale.

2.4.1.1. Registration Statement

A key goal of a public company is to have its securities registered, so that it can more easily sell the securities and so that its investors can freely trade them.¹²¹ Disclosure is accomplished by the registration of security offerings. The registration statement is the most important way to unveil information about the security to potential investors so that they can make informed decisions. In general, the law provides that no security may be offered or sold to the public unless it is registered with the concerned authority, save with the exceptions.¹²² Mainly registration does not imply that the concerned public authority approves of the issue but is intended to aid the public in making informed and educated decisions about purchasing a security.¹²³

The purpose of the registration and disclosure requirements is to ensure that the public has adequate and reliable information regarding securities that are offered for sale. To achieve this, the underwriter has a “due diligence” requirement to investigate the company and verify the information it provides about the company to investors. It is important to note, however, that most of the legal institutions have no authority to prevent a public offering based on the quality of the securities involved.¹²⁴ It only has the power to require that the issuer disclose all material facts.

¹¹⁹ Ibid

¹²⁰ Ibid

¹²¹ Ibid

¹²² Supra note at 110

¹²³ Ibid

¹²⁴ Supra note at 96. See also, *Cohen, M.*, "Truth in Securities" Revisited, *Harvard Law Review Vol. 79 (1966)*, p. 1342.

As a safeguard, some countries require that the registration statement be signed by the directors and principal officers of the issuer as well as the underwriters, accountants, appraisers and other experts who assisted in the preparation of the registration statement.¹²⁵ Any purchaser of the securities who is damaged as a result of a misstatement or omission of a material fact in the registration statement may sue these signatories.¹²⁶

2.4.1.1.1. Due Diligence Requirement

One of the documents that many legal regimes require is the “due diligence” report.¹²⁷ The due diligence process is conducted by the underwriter and is a vastly expanded version of the due diligence it went through when it was initially investigating the company.¹²⁸ The underwriter conducts an exhaustive due diligence process to verify that what the company says about itself is true. This is likely to include interviews throughout the company, a detailed analysis of all operations, company tours, and reference calls to company suppliers and customers.¹²⁹

In particular, the underwriter will investigate the background of each key executive in detail, so be sure that executives’ published resumes are accurate.¹³⁰ The underwriter must conduct this level of detailed review in order to protect itself in case problems arise after the IPO that it should have seen prior to the stock offering.¹³¹ In this case, it will require outside auditors to comb the company’s financial records at a level of detail significantly greater than a standard audit, and then issue a comfort letter to the underwriter, stating the additional procedures it completed at the request of the

¹²⁵ Paul, M., “The Political Economy of the Securities Act of 1933,” *The Journal of Legal Studies*, Vol. 30, No. 1 (Jan., 2001), p. 13.

¹²⁶ Steinberg, M., Claassen, C., “Attorney Liability Under the State Securities Laws: Landscape and Minefields”, *Berkeley Bus. L.J. Vol. 3* (2005-2006), p. 4.

¹²⁷ Supra note at 20, p. 113

¹²⁸ Wing, J., “Guidelines for Underwriter Activity”, *Business Law Vol. 25*, (1969-1970), p.398.

¹²⁹ Jacob, F. V., “*The Due Diligence Process from the Underwriters’ Perspective*,” Practising Law Institute, June 2007, p. 7

¹³⁰ Ibid

¹³¹ Ibid

underwriter.¹³² The auditors send the comfort letter to the underwriter once the initial registration statement has been filed.¹³³ This diligence process generally will involve three aspects: documentary due diligence, discussions with management and accountants and other advisers, and participation in the preparation of the offering document.¹³⁴ The goal of this process is to gain information relevant to disclosure which a reasonable investor would find helpful in making an investment decision.¹³⁵

Documentary due diligence includes a review of all material documents and information relating to a company, including: minutes of the meetings of the board of directors, board committees and shareholders, governing documents of the issuer, records of company decisions and procedures, material agreements and obligations, information about share capital and public records.¹³⁶ Underwriters' counsel normally prepares a set of due diligence questions (generally comprising legal, financial and business sections and prepared before the prospectus is drafted) to which the company will provide responses.¹³⁷ The issuer will also make available its corporate books and records, material contracts and other documents, pertaining to the matters identified in the due diligence question list.¹³⁸

The primary goal of the attorney in reviewing the documents provided by the issuer is to identify potential issues that may expose those working on the transaction to potential liability.¹³⁹ Generally, the risk of liability can be reduced if any risks or potential problems involving the issuer or the securities being offered are disclosed to potential investors in the offering documentation.¹⁴⁰ Accordingly, the attorney conducting documentary due diligence review should look for any information that could affect the

¹³² Ibid

¹³³ Alder, A. *Hong Kong IPO Guide*, Herbert Smith Legal Practice Corporation, (2006) p. 55, available at, www.herbertsmith.com/NR/rdonlyres/...CAB9.../HKIPOGuidefinal.PDF, Accessed on Dec 12, 2010

¹³⁴ Ibid

¹³⁵ Ibid

¹³⁶ Ibid

¹³⁷ Sommer, A. A., "The Practicalities of 'Going Public' in the United States", *International Business Lawyer Vol. 13*, (1985), p. 419.

¹³⁸ Id, p. 420

¹³⁹ Ibid

¹⁴⁰ Ibid

value of the securities to ensure that potential problems identified are rectified prior to the offering and/or disclosed to potential investors in the offering documentation.

One or more meetings are usually held with senior management and directors of the issuer in the course of the due diligence and offering circular drafting process.¹⁴¹ Often, the issuer, upon request, will organize a presentation by operating management in each of its divisions in order to give the underwriters and legal counsel a general overview of the business.¹⁴² In addition to this general presentation, the underwriters and legal counsel typically (and should) hold meetings with specific officers or employees of the issuer responsible for particular areas of the issuer's business.¹⁴³

The underwriters and legal counsel also typically hold at least one meeting with the Chief Executive of the issuer to review strategic aspects of the issuer's business and to obtain his or her personal assessment of the issuer's strengths and weaknesses.¹⁴⁴ Discussions with management also will include discussion of the issuer's business, prospects, plans, internal and disclosure controls and risks. It is also customary to meet with the issuer's current and prior auditors for a broad-based discussion of the issuer's internal accounting policies, controls and procedures, any signs of illegality, contingent liabilities, any aggressive positions taken vis-a-vis accounting or tax policy, and any disagreements or adjustments regarding the issuer's financial statements.¹⁴⁵

Legal counsel generally will begin the drafting process by utilizing precedent documentation used in similar offerings by issuers in the same business or industry as the subject issuer.¹⁴⁶ The regulatory authority ensures that the offering document discloses any material information discovered in the documentary due diligence review and through discussions with management and the accountants.¹⁴⁷ The underwriter, in the

¹⁴¹ Schneider, C., "Going Public: Practice, Procedure and Consequences", 27 *Villanova L. Rev.* Vol. 27, (1981), p. 2.

¹⁴² Ibid

¹⁴³ Cohen M., "Truth in Securities" Revisited," *Harvard Law Review*, Vol. 79, No. 7 (May, 1966), P.1347

¹⁴⁴ Ibid

¹⁴⁵ Ibid

¹⁴⁶ Supra note at 133, p. 22

¹⁴⁷ Ibid

process of drafting the registration statement and prospectus, obtains confirmation from the issuer's management that the disclosure accurately reflects the reality of the issuer's description of business, management's discussion and analysis of financial condition and results of operations and risk factors.¹⁴⁸

2.4.1.1.2. Prospectus Requirement

A prospectus is a formal legal document, which is required by the law and filed with the concerned public authority, which provides details about an investment offering for sale to the public.¹⁴⁹ A prospectus should contain the facts that an investor needs to make an informed investment decision. In the US Securities law, there are two types of prospectuses for stocks and bonds: preliminary and final.¹⁵⁰ The preliminary prospectus is the first offering document provided by a securities issuer and includes most of the details of the business and transaction in question. Some lettering on the front cover is printed in red, which results in the use of the nickname "red herring" for this document. The final prospectus is printed after the deal has been made effective and can be offered for sale, and supersedes the preliminary prospectus. It contains finalized background information including such details as the exact number of shares/certificates issued and the precise offering price.¹⁵¹

The prospectus should contain all information necessary to enable investors to make to make an informed assessment of the activities, assets and liabilities, financial position, management and prospects of the company and of its profits and losses and rights attaching to the securities being offered.¹⁵² This information must be presented in an objective manner.¹⁵³ Whether the information is sufficient is determined based on the particular nature of the issuer and of the securities being offered or admitted to trading.¹⁵⁴

¹⁴⁸ Supra note at 133, p. 17

¹⁴⁹ Supra note at 122, p. 227

¹⁵⁰ Ibid

¹⁵¹ Ibid

¹⁵² Ibid

¹⁵³ Gerven, D., *Prospectus for the Public Offering of Securities in Europe, Volume I*, Cambridge University Press 2008, p. 34.

¹⁵⁴ Ibid

The general rule is that the information made available should permit investors to make an informed assessment of the risks represented by the securities in order to take a decision with full knowledge comprehensible form.¹⁵⁵

Since the offering is made to the public, any type of investor should be able to assess the information. This also means that the form in which the information is made available be suitable for any type of public, regardless of its expertise.¹⁵⁶ Ensuring the completeness and suitable presentation of information contained in the prospectus is part of the approval procedure undertaken by the competent authority.¹⁵⁷

As a result some jurisdictions enact rules or directive that prospectus should contain.¹⁵⁸ And most of these rules require the prospectus to include information about the description of securities being registered and to be listed, the company's capital, industry overview, general information about the group's business and assets, financial information about the group and the prospects of the group including an accountant's report, management discussion and analysis of financial condition, property valuation, information about the company's management, directors, securities held by the directors and directors' service contracts, principal holders of the securities, how the IPO proceeds are to be used and various material contracts and other documents must be made available for public inspection.¹⁵⁹ Matters as products or services of the company, competition, key customers, government regulation, employees, and technology should be included in the business description.¹⁶⁰ The details of the underwriting, the plan for distribution of the securities, pending legal proceeding, directors remuneration, option to repurchase shares, cash and non-cash compensation, long-term incentive plan awards, pension plan benefits, and other forms of compensation, financial statements and

¹⁵⁵ Ibid

¹⁵⁶ Ibid

¹⁵⁷ Ibid

¹⁵⁸ Supra note at 95, p. 19

¹⁵⁹ Supra note at 20, p. 96

¹⁶⁰ Ibid

financial information concerning the company's business segments should also be disclosed.¹⁶¹

2.4.1.1.3. Auditing requirement

A company going public must provide a prospectus that includes a description of its present and future operations and audited financial statements.¹⁶² The due diligence defence that underwriters seek to establish to guard against potential liability depends on a thorough due diligence investigation being conducted in the course of the transaction.¹⁶³ Obtaining a comfort letter from the issuer's independent auditors is one of the many procedures used by underwriters to establish that they have conducted a reasonable investigation in connection with preparing the offering document.¹⁶⁴

The purpose of auditor comfort letters, from the underwriters' point of view, is two-fold: establishment of a defence to liability under securities laws and protection of the underwriter's professional reputation. Primarily, however, the comfort letter from the accountants to the underwriter is intended to help establish the underwriters' due diligence defense regarding the correctness of the financial statements and other financial information included in the offering circular.¹⁶⁵ In the comfort letter, the auditors confirm they are independent in accordance with applicable accounting rules and confirm that they have audited the financial statements set out in the offering circular.¹⁶⁶

2.4.2. Advertisements

Any advertisement relating to a public offering of transferable securities or to an admission to trading on a regulated market is usually required to comply with the

¹⁶¹ Id, P. 110

¹⁶² Beatty, R., "Auditor Reputation and the Pricing of Initial Public Offerings, *The Accounting Review*", Vol. 64, No. 4 (Oct., 1989), p. 693.

¹⁶³ Ibid

¹⁶⁴ Supra note at 137

¹⁶⁵ Beatty, R., and I. Welch, "Issuer Expenses and Legal Liability in Initial Public Offerings", *Journal of Law and Economics* 39, No. 2, (1996), P. 546

¹⁶⁶ Ibid

provisions laid down in the Prospectus Directive of some countries.¹⁶⁷ Advertisements are announcements relating to a specific offer to the public of securities or to an admission to trading on a regulated market which aim to specifically promote the potential subscription or acquisition of such securities.¹⁶⁸

When the advertisement relates to a public offering or an admission to trading on a regulated market for which the securities laws of some countries require the publication of a prospectus must state that a prospectus has been or will be published and indicate where investors are or will be able to obtain it and clearly recognizable as such for a public offering or admission to trading of securities on a regulated market.¹⁶⁹ In addition the information in the advertisement must not be inaccurate or misleading and must be consistent with that contained in the prospectus, if already published, or with the information required to be included in the prospectus, if the prospectus has yet to be published.¹⁷⁰ Furthermore, any information concerning the public offering or admission to trading, disclosed in written or oral form, must be consistent with that contained in the prospectus.¹⁷¹

Chapter Three

Regulatory Framework of Initial Public Offering of Shares

3.1. Public Instruments of Securities Regulation

The role of the government in the economy within the framework of free market varies across countries. Determining the proper role of the government in the regulation of securities market stems from the general policy framework, historical experience, the social and economic condition of that country.

¹⁶⁷ Columbia Law Review Association, Inc, “The Regulation of Advertising”, *Columbia Law Review*, Vol. 56, No. 7 (Nov., 1956), P.1051. See also, MacIntosh, J. “Securities Regulation and the Public interest: Of Politics, Procedures, and Policy Statements”, *Canada Business Law Journal* Vol. 24 (1994-1995), p.289.

¹⁶⁸ Ibid

¹⁶⁹ Supra note at 133

¹⁷⁰ Ibid

¹⁷¹ Ibid

Some free market advocates, like the Chicago School of Economics, believe that the market will regulate most things including the security market.¹⁷² This school of thought believes that the goals of securities regulation-protection of investors, protection of the integrity of the market and economic efficiency- can be attained simply by allowing competition to operate in a way that if companies publish misleading corporate information that is a sign that there is little demand for accurate information and that regulatory requirements are unnecessary.¹⁷³ On the other hand, if there were a strong demand for accurate information companies would compete with each other to provide as much accurate information as possible for investors.¹⁷⁴

This view had been tried in the United States and Britain long before there were legal requirements for this kind of information because there was a demand for information by investors and securities firms. Self regulating institutions and practices were in place to regulate securities transaction long before the securities act. However, the frequent recurrence of fraud and manipulation in the financial market makes it clear that not all companies can be relied on to make adequate disclosure voluntarily. The self regulatory institutions and free market practices were unable to protect the investors and ensure the integrity and efficiency of the market. This is due to the inherent intricate nature of securities and the peculiar complexities of securities markets are beyond the experience or understanding of most public investors; and that a special regulation is needed to protect investors and the public interest.¹⁷⁵ Hence a certain amount of regulation is needed to enable the securities market to perform its price determining functions free from manipulated influences by those who seek to corrupt it for their own profit. As a result successive acts were enacted to regulate the securities market and boost public confidence.

¹⁷² Poser, S. N., *International Securities Regulation*, (Canada, published by Little and Brown Co. 1999), p. 5.

¹⁷³ Ibid

¹⁷⁴ Ibid

¹⁷⁵ Id, p. 6

On the other hand, some states consciously intervene in the market to bring about a desired result notwithstanding whether there is market failure or not.¹⁷⁶ The purpose of the securities law in these kinds of states is to develop the capital market itself in addition to protecting investors, ensuring market efficiency, and reducing systemic risk. For example, the purpose of securities law of Brazil is to accelerate economic development through a sound policy of democratization of capital and employ selective disciplinary measures aimed at expanding and strengthening the capital markets.¹⁷⁷ Significantly, the law includes not only purely regulatory measures such as requirements of corporate disclosure and prohibitions against fraud and manipulation, but also various “promotional” provisions, including favorable income tax treatment for purchasers of corporate shares and provisions aimed at strengthening the securities market and creating private development banks.¹⁷⁸

In order to achieve the goals of securities regulation, instruments (means) of regulating it should be determined. For the past several decades, in many countries legislatures and regulators have been mainly adopted disclosure based approach rather than substantive based (merit-based), in order to accomplish regulatory goals in the securities market, especially in the regulation of initial public offering of shares.¹⁷⁹ In a well developed securities regulations, the regulatory tools schemes which respect to public offering of securities rely principally on disclosure requirements, while the regulation of broker-dealers and particularly investment companies includes a large number of substantive requirement.¹⁸⁰ Registration and licensing, capital requirements and orderly market rules are also employed as an instrument of securities market and participant regulation.

3.1.1. Disclosure

¹⁷⁶Rapley, J., *Understanding Development: Theory and Practice in the Third World*, (USA, 3rd ed, Lynne Rienner pub, 2007), p.155

¹⁷⁷ Poser, S. N., “Securities Regulation in Developing Countries: The Brazilian Experience”, *Virginia Law Review*, Vol. 52, No. 7 (Nov., 1966), p.1284.

¹⁷⁸ Ibid

¹⁷⁹ Dalley, P., “The Use and Misuse of Disclosure as a Regulatory System”, *Fla. St. U. L. Rev.* Vol.34,(2006-2007), p. 1089.

¹⁸⁰ Supra note at 172, p. 8

Disclosure is a key policy instrument in public offering. The use of a disclosure based system as a tool of regulation has several rationales. First, disclosure rules can induce corporate managers to behave more diligently and honestly because they know their actions will be regularly exposed to the public.¹⁸¹ The threat of public exposure can deter corporate misconduct and prevent fraudulent behavior from occurring in the first place.¹⁸² Besides, disclosure serves to reduce agency costs, the costs that shareholders would otherwise incur to monitor their agents, directors and officers to ensure that they are performing their duties properly.¹⁸³

Second, the disclosure of information allows investors to make fully informed investment decisions whether to buy securities or not.¹⁸⁴ Disclosures is aimed at providing timely, accurate and complete information to the market, so that investors can make informed choices based on relevant information about issuers activities.¹⁸⁵ It places responsibility for accurate disclosure in the hands of those with the information who are seeking wide market in which to raise capital.¹⁸⁶ This reduces the informational asymmetry that exists between corporations and investors, which ultimately levels the playing field so that all market participants have equal access to information about corporations and their securities.¹⁸⁷ Investors can then make informed valuation judgments about the price of a share. So disclosure enhances market efficiency and transparency because it can ensure

¹⁸¹ Lowenstein, L., "Financial Transparency and Corporate Governance: You Manage What You Measure," 96 *COLUM. L. Rev.* 1335. (1996), P.1339, cited in, Ripken, S. K., "The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation", 58 *Baylor L. Rev.* 139 (2006), p. 151

¹⁸² Choi, S., Pritchard, A. C., "Behavioral Economics and the SEC", 56 *STAN. L. REV.* 27. (2003), P. 129, Cited in, Ripken, S. K., "The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation", 58 *Baylor L. Rev.* 139 (2006), p. 152

¹⁸³ Mahoney, P., "Mandatory Disclosure as a Solution to Agency Problems", 62 *U. CHI. L. REV.* 1047, (1995), pp. 1048-1051, Cited in, Ripken, S. K., "The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation", 58 *Baylor L. Rev.* 139 (2006), p. 152

¹⁸⁴ Ripken, S. K., "The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation", 58 *Baylor L. Rev.* 139 (2006), p. 152

¹⁸⁵ Sarra, J., "Disclosure as a Public Policy Instrument in Global Capital Markets", 42 *Tex. Int'l L. J.* 875(2006-2007), p. 876

¹⁸⁶ *Ibid*

¹⁸⁷ Sargent, M., "State Disclosure Regulation and the Allocation of Regulatory Responsibilities", 46 *MD. L. REV.* 1027, (1987), p.1046.

effective dissemination of information that is material to investor decisions which in turn facilitates the raising of capital in a cost effective and timely manner.¹⁸⁸

Third, disclosure regulation is important to ensure investor confidence in the market because it deters fraudulent corporate conduct and equalize access to information which ultimately give trust and confidence to the investors.¹⁸⁹ The confidence investors have on the market enables them to freely participate in the public offering and creates liquidity to the shares. All these factors encourage the investors to invest in securities which fuel the investment activities of the country.

Finally, disclosure decreases investor risks and protects the public interest.¹⁹⁰ It can be seen as a way of remedying the social and economic wrongs that occur when those with greater information exploit those with less information.¹⁹¹ Consistent with a minimalist form of government interference in a free market, disclosure regulation promotes the protection of investors and the public interest.¹⁹² Disclosure as an instrument of securities regulation has also weaknesses Disclosure has costs, including costs to create, compile, and publish the relevant information, and the costs of any particular disclosure scheme may outweigh its benefits.¹⁹³

Another important device in the regulation of the market in relation to disclosure is substantive regulation. Substantive regulation evolves mandating a certain conduct to be performed when it is deemed important and prohibiting other conducts that we believe is unfair and improper.¹⁹⁴ The goal of such behavior is to directly affect behavior, not just

¹⁸⁸ Easterbrook, H., Fischel, D., “Mandatory Disclosure and the Protection of Investors”, *Vol. 70. VA. L. REV.* 669, (1984),P. 692.

¹⁸⁹ *Ibid*

¹⁹⁰ Anderson, A., “The Disclosure Process in Federal Securities Regulation: A Brief Review”, *25 GASTINGS L. J.* 311-14(1974), cited in, Ripken, S. K., “The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation”, *58 Baylor L. Rev.* 139 (2006), p. 155.

¹⁹¹ Sargent, M., “State Disclosure Regulation and the Allocation of Regulatory Responsibilities”, *46 MD. L. REV.* 1027, 1044 (1987), p.155.

¹⁹² *Supra* note at 179.

¹⁹³ Sage, W., “Regulating Through Information: Disclosure Laws and American Health Care”, *99 COLUM. L. REV.* 1701,(1999), p. 1708, cited in, Paula J. Dalley, P., “The Use and Misuse of Disclosure as a Regulatory System”, *34 Fla. St. U. L. Rev.* 1089, 2006-2007.

¹⁹⁴ *Supra* Note at 187, p. 190

requiring disclosure.¹⁹⁵ The conducts in the substantive regulation should be respected; notwithstanding the information regarding to the conduct is disclosed. The instrument requires a deep analysis of the merit of the conduct. Generally, a proper balance between disclosure and merit based regulation should be maintained while instruments of regulation are designed.

3.1.2. Registration and Licensing

Registration and licensing of individuals, such as a financial institution's representative agents, independent brokers, dealers and investment advisors is employed as a regulatory instrument.¹⁹⁶ The registration of individuals sets minimum standards for people to engage in the securities market. In some cases, registration requires that applicants pass an examination of competence. For example, in US securities brokers often usually required to pass an examination that tests their knowledge of finance, their field of finance, and their legal and ethical responsibilities to customers and other market participants.¹⁹⁷

Registration allows regulatory authorities to conduct background checks on individuals, who act as brokers, agents or salespeople, who have fiduciary responsibility to the companies and investors.¹⁹⁸ The background check is usually made to test for past criminal conduct because individuals convicted of fraud aren't allowed to act as brokers or security dealer. An example can be drawn from U.S. law that an individual convicted of securities fraud cannot be a registered broker for securities or exchange traded derivatives.¹⁹⁹ So registration or license helps to monitor the individuals who partake in the securities market in order to protect the integrity of the market and investors.

¹⁹⁵ Ibid

¹⁹⁶ Dodd, R., “*The Virtues of Prudential Regulation in Financial Markets*”, Financial Policy Forum Washington D.C. January 10, (2004), p.7

¹⁹⁷ Ibid

¹⁹⁸ Ibid

¹⁹⁹ Id, p.8

3.1.3. Capital Requirement

Securities firms' capital structures are of importance to regulatory authorities, who are concerned on systemic risk and the negative externalities that can arise from defaults.²⁰⁰ National regulatory authorities imposed minimum capital requirement. The requirement is designed to lower the chances of failure, and hence the expected social costs of failure.²⁰¹ So the law of some countries requires all financial institutions to hold capital in proportion to their credit exposure and their current and potential market risk.²⁰²

3.1.4. Orderly Market Rules

Countries strictly prohibit fraud and manipulation in securities markets and adopt “know your customer” and “truth in lending” rules and the reporting of large trader positions in order to detect and deter manipulation.²⁰³ Besides, in order to foster market liquidity, countries require securities dealers to act as market makers by maintaining binding bid and offer quotes throughout the trading day.²⁰⁴ The violations of these rules is also been made punishable by civil and criminal penalties. Some countries establish an enforcement authority which conducts market surveillance and enforce these rules.

In general, several tools can be used to regulate the securities market. Disclosure, registration and licensing, capital adequacy and orderly market rules are some of the instruments which can be adopted in the Ethiopian securities market as well.

²⁰⁰Dimson, E., Marsh, P., “Capital Requirements for Securities Firms”, *The Journal of Finance*, Vol. 50, No. 3, Papers and Proceedings Fifty-Fifth Annual Meeting, American Finance, Association, Washington, D.C., January 6-8, 1995 (Jul., 1995),P. 821.

²⁰¹ Ibid

²⁰² Ibid

²⁰³ Supra note at 196, p. 10

²⁰⁴ Ibid

3.2. Bases of Structuring Regulatory Institutions

Studying the general approaches of structuring ‘financial regulation’²⁰⁵ helps us to come up with the effective and efficient institutional set up of securities regulation. The approaches give us the principles and issues that should be taken in to account while setting up the institution and enable us to compare the alternative regulatory institutions of different countries’ securities market regulation from the prospective of broad financial regulation. The reason to study securities firms and market along with banks and insurance companies is the growing erosion of the distinction among the activities of banking, securities and insurance sectors in the developed and developing countries leads countries to integrate the regulation of securities, banks and insurance markets.²⁰⁶ As a result the optimal institutional structure of securities regulation is discussed with in the broader context of financial regulation.

The following bases are used to set up the institutional structure of financial regulation. These are Institutional (Sector)-based regulation, Objectives-based regulation and Function (activity) - based regulation.

3.2.1. Sector Based Regulation

The first base to structure financial regulators is institution based regulation. In this approach, regulation is performed over each single category of financial institution (bank, insurance and securities firms) or over each single segment of the financial market (banking market, insurance market and securities market) is assigned to a distinct agency

²⁰⁵ The concept of financial regulation denotes the set of rules, controls and processes, established by state authorities, with the aim to shape or prohibit certain behavior, decision making and transactions in financial markets and financial institutions. Thus financial regulation is a wide concept, which encompasses the regulation and supervision of (1) financial firms such as commercial banks, investment banks, insurance companies, financial advisers, stock brokers etc; (2) organized financial markets such as Stock Exchanges or alternative trading systems where financial assets are normally traded; (3) financial services, processes and transactions such as the acceptance of deposits, the granting of loans, the provision of financial advice, the issuance and listing of securities, the execution of trades in financial instruments and so on; and (4) the general market infrastructure such as systems for the clearing and settlement of large value bank payments as well as the clearing and settlement of trades in financial instruments.

²⁰⁶ Developing countries gradually allow their banks to engage in previously restricted non-bank activities. For example, banks in Ethiopia are in direct competition with securities brokerage firms in selling shares to the public.

for each financial institution and the entire complex of activities.²⁰⁷ This model follows the traditional segmentation of the financial system into three markets; we thus have three supervisory authorities acting as regulators over, respectively, banks, securities firms, and insurance companies (and the corresponding markets).²⁰⁸ Accordingly, banks and its associated markets are regulated by an independent institution; insurance companies and markets are regulated by another entity; and any other distinct body is established to regulate securities intermediaries and markets. .

If it is possible to retain the traditional distinction between the banks, insurance and securities firms, this approach may have the following advantages. Due to each intermediary and market has only one supervisory authority as a counterpart, institutional regulation is deemed effective in the realization of controls.²⁰⁹ In addition, since the regulation is performed with regards to subjects that are regulated as to every aspect of their activity and as to all the objectives of regulation by a single authority, duplication of controls is avoided and the costs of regulation can be considerably reduced.²¹⁰

The disadvantage of this model stems from the continued trend of the erosion of the traditional distinction between banks, insurance and securities firms associated with their markets.²¹¹ The progressive phenomenon of integration among banks, securities and insurance institutions and markets makes it impossible to retain their traditional places hence poses a challenge to the approach.²¹² Sector based regulation may also affect the competition among different financial institutions conducting the same activities due to the variation in regulatory approaches.²¹³

²⁰⁷Christos, H., "Institutional Structure of Financial Regulation: A Trend Towards 'Megaregulator'", 5 *Y.B. Int'l Fin. & Econ. L. (2000-2001)*, p.127.

²⁰⁷ Ibid

²⁰⁸ Ibid

²⁰⁹ Fein, L. M., "Functional Regulation: A Concept for Glass-Steagle Reform?", *Stan. J.L. Bus. & Fin. Vol. 2, (1995-1996)*, p.90.

²¹⁰ Ibid

²¹¹ Ibid

²¹² Ibid

²¹³ Supra note at 207, p. 131

The other weakness of this model emanates from the regulation of different activities of the same institution by a single authority.²¹⁴ The different activities of financial institutions may have different objectives and different approaches.²¹⁵ When these functions are regulated by a single authority, conflict and domination of objectives may arise.²¹⁶

However, this model can still be used by countries where there still exist a clear cut distinction among banks, insurances, and securities and their respective markets.

3.2.2. Objective-Based Regulation

According to this system financial regulatory institutions should be structured according to their objectives. Due to the variation of the definition of regulatory objectives the proponents of objective based regulation reach divergent conclusion regarding the optimal institutional structure. The best known proposal for tailoring the institutional structure of financial regulation around the regulatory objectives is that of Michael Taylor, who put forward ‘twin peaks’ model.²¹⁷ Taylor draws a sharp distinction between the ‘systemic protection’ and ‘consumer protection’ objective, linking them to the approaches and instruments of, respectively, prudential and conduct of business regulation.²¹⁸ On these bases, he proposes the creation of only two cross sectoral agencies, a Financial Stability Commission which is responsible for the prudential regulation of almost all financial institutions, and a Consumer Protection Commission which is responsible for the conduct-of-business regulation of those institutions which engage in business with retail clients.²¹⁹

Another well known proposal for objective based regulation, promoted by a group of experts headed by Charles Goodhart, envisages the creation of at least five agencies; a ‘systemic prudential regulation’ responsible for banks and other deposit taking institutions, whose failure can lead to contagion or panics; a non-systemic-prudential

²¹⁴ Ibid

²¹⁵ Ibid

²¹⁶ Ibid

²¹⁷ Taylor, M., “‘Twin Peaks’: A Regulatory Structure for the New Century”, *CSFI Paper No. 20* (London: Center for the Study of Financial Innovation) (1995), pp. 10-11, cited in, *Supra note at 207, p.138*

²¹⁸ Ibid

²¹⁹ Ibid

regulator, responsible for insurance companies, two conduct-of-business regulator, one for retail and one for whole sell securities business and a regulator of exchange.²²⁰

Other still advocates a single regulatory agency with comprehensive powers, respectively for all regulatory objectives and jurisdictions over all regimes of financial Service industry.²²¹ Proponents of this approach advance various arguments in support of the proposition that the creation of a financial megaregulator would entail significant gains in terms of regulatory efficiency and effectiveness.²²² While the critics, on the other hand, maintain that, while it may prove practically impossible that to realize all potential benefits of a fully consolidated supervisory system, weaknesses and inefficiencies in a single regulatory organization and operation could lead to failure of the institution.²²³

3.2.3. Function- Based Regulation

Under this system, all institutions regardless of description, which carries on financial activities ('functions') of a specified type, should be placed under the supervision of a common regulator.²²⁴ Functional regulation rests on the principle that like functions should be regulated alike, regardless of the type of entity performing the function. Functional regulation attempts to regulate each common activity or product by a single agency under a common set of rules irrespective of the types of institutions involved. Historically this system was adopted in 1980's by SEC in USA, to extend its jurisdiction to include bank securities activities under the Federal Securities Laws, but that they should also be regulated by SEC as the agency primarily responsible for administering those laws.²²⁵ Four policy rationales supporting the use of functional regulation in the banking and securities industries are forwarded. First, (functional regulation) allocates to each regulatory agency jurisdiction over their economic functions it knows best.²²⁶ The principal concern of bank regulators is assuring the safety and soundness of the banking

²²⁰ Ibid

²²¹ Supra note at 207, p. 139

²²² De Luna Martinez, J., Rose, T.A., "International survey of integrated financial sector supervision". *Policy Research Working Paper Series, n.3096*, World Bank, Washington D.C,(2003), P. .4

²²³ Taylor, M. and Fleming, A. "Integrated Financial Supervision: Lessons of Scandinavian Experience", *Finance and Development, Vol. 36, No. 4, IMF*, (1999), p.11

²²⁴ Supra Note at 207, p. 142

²²⁵ Ibid

²²⁶ Ibid

system and their statutory mediate gives priority to the protection of banks and their depositors over protection of the investors. Thus their expertise in the protection of the investors is not as great as that of the SEC. It is sensible, therefore, to change the SEC with regulating securities activities and the banking agencies with regulating banking activities.

Second, allocating regulatory jurisdiction by function permits the application of a consistent regulatory philosophy.²²⁷ A major thrust of the securities laws is full-disclosure. By contrast, bank regulators are concerned about the need for public confidence in banks and therefore tend more toward confidentiality. The result is that the banking regulators approach to their responsibilities under the securities laws is different from the SEC's.

A third advantage of a functionally based system of regulation is that it minimizes the regulatory conflict, duplication and overlap.²²⁸ A regulatory system based in some respects on regulation by industry segment and in others on functional regulation creates confusion. Jurisdictional lines based on industry categories inevitably become blurred as the industries evolve and economic conditions change.

Finally, functional regulations have the distinct advantage that it establishes the conditions for equal treatment of the competitors.²²⁹ For example, banking securities activities would have been subject to extra regulation than other securities firms engaged in the same activities if they were regulated by different entity.

Hence it serves the public interest by reducing duplication among different government agencies and by promoting equal regulation of computing activities by different types of financial firms.²³⁰ By making regulation transparent as to the type of the firm involved, functional regulations helps promote the availability of the widest possible range of financial products for the public the lowest possible cost, with different firms prospering

²²⁷ Ibid

²²⁸ Ibid

²²⁹ Ibid

²³⁰ Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services reprinted in 1050 Fed. (1984)

or failing to the greatest degree possible on their efficiency and merits rather than because of arbitrary differences in government institutions.²³¹

However this system of regulation isn't without drawbacks. First, it is the requirements of various regulators to maintain separate staff and resources in order to exercise regulatory jurisdiction over distinct areas of financial institutions operations, potentially increases the costs of regulation.²³²

Second, the tendency that the regulators with different regulatory focuses to examine different aspects of the same institutions in isolation from one another and without the regard for the overall operation and condition of the institution as an organic whole may end up in fragmentation of financial institutions regulations.²³³

Third, this fragmented regulation form could also result in duplicative and potentially inconsistent regulatory requirements.²³⁴ Forth, complying with the requirements of multiple functional regulators could substantially increase costs for financial institutions.²³⁵ Finally, financial products may sometimes be not fit to any of the existing functional regulator. So, the merits of this base should be weighed against its weaknesses in order to establish regulatory institutions based up on this approach.

Depending on these bases, different states establish their financial market regulator differently. A mix of approaches may also be used if it is deemed effective and efficient. The next sub section discusses the experience of other countries in order to get an insight regarding an optimal institutional structure of securities regulatory institutions.

3.3. Government Regulation

²³¹ Ibid

²³² Supra note at 217

²³³ *Securities Regulator Equality: Hearings on H.R. 3447 Before the Subcomm. On Telecommunications and Finance of the House Comm. Energy and Commerce*, 103d Cong., 2nd Sess. 3(1994), cited in, Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagle Reform?*, 2 Stan. J.L. Bus. & Fin. (1995-1996), p. 94

²³⁴ For example, banking regulators would continue to regulate securities activities conducted by the bank as part of their general oversight responsibility for the operations and condition of banking organization and would not voluntarily relinquish their regulation of securities activities. See, supra note at 41, page. 110

²³⁵ Supra note at 201, p. 112

The need to regulate securities market and the form that regulation should take, have been always controversial, as is the optimal institutional structure of the regulatory agency.²³⁶ Market failure is the usual justification of which requires regulatory intervention.²³⁷ The protection of investors and reduction of systemic risk are also the grounds for the government to intervene in the market. Regulation by the government requires the enactment of laws and establishment of agencies entrusted to regulate the market.²³⁸ The laws and agencies are normally backed by sanctions in case the subjects fail to comply with the laws and institutions.

In the process, the government usually applies regulatory devices to regulate securities. These devices are mainly antifraud provisions, provisions requiring the registration or licensing of certain persons engaged in the securities business, and provisions requiring the registration or licensing of securities.²³⁹ These three devices are interdependent and supportive to each other. Public authorities are established to regulate and implement the securities market.

Each of the three regulatory devices represents somewhat different approach toward the same end of protecting the investing public and ensuring market efficiency. Antifraud provisions are intended to enable the administrator to issue public warnings, to investigate and suspend fraudulent activities, to take an injunctive or other step to stop the fraudulent activities, or as a last resort to punish the wrongdoers.²⁴⁰ Registration of brokers, dealers, agents, and investment advisors is intended to prevent fraudulent or unqualified persons from entering the securities business, to supervise their activities once registration has achieved, and to remove them from registration if they fail below the legal standards.²⁴¹ Registration of securities is intended to allow the issuer to sell

²³⁶ Saari, P. C., "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry", *Stanford Law Review*, Vol. 29, No. 5 (May, 1977), p. 1037

²³⁷ Ibid

²³⁸ Yang, Xusheng, 'Securities Regulation in China: A Study of Its Path to Market Economy, Unpublished, Faculty of Law, the University of British Columbia, (1997), p. 12

²³⁹ Ibid

²⁴⁰ Ibid

²⁴¹ Ibid

securities after disclosing material information to the potential investors and to exclude other securities which don't satisfy the statutory standards.²⁴²

3.3.1. Institutional Structure

Institutional structure refers to issues related to the number and structure of agencies responsible for the regulation and supervision of financial institutions and markets in general and securities regulation in particular.²⁴³ The optimal regulatory authority of securities markets should be seen in light with the regulation of banks and insurance companies. The institutional structure of securities regulator is not an independent organ from other financial institutions. In most countries, the traditional structure has been for there to be separate agencies and arrangements for regulating and supervising banks, insurance companies, and securities firms.²⁴⁴ This is largely because, traditionally in many countries, financial regulation and supervision, has been organized around specialist agencies that have distinct and separate responsibilities for banking, securities and insurance sectors.²⁴⁵

However, the emergence of 'financial conglomerates',²⁴⁶ and firms which provide the services of banks, insurance and securities firms with in one roof affects the traditional regulation and supervision of banks, insurance companies and securities firms by a separate public authority which is specialized in dealing with one financial sector.²⁴⁷ Specially, the revolution in telecommunication and information technology increased the speed of transactions, eliminated geographical distances as a constraining factor, reduced the transaction costs, and provide an immense computational capacity in the field of

²⁴² Ibid

²⁴³ Llewellyn, D., "*Institutional Structure of Financial Regulation: The Basic Issues*", paper presented at the World Bank and IMF conference *Aligning Supervisory Structures with Country Needs*, Washington DC, June 5-6, (2006).

²⁴⁴ Ibid

²⁴⁵ Ibid

²⁴⁶ 'Financial conglomerates' would be used to refer to "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, insurance)", see, De Swann (1995), *The Supervision of Financial Conglomerates*, Report of the Tripartite Group of Bank, Securities and Insurance Regulators, Bank for International Settlements, Basle.

²⁴⁷ Group of Ten, 2001, "*Report on Consolidation in the Financial Sector*", and Supra Note at 15, pp. 12-14

financial services.²⁴⁸ This fact blurred the classic distinctions applicable to financial institutions and services- distinctions between categories of firm (banks, securities firms, insurance companies, etc), between varieties of standard services (so- called financial products).²⁴⁹

To a significant extent, the difference between banking and securities finance, but also between debt and equity instruments, has disappeared, as a result of the unbundling of long-established, standardized contractual arrangements and their repackaging in hybrid forms.²⁵⁰ For instance, the securitization of various types of direct credit provision (mortgage lending, credit-card receivables, consumer loans) has changed the bank's function from principal creditor to fee-earning originator of the relevant securities issues.²⁵¹ Derivative instruments, serving both hedging and risk-trading purposes, have become a pivotal part of the financial landscape; as well as the existing distribution channels are put to additional uses, while new ones are gaining ground rapidly.²⁵² For instance, banks now use their branch networks to make forays in the distribution of insurance products and shares, in direct competition with insurance brokers and securities brokers.²⁵³ At the same time, however, their old territory is invaded by internet based providers of mainstream banking products, but also by large nonfinancial retailers, who discover that offering a limited range of retail banking services alongside their main line of business can be profitable, due to economic of scope.²⁵⁴

So some countries regulate banks and insurers in a single organ and securities independently; others regulate securities and insurers together and still others establish a single regulatory organ to supervise all securities, banks and insurance companies. So to determine the optimal regulatory institution of securities market requires viewing the issues with in the broader context of financial regulation.

²⁴⁸ Ibid

²⁴⁹ George, E.A., '*Some Thoughts on Financial Regulation*', Bank of England Quarterly Bulletin, May (1996), p. 2

²⁵⁰ Supra note at 223, p. 5

²⁵¹ Supra note at 209, p. 130

²⁵² Ibid

²⁵³ Supra note at 207

²⁵⁴ Ibid

Before discussing the arguments in favor or against any models of securities regulation, given the wide diversity of institutional arrangements for financial regulation and supervision that exists in the world, it is evidently the case that there is no single model for optimal institutional structure.²⁵⁵ There are advantages and disadvantages of all forms of institutional structure including unified agencies which ultimately leads to the fact that no single model is exclusively better than the other.

Nevertheless, the general trend in the structuring and reforming of financial regulation is towards consolidation, even establishing single unified agency to regulate all banking, insurance and securities firms.²⁵⁶ A review of international experience indicates a wide variety of institutional structures; some countries have created a single agency for 'prudential supervision'²⁵⁷ while others have opted for multiple agencies; some have also created unified agencies and there is considerable variety within the spectrum and even within the same basic model.²⁵⁸ National differences reflect a multitude of factors: historical evolution, the structure of the financial system, political structures and traditions, and the size of the country and financial sector.²⁵⁹ Although there is no universal common pattern, there is a general trend towards reducing the number of separate agencies, a move towards integrated prudential supervisory arrangements, reducing the role of the central bank in prudential oversight of financial institutions,

²⁵⁵ Briault, C., "*The Rationale for a Single National Financial Services Regulator*" 6 (*Fin. Servs. Auth., Occasional Paper No. 2, 1999*), available at, <http://www.fsa.gov.uk/pubs/occpapers/OP02.pdf>.
And, Schoenmaker, D., 2003. "*Financial supervision: from national to European?*". Financial and Monetary Studies, NIBE - SVV, vol. 22, no. 1, Amsterdam.

²⁵⁶ Taylor, M and Fleming, A, "*Integrated Financial Supervision: Lessons from Northern European Experience*", Policy Research Working Paper 2223, World Bank, Washington. (1999), p. 1

²⁵⁷ Prudential regulation concerns with promoting the stable and prudent operation of the financial system through the effective regulation of financial firms, like banks and other deposit-takers (including building societies and credit unions); broker-dealers (or investment banks); and insurers. The necessary functions may include exercising judgments about the safety and soundness of financial firms, and taking appropriate action; making the rules which govern the performance of regulated activities by financial firms; the authorization of firms via the provision of permissions to firms to engage in regulated activities; supervision, and where necessary, enforcement of compliance with rules; and the approval of individuals to perform certain controlled functions within financial firms.

²⁵⁸ Supra note at 223

²⁵⁹ Ibid

increasing emphasis to the central bank in its systemic stability role and, if a unified agency is created, for this not to be the central bank.²⁶⁰

Even though the optimal institutional structure of securities regulation is different across different countries, the following criteria should be taken in to account in the process of organizing. The administrative and compliance costs of regulation, the objectives of regulation, the nature of the financial institutions and their services, the effectiveness and efficiency of the regulatory institutions should be taken in to account.²⁶¹

While several countries have moved in the direction of an integrated agency for prudential regulation and supervision, the case for also integrating conduct-of-business and prudential regulation and supervision within the same agency is considerably less common.²⁶² The following subsections deal with two models of financial regulatory institutions which the paper believes important to gain experience to establish securities regulatory agency in Ethiopia. The first is the single regulatory body which is responsible for banks, insurance companies and securities firms and their respective markets. The other is establishment of two institutions which the first is responsible for prudential regulation and the other is business conduct (consumer protection) regulation.

3.3.1.1. Single Financial Regulator

In May 1997, the United Kingdom reformed its institutional structure of financial regulation. A single regulator, Financial Service Authority (FSA), is established which is responsible for both prudential and conduct of business regulation and supervision, and for all financial institutions and markets (banks, insurance companies and securities firms and their respective markets).²⁶³ For countries which establish such model, the important argument in favor of a unified regulator is that it matches their market, which is the emergence of financial super-markets and increased use of sophisticated techniques such

²⁶⁰ Ibid

²⁶¹ Supra note at 247. Effectiveness relates to whether the objectives of structuring financial regulation are met and efficiency relates to whether they are met in an efficient way and without imposing unnecessary costs on consumers and regulated firms

²⁶² Joseph, N., "Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience- A Critical Reevaluation", *Int'l Law. Vil.* 39(2005),p.3

²⁶³ Ibid

as securitization and derivatives trading have broken down the traditional sectoral distinction among securities, banks and insurance.²⁶⁴

The supporters of the consolidation of all three major financial services, i.e., banking, insurance and securities firms, within single financial institutions argue that the multiple regulation and supervision of financial conglomerates could lead to fragmentation of the supervisory responsibility, especially function based regulation, which might then lead to an inadequate assessment of the institution's safety and soundness. An independent assessment of the overall safety and soundness of banks, insurance companies and securities firms by each regulator could also lead to unnecessary costs.²⁶⁵

Another main argument for a unitary regulator is that such a system will achieve significant economies of scale and scope.²⁶⁶ In particular, it would be able to rely on a single central administration, a uniform information-gathering system and a consolidated database, as well as a single enforcement mechanism.²⁶⁷ It could utilize resources and expertise efficiently, shift excess resources to areas of current need, increase employment specialization, but also take advantage of potential synergies amongst specialist functional supervisors, now operating under a single umbrella.²⁶⁸

A unitary regulator eliminates confusions about the exact allocation of competencies by avoiding jurisdictional uncertainties which could have been existed in multiple financial regulators. It also allows consumers to have ease access by providing a one-stop point of contact with the regulatory regime.²⁶⁹

A situation may arise where financial institutions offering similar services or products are supervised by different authorities. In this case, there is a strong likelihood that there will

²⁶⁴ Ibid

²⁶⁵ Supra note at 247, p. 13.

²⁶⁶ Richard A., and Taylor, M., "Issues in the Unification of Financial Sector Supervision," IMF Working Paper 00/213 (Washington: International Monetary Fund, (2000), p.10

²⁶⁷ Ibid

²⁶⁸ Supra note at 255, pp. 12-14

²⁶⁹ Goodhart, C., Hartmann, P., Llewellyn, D., Rojas-Suarez, L., and Weisbrod, S., *Financial Regulation: Why, How and Where Now?*(London: Routledge, 1998), pp. 159-168, cited in, Christos, H., "Institutional Structure of Financial Regulation: A Trend Towards 'Megaregulator'", *5 Y.B. Int'l Fin. & Econ. L. (2000-2001)*, p. 140.

be differences in their regulation and the associated costs of achieving compliance which may give certain institutions a competitive advantage for the same activity for different players.²⁷⁰ Unified supervision could thus help to achieve competitive neutrality by setting regulatory rules, which would ensure consistent treatment of similar issues across the various sectors.²⁷¹ At the same time, the possibility would be left open for differentiated treatment, where this is deemed appropriate in view of the special characteristics of particular regulated institutions and their activities.²⁷²

Besides, the unified system would also result in reduced problems of regulatory communication and coordination, since these can be resolved more efficiently and effectively within a single organization, with unified management, than between separate organizations.²⁷³ A unified model could also internalize the various regulatory objectives of banks, insurance and securities firms and to adopt the most efficient solutions, taking into consideration a broad range of factors.²⁷⁴

On the other hand, counter arguments to the adoption of a mega-regulator are also forwarded. The first is that banking, securities and insurance undertakings, at least for some time, retain certain distinctive features and required differentiated policy orientation, regulatory treatment and specialized knowledge.²⁷⁵ So the “One-size-fits-all” approach to regulation may be inappropriate and even counterproductive.²⁷⁶ If, however, the complex and varied nature of the financial industry is recognized and, in response, the megaregulator is established to regulate the financial market, the appearance of regulatory simplicity may become little more than an illusion.²⁷⁷

²⁷⁰ Ibid

²⁷¹ Ibid

²⁷² Ibid

²⁷³ Briault, C., Revisiting the Rationale for a Single National Financial Services Regulator - in “Financial Services Authority OP”, No.16, 2002. See also, Christos, H., “Institutional Structure of Financial Regulation: A Trend Towards ‘Megaregulator’”, 5 *Y.B. Int’l Fin. & Econ. L. (2000-2001)*, p. 141

²⁷⁴ Ibid

²⁷⁵ Supra Note at 247, p. 15

²⁷⁶ Ibid

²⁷⁷ Reddy, Y, “Issues in choosing between single and multiple regulators of financial system”, Speech delivered at the Public Policy Workshop, ICRIER, 22 May, New Delh, (2001), P. 5. See also, Howard Davis, speech on ‘*Integrated Financial Regulation: Lessons from the UK’s Financial Services Authority*’,

Second, the elimination of regulatory competition and the concentration of power over the financial sector in the hands of a single agency can lead to inefficiencies and abuses.²⁷⁸ This is more likely to be the case where the megaregulator combines rulemaking powers and wide administrative discretion, enjoys high institutional prestige and is sheltered, for legal and practical reasons, from judicial and political control.²⁷⁹

Third, the promised operational coherence mayn't be easily achievable.²⁸⁰ Specialist units will exist even within a single regulatory agency, especially if the agency is large.²⁸¹ The megaregulator may encounter problems of internal cooperation, information available to the organization may not be shared effectively between departments, and the latter may reach inconsistent decisions.²⁸² In case the agency is very large and has diverse responsibilities, the creation of the megaregulator may lead to diseconomies and bureaucratization.²⁸³ Another argument against a megaregulator is the problem of moral hazard.²⁸⁴ In many situations a special scheme is in place to protect depositors in case banks fail or become illiquid. But such kind of compensation scheme is rarely found to protect investors of shares. So investors may presuppose that the protection available for depositors are also applicable to them and take excessive risk which may affect the interests of investors and integrity of the securities market.

The existence of multiple different objectives among securities, bank and insurance regulation may lead to trade off against one another which decreases the perceived importance of transparency, simplicity and accountability meaningless.²⁸⁵ The

delivered at the Centre for Financial Studies Seminar, Auditorium der Commerzbank AG, Frankfurt (5 Dec. 2001), para. 2(a), cited in, supra note at 243, p. 140

²⁷⁸ Ibid

²⁷⁹ Ibid

²⁸⁰ Martin, C., Podpiera, R., "Is One Watchdog Better Than Three? International Experience with Integrated Financial Sector Supervision," *IMF Working Paper No. 06/57* (Washington: International Monetary Fund), (2006), p. 108

²⁸¹ Ibid

²⁸² Ibid

²⁸³ Ibid

²⁸⁴ Ibid

²⁸⁵ Supra note at 243, p. 144. See also, Kenneth, M., "Legal aspects of financial services regulation and the concept of a unified regulator", *Law, Justice, and Development Series, The World Bank*, (2006), p. 3

transitional risks and costs incurred during the transformation of the institution to a unified system should also be considered to weigh its merit.²⁸⁶

3.3.1.2. Twin Peaks Financial Regulator

Australia capital market is based up on objective based regulation. The framework is designed to promote confidence that fair, orderly, and transparent processes govern the market.²⁸⁷ Within this framework the Australian Prudential Regulation Authority (APRA) has responsibility for ensuring capital adequacy, banking regulation and other financial industry.²⁸⁸ Market integrity issues, including continuous disclosure, the regulation of directorial conduct and fiduciary obligations imposed on intermediating professions, fall within the ambit of the Australian Securities and Investment Commission.²⁸⁹

International experience shows that some countries are also inclined towards this model in addition to Australia. Netherland adopted fully-fledged alternatives of the Twin Peaks model.²⁹⁰ In Netherland the Central Bank, De Nederlandsche Bank (DNB), has retained responsibility for prudential regulation of all financial services, while the Authority for the Financial Markets (AFM) is responsible for conduct of business regulation in the Dutch financial markets.²⁹¹

in 2008 US Treasury “Blueprint for a Modernised Financial Regulatory Structure” presents a long-term optimal regulatory structure based on a separation between

²⁸⁶ Ibid

²⁸⁷ Taylor, M., “The Road from “Twin Peaks” and the Way Back”, *16 Conn. Ins. L.J.* 61 (2009-2010), p.81

²⁸⁸ Michael Taylor, *“Twin Peaks”: A Regulatory Structure for the New Century*, CSFI Paper No. 20 (London: Center for the Study of Financial Innovation) (1995), pp. 10-11, cited in, *Supra* note at 36, p.138 Hadjiemmanuil Christos, *Institutional Structure of Financial Regulation: A Trend Towards ‘Megaregulator’*, 5 *Y.B. Int’l Fin. & Econ. L.* (2000-2001), p. 127 Thompson, G. (1996), *‘Regulatory Policy Issues in Australia’*, *Future of Financial System*, Sydney, Reserve Bank of Australia

²⁸⁹ Ibid

²⁹⁰ *Supra* note at 256, p. 4

²⁹¹ Ibid

prudential and conduct of business regulation for US is favored the Twin Peaks model.²⁹² France and Spain are also reported to be considering adoption of a Twin Peaks model.²⁹³

The main reason to prefer this approach to a unified regulator is the existence of conflict of interest between prudential and conduct of business regulation regarding their regulatory objectives and regulatory style and culture of regulation.²⁹⁴ The remedial “doctor” approach of the prudential regulator is often contrasted with the enforcement-led “policeman” approach of the conduct of business regulator.²⁹⁵ If the two functions are combined within the same agency, this can lead to internal conflicts and possible misallocation of resources.²⁹⁶

The other reasons to adopt Twin Peaks model than the single regulatory authority are the following. The two agencies in the Twin Peaks model have dedicated objectives and clear mandates to which they are exclusively committed.²⁹⁷ Their accountability is clear because the objectives and mandates of the agencies are clearly defined.²⁹⁸ There is no danger that one or the other areas of regulation and supervision will come to dominate.²⁹⁹ Unlike the unified model, there could be no problem of mixing the different cultures of the two areas of regulation and supervision.³⁰⁰ And finally, reputation and contamination risks between the two peaks are likely to be lower.³⁰¹

However, the model has its own flaws and weaknesses. For example, the respective responsibilities of the two regulators would need to be carefully defined to avoid overlap and duplication.³⁰² Moreover, separation of prudential and conduct of business regulation does not eliminate the possibility of conflict between them, e.g. if the conduct

²⁹² Saule Omarova, S., Feibelman, A., “Risks, Rules, and Institutions: A Process for Reforming Financial Regulation,” *39 U. Mem. L. Rev. (2008-2009)*, p. 887

²⁹³ *Ibid*

²⁹⁴ Mwenda, K. and A. Fleming, ‘*International Development in the Organizational Structure of Financial Services Supervision*’, Conference on the Challenges of Unified Financial Supervision, 2001 (World Bank: Washington DC), p. 20

²⁹⁵ *Ibid*

²⁹⁶ *Ibid*

²⁹⁷ *Supra* note at 243

²⁹⁸ *Ibid*

²⁹⁹ *Ibid*

³⁰⁰ *Ibid*

³⁰¹ *Supra* note at 207, p. 12

³⁰² *Ibid*

of business regulator wished to take action against a firm or group of firms for improper conduct which, in the judgment of the prudential regulator, might threaten their financial viability.³⁰³ Coordination problem between the two regulators is also another problem that may affect the entire financial stability.³⁰⁴

Generally speaking the choice as to the proper approach in structuring financial regulation as a whole, and securities regulation specifically must be country specific which takes in to account the distinct features of that country.

3.3.2. Central Bank and Securities Regulation

Central Banks have always been given due attention in the process of determining the regulatory structure of securities regulation in particular, and financial regulation in general.³⁰⁵ In the vast majority of countries, the central bank has historically been responsible for both systemic stability and the prudential regulation and supervision of banks.³⁰⁶ There are several alternative models for the role of the central banks in the regulation of financial market in general and securities market in particular. The role of the Central Bank in the financial regulation depends on its involvement in monitoring the payments system, the provision of emergency liquidity to the markets, the supervision of banks and insurance firms, the management of deposit insurance, and a safety-net/ crisis resolution role.³⁰⁷

When we look at the experiences of different countries, there is no single optimal role of the central bank in the arena of financial regulation in general; and securities regulation specifically. There are countries where the central bank is responsible for the supervision of banks and only banks. In other countries it is responsible for banking and insurance and/or securities trading. In some countries, responsibility for prudential supervision of

³⁰³ Ibid

³⁰⁴ Ibid

³⁰⁵ Abrams, K., and M.W. Taylor, 'Issues in the Unification of Financial Sector Supervision.' IMF Working Paper WP/00/213. International Monetary Fund. Washington, (2000), p. 7

³⁰⁶ Ibid

³⁰⁷ Masciandaro, D., Quintyn, M., 'Reforming Financial Supervision and the Role of the Central Banks: a Review of Global Trends, Causes and Effects (1998-2008)', CEPR Policy Insight, n.30, (2009), p. 6

all financial institutions (including banks) has been withdrawn from the central bank.³⁰⁸ Nevertheless, in most cases the central banks are allocated at least some role in maintaining systemic stability even if it is not involved in the prudential supervision of financial institutions that make up the system.³⁰⁹

3.4. Self-Regulation

3.4.1. Nature of Self Regulation

Self regulation and self regulatory organizations have been an integral part of securities regulation in developed and developing countries.³¹⁰ It is not uncommon to find the concept of self regulation in guiding and enforcing social behavior in a range of professions and social thought, including law, medicine, education, private business and institutions, accreditation bodies, consumer goods, ISO (International Organization for Standardization) classification standards.³¹¹ Besides, the concept of self regulation is not static even in a single profession.³¹² Over time it assumes different forms, different objectives, processes, and success across time and countries.³¹³ As a result it is impossible to come up with a universally acceptable definition of self regulation.³¹⁴

The term self-regulation in the securities regulation may be used to refer to formal self-regulatory organizations (SROs), to standards set by financial industry associations, and to the internal supervision and compliance functions within financial firms.³¹⁵

Self Regulatory Organizations (SRO), which are mainly private institutions that establish, monitor compliance with, and enforce rules applicable to securities markets and the conduct of market participants.³¹⁶ These organizations perform industry, regulatory, or

³⁰⁸ Ibid

³⁰⁹ Ibid

³¹⁰ John, C., “ Self-Regulation in Securities Markets”, *Working Paper for World Bank Financial Sector Policy Group*, The World Bank, Washington, DC , August 2010, P. 11

³¹¹ CFA Institute. “*Self-Regulation in Today’s Securities Markets: Outdated System or Work in Progress?*” CFA Institute Publications, (2007), p. 1, available at, <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n7.4819>.

³¹² Ibid

³¹³ Ibid

³¹⁴ Ibid

³¹⁵ Supra note at 294, p. 9

³¹⁶ Ibid

public interest functions under the supervision of a securities regulatory authority.³¹⁷ Self-regulation, which typically involves a unique combination of private interests with government oversight, is deemed an effective and efficient form of regulation for the complex, dynamic and ever-changing financial services industry.³¹⁸ As stated in IOSCO's seminal report on Objectives and Principles of Securities Regulation, "self-regulatory organizations ("SROs") can be a valuable component to the regulator in achieving the objectives of securities regulation."³¹⁹

The roles of self regulatory organizations are the protection of investors, market efficiency and integrity of the market. Self regulatory organizations have the following advantages to achieve their objectives.³²⁰ First, having the motivation to develop best practices and monitoring their markets out of economic, reputational and regulatory self-interest, self regulatory organizations have been effective in many countries.³²¹ Regulation by the government alone would not be possible in practical terms due to restraints on resources, whether financial, personnel or expertise.³²²

Second, self regulatory organizations are flexible.³²³ The rules can be quickly and easily adjusted to meet changing circumstances because self regulatory organizations are not subject to some of the other constraints of government, including budget and personnel controls. Their close relation with the market and market users enable self regulatory organizations to be flexible to adapt to regulatory requirements of a rapidly changing business environment.³²⁴

³¹⁷ Id, p. 10

³¹⁸ Ibid

³¹⁹ IOSCO (International Organization of Securities Commissions). *Objectives and Principles of Securities Regulation*. IOSCO public document no. 125(2003),p.12, available at, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>.

³²⁰ Supra Note at 247, pp. 12-13

³²¹ Ibid

³²² Priest, M., "The Privatization of Regulations: Five Model of Self-Regulation", *Vol. 29 Ottawa L. Rev. (1997-1998)*, p.268

³²³ Supra note at 319, p 12

³²⁴ Ibid

Third, self-regulation can result in substantial cost savings to the government, because those regulatory costs are largely shifted to the regulated industry.³²⁵ Finally, self regulatory organizations have the experience, resources and commitment to play a constructive role in assisting statutory regulators to examine issues and to arrive at creative and effective solutions which enhance the health of the securities markets and the protection of investors.³²⁶

Self-regulation in securities markets takes a large variety of forms. At an informal level, in some countries, almost all trade associations that represent firms active in the securities market develop codes of conduct and other forms of guidance for their members, although generally this guidance is not binding.³²⁷ At a formal or official level, almost all exchanges exercise some regulatory authority over their markets and member firms. SROs that regulate the vast majority of market participants have developed in several jurisdictions.³²⁸ In some cases, these SROs regulate markets as well as market participants, but do not own or operate an exchange or marketplace.³²⁹ In other cases, these SROs regulate markets and market participants and also own and/or operate an exchange or marketplace.³³⁰ Finally, in some countries, these SROs also function as trade associations and, in that capacity, advocate on behalf of the industry.³³¹ Some self-regulatory bodies are stronger and more effective than others.³³² At the weakest end of the spectrum lies a voluntary industry code of conduct for which compliance is voluntary and the industry has little or no enforcement capability.³³³

3.4.2. Self Regulatory Organization in Securities Regulation

³²⁵ Ibid

³²⁶ Ibid

³²⁷ ICSA (International Council of Securities Associations).“*Best Practices for SROs*”, (2006a) , p. 1, available at, <http://www.icsa.bz/pdf/ICSABestPracticesSRO.pdf>.

³²⁸ Ibid

³²⁹ Ibid

³³⁰ Ibid

³³¹ Ibid, pp. 2

³³² Ibid

³³³ Supra note at 266, p. 12

The self regulatory institutions include the ‘exchanges’, industry or dealers associations and clearing and settlement associations. These organizations traditionally play important and effective regulatory functions in some jurisdictions.

3.4.2.1. Stock Exchanges

A stock exchange is defined as any organization, association, or group of persons which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.’³³⁴

Stock exchanges play an important role in the regulation of initial public offering of shares through their listing and corporate standard requirements.³³⁵ The application of listing standards to prospective issuers in many jurisdictions is subject to the discretion of the stock exchanges.³³⁶ In practice, most exchanges treat listings as part of their self-regulatory or at least their supervision functions.³³⁷ This regulatory function has traditionally been undertaken by setting listing rules in areas such as financial and business disclosure, protection of minority shareholders’ interests, and corporate governance standards for listed issuers.³³⁸ In some countries, exchanges had traditionally performed the job of approving prospectuses too (requirements for approval for public trading of a security), but this function has moved to regulators around the world.³³⁹

However, the exchanges traditional regulatory role through their listing and corporate standard requirements within a specific countries legal framework is now being

³³⁴ Macey, J., and O’Hara, M., “Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspectiv”, *The Journal of Legal Studies*, Vol. 28, No.1 (Jan., 1999), p. 21

³³⁵ Ibid

³³⁶ Christiansen, H., Koldertsavo, A., “The Role of Stock Exchanges in Corporate Governance”, *Financial Market Trends- ISSN 1995-2864, OECD (2009)*, p. 5

³³⁷ Ibid

³³⁸ Supra note at 249, pp. 41-42

³³⁹ CFA Institute. “*Self-Regulation in Today’s Securities Markets: Outdated System or Work in Progress?*” CFA Institute Publications, (2007), p. 4, available at: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n7.4819>.

questioned for different reasons. Demutualization and the subsequent self-listing, their for-profit activities, competition from other exchanges and the rise of alternative trading systems lead the states to question the regulatory role of exchanges free from conflict of interest.³⁴⁰ So the general trend is to separate the regulatory authority of exchanges and give it to independent self-regulatory organizations.³⁴¹ Nevertheless, exchanges, as self-regulatory organizations, are still playing important roles in the regulation of securities intermediaries and markets in several countries.³⁴²

3.4.2.2. Association of Securities Dealers and Brokers

This SRO may take different forms ranging from voluntary to mandatory membership of securities dealers and brokers.³⁴³ For example, the US National Association of Securities Dealers (NASD) is the primary private-sector regulator of US securities industry.³⁴⁴ It licenses individuals and admits firms to the industry, writes rules to govern their behavior, examines them for regulatory compliance and disciplines who fail to comply.³⁴⁵ In addition, the NASD oversees and regulates trading in equities, corporate bonds, securities futures and options.³⁴⁶ Brokers of securities must be registered with the NASD and where they do business.³⁴⁷

3.4.2.3. Central Securities Clearing System

Another important SRO is the Central Securities Clearing System that facilitates clearing and settlement of trade in securities. This system facilitates the exchange of stock and bond holdings as well as offers custodian services. As a clearing house, it facilitates the validation, delivery and settlement of securities transactions. This SRO regulates the members' capital requirement and market in order the securities market becomes efficient.³⁴⁸

³⁴⁰ Ibid

³⁴¹ Ibid

³⁴² Ibid

³⁴³ Oladele, O., Ogunleye, A., "The Conceptual Basis and Limits of Self-Regulation by Securities Markets in Nigeria and United States", *3 University of Botswana Law Journal Vol.3* (2006), p. 57

³⁴⁴ Ibid

³⁴⁵ Id, p. 58

³⁴⁶ Ibid

³⁴⁷ Ibid

³⁴⁸ Ibid

3.4.3. Government Oversight

IOSCO emphasizes the need for effective oversight of an SRO by supervising regulators.

IOSCO's principle 7 states: "SROs should be subject to oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and responsibilities".³⁴⁹

The supervising regulator is expected to approve SROs, including exchanges, in the field of securities regulation. Once an SRO is licensed, it is subject to ongoing supervision to ensure that it continues to meet the terms of license and its legal obligations.³⁵⁰

The main reasons for the interference of the statutory regulator are the problems associated with self regulation. The first of these problems is self interest.³⁵¹ Self regulation is intended to regulate the securities market and members to protect public interest.³⁵² However, self regulatory organizations may neglect the public interest aspect and stand for their own self interest, and may abuse the system to avoid stringent direct regulation and may use the system as anti-competitive device by limiting entry or restricting competition among themselves.³⁵³ Self regulatory institutions may also favor certain group against the interest of the public and the market.³⁵⁴ In some jurisdictions, due to the immunity from charge and prosecution, self regulatory institutions may pursue the interests of those groups at the expense of their regulatory function and may neglect their regulatory role.³⁵⁵

The existence of these potential dangers justifies the government oversight role of the SROs. Oversight includes processes such as periodic reviews or inspections of the SRO, reporting requirements, review of corporate governance arrangements, and review or

³⁴⁹ Supra note at 319, P. 11

³⁵⁰ Jordan, C., Hughes, P., "Which Way for Market Institutions: The Fundamental Question of Self-Regulation", *Berkeley Business Law Journal* Vol. 4 (2007), p.223

³⁵¹ DeMarzo, P., Fishman, M., Hagerty, K., "Self-Regulation and Government Oversight", *The Review of Economic Studies*, Vol. 72, No. 3 (Jul., 2005), p. 688

³⁵² Ibid

³⁵³ Ibid

³⁵⁴ Ibid

³⁵⁵ Ibid

approval of SRO rules.³⁵⁶ The purpose of an oversight program is to ensure that an SRO is meeting its legal and regulatory responsibilities and is capable of performing its regulatory functions effectively.³⁵⁷ Supervision of an SRO by a public authority is needed to ensure the SRO is accountable and to ensure that conflicts of interest are managed appropriately.³⁵⁸

Chapter Four

Regulation of Initial Public Offering of Shares in Ethiopia: Critical Issues and Challenges

4.1. Significance of IPOs Regulation for Ethiopia

Some individuals view stock markets in developing countries as having little positive impact on economic growth.³⁵⁹ Some Ethiopian government officials also states that since the government believes that regulation of securities market in the economy is not a policy priority, setting policy guidelines, enacting appropriate laws and establish the regulatory institutions of the securities market do not get the appropriate attention by the government.³⁶⁰ As a result the country fails to come up with a sound policy and regulatory frameworks of securities market so far. Without the right attitude to the

³⁵⁶ IOSCO SRO Consultative Committee. “*Model for Effective Self-Regulation*”, (2000), P.9, available at, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD110.pdf>

³⁵⁷ Ibid

³⁵⁸ ibid

³⁵⁹ Azarmi, T., Lazar, D., Jeyapaul, J., “Is The Indian Stock Market A Casino?”, *Journal of Business & Economics Research* Volume 3, Number 4, (April 2005), p. 2

³⁶⁰ Anonymous

significance of the securities market, it is impossible to create conducive environment for the efficiency, effectiveness and development of the securities market. The purpose of this subsection is to briefly discuss the outcomes of different researches regarding the significance of the regulation of the securities market to the developing countries like Ethiopia. The regulation of the securities market is aimed at gaining and ultimately achieving the following significances.

The securities markets can give a big boost to economic development and is expected to accelerate economic growth for the following reasons.³⁶¹ First securities market is recognized as an effective way of raising capital for commercial enterprises, and at the same time providing an investment opportunity for individuals and institutions. The activities of buying and selling securities in the securities markets are extremely important for the efficient allocation of capital within economies. The securities market is a requisite for the sound development of an economy because it not only provides stable long-term capital for companies and an effective savings vehicle for the public, but also functions as an efficient tool for resource allocation.

Second, Securities markets contribute to mobilization of domestic savings by enhancing the set of financial investments available to savers to diversify their portfolios which provide an important source of investment capital at relatively low cost.³⁶² For sustainable growth and development, funds must be effectively mobilized and allocated to enable businesses and the economy to effectively use their human, material, and management resources.³⁶³ When people draw their savings and invest in shares, it leads to a more rational allocation of resources because funds, which could have been consumed or kept idle, are mobilized and redirected to promote business activity which benefits several economic sectors.³⁶⁴

³⁶¹ Ajit, S., “Financial Liberalization, Stock Markets, and Economic Development”, *The Economic Journal*, Vol. 107, (1997), p.772

³⁶² Ross, L., Zervos, S., “Stock Markets, Banks and Economic Growth”, *American Economic Review*, Vol. 88, (1998), p. 538

³⁶³ Ibid

³⁶⁴ Ibid

In relation to mobilization of savings, securities market could also increase remittances and facilitate their use.³⁶⁵ A well established securities market is a good mechanism to facilitate cost-effective transfers and savings of funds through remittances, which is rapidly emerging source of foreign currency in Ethiopia, which can be used for economic growth.³⁶⁶

Third, well-functioning stock markets contribute to economic development by enhancing the liquidity of capital investments.³⁶⁷ Many profitable investments require a long-term commitment of capital, but investors might not want to tie up their savings for such long periods.³⁶⁸ A liquid equity market allows savers to sell shares easily if they so desire, thereby making shares relatively more attractive investments.³⁶⁹

Securities markets help investors to cope with liquidity risk by allowing those who receive a liquidity shock to sell their stock to other investors.³⁷⁰ The result is that capital is not prematurely removed from firms to satisfy short-term liquidity needs. Securities market benefits savers to have liquid assets while firms have permanent use of the capital raised by issuing shares. Investors don't lose access to their savings for the duration of the investment project because they can quickly, cheaply and confidently sell their share in the company. Thus, more liquid stock markets ease investment in long-run, potentially more profitable projects, thereby improving the allocation of capital and enhancing prospects for long term growth.³⁷¹

Fourth, stock markets help to redistribute wealth to achieve distributive justice.³⁷² Stock markets gives a wide spectrum of people a chance to buy shares and therefore become part owners (shareholders) of profitable enterprises, the stock market helps to reduce

³⁶⁵ Ibid

³⁶⁶ Ibid

³⁶⁷ Ross, L., Zervos, S., “ Stock Market Development and Long-Run Growth”, *World Bank Economic Review*, Vol.10 (2) (1996), p.325

³⁶⁸ Ibid

³⁶⁹ Ibid

³⁷⁰ Ibid

³⁷¹ Ibid

³⁷² Charles, A., Biekpe,N., “ Stock Market Development and Economic Growth: The Case of Selected African Countries”, *African Development Review*, Vol.18, No. 1 (2006),p. 145

large income inequalities.³⁷³ Mass participation in country's industrialization process is possible only through the efficient mechanism of securities markets as it promotes efficient collection of small and scattered savings from the investors and provides returns to them in the form of dividend.

Fifth, stock markets enhance corporate governance.³⁷⁴ Due to the wide and varied scope of shareholders, companies are under pressure to satisfy the demands and expectations of the shareholders in the corporate governance aspect. Besides, the government and self-regulatory organizations require public companies to comply with stringent rules of corporate governance to go public.

Sixth, equity financing eases the burden of bank loan.³⁷⁵ As has been observed in the global financial crises which affected the developed, emerging and developing countries, banks aren't infallible. Especially, at times when loan is limited to a selected group of companies and individual investor and loan caps which are imposed up on banks in 2010 by the National Bank of Ethiopia, equity financing can play an important role in financing projects. So equity financing through public offering can ease the burden of excessive reliance on bank loan and its negative consequences.³⁷⁶

So to reap the benefits of the securities market, due attention should be given to develop it. Securities markets cannot be developed without effective and efficient regulation.³⁷⁷ Optimal regulation help the securities market to function properly by boosting investors' confidence to participate in investment and ensuring market efficiency to allocate resources efficiently which ultimately enhance economic growth, wealth distribution and channel foreign direct investment and remittance.

4.2. Legal Regimes Governing Public Offering

The existing legal regime of securities law in Ethiopia resembles the USA situation before 1933. Researches have shown that there was a bubble in the securities market

³⁷³ Ibid

³⁷⁴ Ibid

³⁷⁵ Ibid

³⁷⁶ Demirguc-Kunt, A and Levine, R., "Stock Markets, Corporate Finance, and Economic Growth: An Overview", *Working Paper, World Bank, No 1389. (1995), p.3*

³⁷⁷ Ibid

before the 1933 great depression of the USA.³⁷⁸ And Ethiopia could not be an exception to the crises and scandals of securities market prevalent in a situation where there are no legal and institutional infrastructures of securities regulation. Due to the existence of other kind of company in Ethiopia, i.e. Private Limited Company, it must be clear that all companies can't issue freely transferable shares to the public. Share companies are the only business organization which can issue freely transferable shares outside the company to the public in Ethiopia.³⁷⁹

The term 'corporation' is used in a legal system which adapts a single approach to companies which can issue shares and other securities to the public, like for example USA.³⁸⁰ In other jurisdictions companies which are allowed to issue share are called 'Marketable share companies' while other kind of companies which are not allowed to issue shares and other securities are called Limited Liability Companies.³⁸¹ The Ethiopian Commercial Code makes a distinction between share companies which can issue shares to the public and 'private limited companies' which cannot issue shares to the public.

A share company is a company whose capital is fixed in advance and divided in to shares.³⁸² Capital is the "original value of the elements put at the disposal of the undertaking by the owner or partners by way of contributions in cash or in kind".³⁸³ Capital doesn't refer to the specific property contributed rather it's the corresponding monetary values. Capital of the share company is divided in to shares.³⁸⁴ Shares of the company don't represent the assets of the company because capital and asset are quite different. Asset constitutes the total monetary values of property at any point in time³⁸⁵

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³⁷⁹ Art.723(1) of the Commercial Code Commercial Code of the Empire of Ethiopia (hence forth Commercial Code). 1960

³⁸⁰ R.M. Buxabaum, the Formation of Marketable Share companies , A. Conard(ed), international encyclopedia of comparative law (1975), p. 2

³⁸¹ Ibid

³⁸² Art 304 of the Commercial Code

³⁸³ Art 80 of the Commercial Code

³⁸⁴ Art. 314(1) of the Commercial Code

³⁸⁵ Art 73 of the Commercial Code

while capital refers to the original value of things and cash contributed by the share holders.³⁸⁶

There is no specific securities law which is enacted to regulate and address the issues associated with the public offering process. Legal regimes governing public offering are inextricable from the process of share company formation. The legal regimes governing share companies formation are the Commercial code of Ethiopia, Civil Code, Banking Business proclamation, Insurance Business proclamation, Micro finance business proclamation, Business Licensing and Registration Proclamation, and other specific government institutions which issue license under their specific jurisdictions.³⁸⁷

Founders go through the following two steps to complete the formation or expansion of the share company through the public offering process. First, “before signing their memorandum and articles of association, founders or members of a business organization shall get the verification of the registering office that another business person has not occupied the name of the business organization”.³⁸⁸ The second step is, after the public offering is over, the company must be registered by fulfilling the legal requirements that must be complied with. The legal requirements of formation of share companies through public offering are provided by different proclamations which are applied to the kind of business in which the company aspires to engage in. A company whose purpose is to undertake banking, insurance business or to engage in micro financing activities has additional legal requirements which are stipulated in their respective business proclamation and directive in addition to the Commercial Code.³⁸⁹ Minimum number of members, minimum initial capital, full subscription of capital and payment of one-fourth of the par value of shares, submission and valuation of contribution in kind, prospectus,

³⁸⁶ Art 80 of the Commercial Code

³⁸⁷ Banking Business Proclamation No. 592/2008, Federal Negaret Gazeta, 14th year No.57; Civil Code of the Empire of Ethiopia, Proclamation No 165 of 1960, Negarit Gazeta, 19th year No. 2; Commercial Code of the Empire of Ethiopia of 1960, Nagaret Gazeta, Extra ordinary issue, No. 3 of 1960; Commercial Registration and Business Licensing Proclamation No. 686/2010, Federal Negaret Gazeta, 16rd year No.42; The Criminal Code of the Federal Democratic Republic of Ethiopia, Proclamation No. 414/2004; and The National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008, Federal Negaret Gazeta, 14th year No.50

³⁸⁸ Art 6(8) of Commercial Registration and Business Licensing Proclamation No. 686/2010

³⁸⁹ See the Banking Business Proclamation No. 592/2008

adoption of memorandum and articles of association, registration and licensing are the legal requirements which must be fulfilled in order to get a license to engage in business.

The traditional approach of enforcement of contract, bankruptcy law, extra-contractual liability law, property law and criminal liabilities are the legal sources that can be used to redress damages and offenses which arises in realm of public offering. The problems associated with this traditional approach are discussed later.

These laws do not specifically address whether the shares offered to the public do in fact represent the actual value of the assets and future prospects of the company. The issuers of share have more information about the assets and future prospects of the company up on which the subscribers make a decision to subscribe/buy shares or not. Any particular offering of shares to the public does not necessarily reflect the actual value of the assets and prospects of the company. The actual value of the assets and future prospects of the company might not necessarily be equal to the capital of the company which is represented by the shares offered. Issuers may issue shares to the public to attract more capital which doesn't fully match with the assets and prospects of that company. The regulation of market misconducts, issue of regulatory authority, and securities market infrastructure are not specifically addressed by the existing legal regimes. These issues will be discussed in the next sub titles in detail.

4.3. Approval Requirement

Article 12(5) of the Commercial Registration and Business Licensing Proclamation contains a provision which is neither clear nor ostensibly has any purpose to achieve. The provision states that “the founders of Share Company to be established by public subscription as provided for under Article 317 to Art 322 of the Commercial Code, in order to start the formation of the company, shall in advance obtain the written permission of the registering office”.³⁹⁰ Since this article refers to the Commercial Code

³⁹⁰ Art. 12 (5) of Commercial Registration and Business Licensing Proclamation No. 686/2010.

provisions regarding Share Companies which are formed by public subscription, it is possible to discern that the purpose of the provision stems from the companies' peculiar nature of being subscribed by the public. This sub article is deemed a response to the pressures from the public and media regarding the legal framework governing the public offering process and the protection of investors from manipulation and fraud.³⁹¹ However, the provision doesn't make clear what are the standards to give permission to start the formation of a company through public offering.

If we compare Art. 12(5) of the Commercial Registration and Business Licensing proclamation with other countries, two approaches might be discerned. The first is the issuers are required to disclose all material facts and register the prospectus and shares before offering them to the public.³⁹² The concerned authority ensures the proper disclosure and registration is made. A good example is the U.S Federal Securities Act.³⁹³ The Securities and Exchange Commission (SEC), the public body responsible to regulate and supervise the securities market, registers securities and prospectuses in order to ensure that the securities markets are fair and honest before the issuers makes a final offering of shares.³⁹⁴ Registration is intended to provide adequate and accurate disclosure of material facts concerning the company and the securities it proposes to sell. Registration doesn't guarantee the accuracy of the facts represented in the registration statement and prospectus but requires that investors be provided with material information concerning securities for public sale and prevents misrepresentation, deceit, and other fraud in the sale of securities.

In other countries the concerned authority goes beyond disclosure and registration and assesses whether the disclosed information is fair and doesn't create damage to the public. Thailand here is a good example. Thailand rejected a liberal view of the USA Federal Securities Act and preferred to have registration and disclosure and adopt merit

³⁹¹ A discussion with Ato Anteneh Mengistu, Legal Directorate Director at the Ministry of Trade, September 10, 2010

³⁹² Danils, J., "Comparing U.S. and Hong Kong Public Offering Regulation: How Cost Effective is China's Primary Capital Market?", *S. Cal. L. Rev. Vol. 69*1821 (1995-1996), p. 1826

³⁹³ Ibid

³⁹⁴ Ibid

approval as a requirement to offer shares to the public.³⁹⁵ The office, which is established to approve the public offering, approves the public offering after assessing the nature of business, the performance of the business, the financial and shareholding structure.³⁹⁶ If the draft prospectus is false, or incorrect or fails to disclose material facts that should have been stated there in, or may cause damage to the purchasers of securities, or there is an event which causes a material change in the information contained in the registration statement and the draft prospectus which may affect the investment decisions of the purchaser of securities, the office suspends the public offering process.³⁹⁷ To some extent the merit regulation is also in place in some states of the USA. State securities laws, commonly known as blue sky laws, employ a wide variety of standards which require examination of the substantive merits of prospective offerings.³⁹⁸ Although collectively the substantive standards are referred to as "merit requirements" or the "fair, just, and equitable" registration standards, their application among different states takes various forms.³⁹⁹ The most common substantive standards, whose absence or unfairness leads to denial of registration and offering, among states are underwriting commissions and offering expenses, cheap stock, options and warrants, offering price, share-holder voting rights, debt and interest coverage, and promoters' investment.⁴⁰⁰

Art 12(5) of the Proclamation No. 686/2010 empowers the Office of Commercial Registrar to give permission to the founders to start the formation of Share Company. The provision refers to Article 317-322 of the Commercial Code. These articles of the code discuss the content, form and offering of the prospectus. Hence the purpose of the provision seems to regulate the prospectus in order to protect the public from the manipulation of founders.

³⁹⁵ Sethsathira, P., "Securities Regulation in Thailand: Laws and Policies", 4 *Pac. Rim L. & Pol'y J.* (1995), p. 790

³⁹⁶ Ibid

³⁹⁷ Ibid

³⁹⁸ Goodkind, C., "Blue Sky Law: Is There Merit in the Merit Requirements?", *Wis. L. Rev.* 79 (1976), p.

87

³⁹⁹ Ibid

⁴⁰⁰ Ibid

Art. 58 of the Proclamation No. 686/2010 gives power to the Ministry of Trade to issue public notices in order to carry out its powers and duties.⁴⁰¹ One duty of the Ministry of Trade (under its Office of Commercial Register) is to give permission to the founders to establish share company through offering of shares to the public.⁴⁰² Accordingly, the directorate for the Office of Commercial Register at the Ministry of Trade, on the one hand, mentioned that the detail regulation for the implementation of the approval is being undertaken to implement the provision. On the other hand, it isn't clear how the Office of Commercial Register is going to enact further guidelines and directives due to the problem that the Proclamation doesn't give any guideline or standard as to how to implement the provision.

In practice the Office of Commercial Register has not yet implemented the provision due to lack of detail guidelines and standards to give permission.⁴⁰³ As a result the purpose of the provision has not yet been achieved and founders offer shares to the public without a prior permission by any public authority.

4.4. Registration and Disclosure Requirement

4.4.1. Prospectus Regulation

The Commercial Code states that an offer to potential subscribers, in forming public share companies, shall be made by a prospectus.⁴⁰⁴ Comparing with other countries scope of application of the requirement of prospectus to issue securities, the Commercial Code requires a prospectus to offer shares and debentures to the public.⁴⁰⁵ For example, the securities law of Hong Kong includes the prospectus requirement for the issuance of debentures in addition to the public offering of shares like the Ethiopian Commercial Code, while the US system applies the prospectus requirement to all kinds of securities.⁴⁰⁶

⁴⁰¹ Art. 58 of Commercial Registration and Business Licensing Proclamation No. 686/2010

⁴⁰² Id. Art. 12(5)

⁴⁰³ An interview to Ato Nuredin Muhamed, Commercial Register and Business Licensing Directorate at the Ministry of Trade, November 3 10, 2010

⁴⁰⁴ Art 318(1) of the Commercial Code of Ethiopia

⁴⁰⁵ Art. 318 and Art. 434 of the Commercial Code

⁴⁰⁶ Supra note at 393

4.4.1.1. Regulation of Content and Form of a Prospectus

Art 318(1) of the Commercial Code states that an offer to the public shall be made by a prospectus signed by all the founders and shall contain the draft memorandum of association; a summary of the principal provisions of the articles of association; a summary of the expert report according to Art. 315 of the Commercial Code, if any; the date until when the subscribers may be required to discharge their obligation; the price at which shares are to be issued; the amount to be paid up on the shares until the general meeting of the subscribers; and the place where applications and payments shall be made. Even though the article ostensibly makes clear what the prospectus shall contain, issues regarding the prospectus requirement in relation to its content and form remain to be addressed because the article neither define what prospectus is nor makes the purposes of the prospectus clear.

The first issue is whether the information required to be disclosed are sufficient enough to enable subscribers to make an informed decisions. In this regard the primary document which shall be included in the prospectus is the draft memorandum of association. Looking at the items that the memorandum of association should contain and considering the fact that a prospectus only requires a draft memorandum of association to offer shares to the public, a memorandum of association seems a document which defines the scope of its activities and the relations of the company with the outside world, not primarily intended to ensure disclosure of material facts to protect investors from the manipulation of issuers and to ensure the integrity of the securities market. Art 313 of the Commercial Code list the items that the memorandum of association shall contain. The items are; the names, nationalities, and addresses of the members and the number of shares which they have subscribed; the name of the company; the business address; the business purpose; the paid up and subscribed capital of the company; the number, par value, the form and classes of shares; contributions in kind; the manner of distributing profits; the shares of profits allocated to founders; the number of directors and their powers; the auditors; the period of time for which the company is to be established and the manner in which the company will issue its reports. The amount of capital subscribed and paid up and the names and addresses of the members can't be determined during the public offering process for it can't be known during that time. So the draft items of the memorandum of

association cannot disclose all material information to the public and falls short to ensure the integrity of the securities market.

The article of association, on the other hand, is intended to contain detailed rules regulating the detailed internal operation of the company. Art 314 of the commercial code states that the articles of association which govern the operation of the company shall be drawn up by the founders in accordance with the law⁴⁰⁷ and may follow the model supplied by the Ministry of Trade. And the model Article of Association supplied by the FDRE Ministry of Trade contains the rules and regulation on the following matters: right of shareholders; transfer of shares; joint holdings of shares; register of shareholders; substitution of lost shares; meeting of shareholders; powers and duties of the board of directors; appointment and removal of directors; register of shares of directors; remuneration of directors; meeting of directors; reserve funds; the manner of allocation of profits; and the dissolution and winding up of the company.⁴⁰⁸

This information that the prospectus is required to contain may be important to make investment decisions; however, most of the items required are neither sufficient nor material to assess the prospect and value of the company. A prospectus should enable investors to make an informed assessment of the activities, assets and liabilities, financial position, management and prospects of the company and of its profits and losses and rights attaching to the securities being offered. As a result the Code should have made the following information mandatory to be included in the prospectus. The first is the potential legal, financial and business risks. In a business world there are always risks. Especially an investment in equity securities and a company under formation involves a high degree of risk. These risks may vary from case to case but the law should have made omitting these risk factors would bring legal liability. Information about the issuer and promoters, financial information which includes audited report and management's discussion and analysis of financial condition and results of operations, outstanding litigations and government approvals, and any other information which is

⁴⁰⁷ Like for example Art. 352, 362(2), 457, 404, 418(2) and 420(2) of the Commercial Code

⁴⁰⁸ Model of Articles of Association of Share Company supplied by FDRE Ministry of Trade and Industry, cited in, Gobezie B. Founders of Share Company: Their Roles, Liabilities and Rights under Ethiopia Law, AAU, Law Faculty, unpublished (2006), P.16

deemed material to make an informed decision should have been part of the prospectus rule. However, Art 318 of the Commercial Code doesn't make this information to be mandatorily disclosed to the public.

The other issue regarding the prospectus requirement is whether the items mentioned under Art 318 of the Commercial Code are the minimum (illustrative) requirements or exhaustive lists. As per the discussion made with commission agent, soliciting the public to subscribe shares has been made through brochures, phone call, internet(mail), or/and oral communication.⁴⁰⁹ Advertisements by radio, television, board or any other means is also used in order to lure the public to subscribe to the shares offered.⁴¹⁰ The question is: are all these means considered as part of the prospectus or not?

The Commercial Code requires all founders to sign on the prospectus.⁴¹¹ The requirement of signature and the subsequent list of items to be included make a prospectus appear to be a document. Hence soliciting through phone call and oral communication seems excluded from the prospectus. This argument, however, does not exclude offering shares through email, posts, brochures and any other documents for it is possible to sign on them. So this provision does not make clear whether all documents are part of the scope a prospectus or not.

Looking at the experiences of other countries, a prospectus has a broad concept. The US Securities Act defines a prospectus as 'any prospectus, notice, circulars, advertisement letter, or communication, written or video or television, which offers any security for sale or confirms the sale of any security'.⁴¹² Similarly, the Hong Kong securities law defines prospectus as any notice, circular, brochure, advertisement, or other document, (a) offering any 'shares or debentures of a company to the public for subscription or purchase for cash or other consideration, or (b) calculated to invite offers by the public to subscribe for or purchase for cash or other consideration any shares or debentures of a

⁴⁰⁹ A discussion made with a Commission Agent

⁴¹⁰ Ibid

⁴¹¹ Art. 318(1) of Ethiopian Commercial Code of 1960

⁴¹² USA Securities Act of 1933, Section 5(c)

company’⁴¹³. The Black’s Law Dictionary defines ‘prospectus as a document published by a company or corporation or persons acting as its agents or assignees, setting forth the nature and objects of an issue of shares, debentures corporation and inviting the public to subscribe to the issue...it is a document which is to contain all material facts concerning a company and its operations so that a prospective investor may make an informed decisions as to the merit of all investment’.⁴¹⁴

A document is an essential element of a prospectus in the Black’s Law Dictionary. However, a document may be a brochure, advertisement, email, letter or any other. So whether these documents are considered as prospectus or not isn’t made clear. Oral communication, phone call, radio and television advertisements are not considered as a prospectus. The Hong Kong and USA securities laws consider every means oral communication or document by which invitation is made to the public to subscribe is considered as a prospectus.

The Commercial Code doesn’t make clear whether oral solicitation, phone call, radio and television advertisements, brochure, advertisement, email, letter or any other means used to offer a share to the public is part of the prospectus or not. Art 318 of the Commercial Code states that public offering of shares shall be made to the public through a prospectus and lists what the contents of the prospectus should be. And it seems the other means employed by issuers and founders to distribute prospectus are left out of the scope of the prospectus.

On the other hand, Art 309(1) (c) of the Commercial Code states that the founders shall be jointly and severally liable to the company and third parties for any damage in connection with the accuracy of statements made to the public in respect of the formation of the company. Accordingly, one may argue here that the word ‘statements’ should be interpreted broadly to include all solicitations, including oral communication, phone call, radio and television advertisements, brochure, advertisement, email, letter or any other means, which are made by the issuers and promoters. In addition, Art. 309 (1) (C) of the

⁴¹³ Supra note at 393

⁴¹⁴ Black, Henry C., Black’s Law Dictionary, (6th ed), West Publishing Co. St. Paul, 1991)

Commercial Code talks about statements which are made to the 'public'. Even if it is possible to broadly interpret this provision, there might be information which is disclosed to private persons through mail or phone or oral conversation. Are the founders still liable to the accuracy of statements made to the private individuals? And are the information disclosed to the private individuals through different means considered part of the prospectus? It is not made clear.

Others writers may still challenge such broad interpretation of defining the article to include all information disclosed to the public through any means. The 'statements' which is stated in Article 309(1) (C) might be interpreted narrowly to restrict its scope of application only to the items mentioned in Art 318 of the Commercial Code which requires the prospectus to contain a draft memorandum and articles of association, a summary of the expert report according to Art. 315 of the Commercial Code, if any; the date until when the subscribers may be required to discharge their obligation; the price at which shares are to be issued; the amount to be paid up on the shares until the general meeting of the subscribers; and the place where applications and payments shall be made. Such kind of interpretation excludes the possibility of including oral solicitation, phone call, radio and television advertisements, brochure, advertisement, email, letter or any other means used to offer a share to the public as part of the prospectus.

The Commercial Code doesn't satisfactorily answer the question of whether solicitations made through oral communication, phone call, radio and television advertisements, brochure, advertisement, email, letter or any other means be considered as a prospectus or not. The absence of special securities law and judicial interpretation of what constitutes a prospectus left the content of the prospectus to the discretion of the issuers, founders and promoters of the company.

The paper argues that in the absence of clear legislative guide and judicial interpretation, the issue of the content and form of the prospectus should be defined in terms of the purpose of the prospectus and lessons should also be drawn from other countries. The purpose of the prospectus is to make available all information necessary to enable investors to make an informed assessment of the business. The fact that the commercial code only requires prospectus for public offering of shares indicates that the purpose of

the prospectus is to help investors get the necessary information to value the business offer.

The principle is that a prospectus should give to the public a full, accurate and fair picture of the current position, as well as the future prospects of the company. It should therefore disclose every material fact and contract in relation to the company. Hence all information provided by the issuers to the public by a document, email, advertisement, brochure, oral communication, phone call or letters should be part of the prospectus.

4.4.1.2. Amendment of Prospectus

The other issue regarding the regulation of prospectus is the issue of amendment. The public offering of shares may take time until the required capital is subscribed. Art 313(3) of the Commercial Code the time for the subscription to shares may take one year starting from the paid up capital is deposited in a bank. During the public offering period, new developments which might substantially alter the profitability of the business may occur. These new developments should have to be included in the prospectus in order the company to be profitable and survive within such environment. On the one hand, there is a need to incorporate those new developments in the prospectus. If it isn't totally possible to amend the prospectus for any reason once made public, the subsequent risks may be detrimental to the issuers, investors and the public at large. And the law should enable the issuers, founders and promoters to respond to the situation by amending the prospectus. On the other hand, due to the inadequate disclosure requirement of material facts from the beginning and absence of any regulatory authority, there is a fear that the founders, issuers and promoters may distort the securities public offering system and manipulate the investors under the pretext of amendment. The issue here that needs to be addressed is, as per the relevant provisions of the law, at what point the issuers, founder and promoters can amend the prospectus after they commence the public offering process if new developments occur within or outside of the company.

Different laws of the country do not clearly address the amendment process of a prospectus in a manner which ensures the investors are protected and maintains the integrity of the securities market. There are three scenarios to try to deal with the issue of amendment according to the Commercial Registration and Business Proclamation,

Commercial Code and finally the Civil Code. The first is the application of alteration or amendment after the company and its prospectus is registered in the commercial register. Art 16 of the Commercial Registration and Business Licensing Proclamation elucidates how alteration and amendment of commercial registration is made. If the application is accepted and alteration and amendment to the commercial register is effected, the registering office gives verification for the submission and acceptance of alteration and amendment of commercial registration and notifies the applicant and the concerned bodies in writing by citing the details of the date of acceptance and the entry of alteration or amendment of the commercial register. The scope of the Proclamation, however, doesn't govern the amendment of a prospectus before the company and its prospectus is registered at the commercial register.

The second approach is to prohibit the amendment of a prospectus until the subscribers meeting is called according to the Commercial Code. Art 320 the Commercial Code states that when the time for making applications has expired, the founders call a meeting of the subscribers. The purpose of the meeting is to verify that the requirements relating to the formation of the company have been complied with; to draw up the final text of the memorandum and articles of association; to approve contributions in kind, if any, and the share in the profits allocated to the founders; and to make all appointments. Amendments regarding to the substance of the draft memorandum and articles of association require the approval of all the subscribers, while a majority vote is sufficient where the amendments relate to approval of contributions in kind or approval of shares allocated to the founders. From the perspective of this provision one may argue that the issuers can't amend the draft memorandum and articles of association (prospectus) once it is offered to the public. However, a memorandum and articles of associations are not primarily a disclosure document to the subscribers; rather they are concerned with the constitution of the company and to determine the internal operation of the company, respectively. But, a prospectus may also contain most important documents like 'due diligence reports' in addition to the draft memorandum and articles of association. Does it mean that issuers and founders can unilaterally amend these documents?

The dilemma whether it is possible to amend the prospectus or not before the time of the expiry of application, if a new event happens within or outside of a company, under formation or a company which is formed, which substantially affect the company and the interests of the subscribers, isn't fully dealt with in the Commercial Code and the proclamation.

The issue might also be tried to be addressed by the existing private laws, especially contract law, to be applicable in this regard. A share company is a business organization. A business organization is any association arising out of a partnership agreement.⁴¹⁵ And partnership agreement is a contract where two or more persons who intend to join together contributions for the purpose of carrying out activities of an economic nature and of participating in the profits and losses arising out there of, if any.⁴¹⁶ A share company is formed out of a contract among shareholders to engage in a business. Hence, the public offering process is subject to the contract law and the obligation of the parties, who are founders and subscribers, may be determined based on the terms of their partnership agreement. Accordingly, the issue as to the amendment of the prospectus could be settled by a general contract law which proscribes unilateral amendment of the terms of the contract which is the prospectus in this case.

Nevertheless, the question of when is a contract deemed formed in relation to public offering process isn't made clear. A contract is deemed completed where the parties have expressed their agreement through offer and acceptance.⁴¹⁷ When one contracting party offers and the other party accepts the offer, then a contract is deemed formed. However, regarding the concept of an offer, in the strict sense of the contract law, and when the offer is considered accepted do not fit the concept of offer in the realm of public offering of shares.

Art 318 states that an 'offer' to subscribers shall be made by a prospectus signed by all the founders. This provision considers a prospectus as an 'offer'. Some writers argue that

⁴¹⁵ Art. 210(1) of the Commercial Code

⁴¹⁶ Art. 211 of the Commercial Code

⁴¹⁷ Art 1680 of the Civil Code of The Empire of Ethiopia (hence forth civil code) Proclamation No. 165/1960

in relation to public offering of shares the term ‘offer’ stated under Art 318 of the Commercial Code should not be strictly interpreted according to the general contract law.⁴¹⁸ The offering of a prospectus is an invitation, not an offering in the strict sense of the term. In other jurisdictions, for example USA, the prospectus is an invitation not an offer and the application to shares is considered as an offer for the invitation made through the prospectus.⁴¹⁹ The final acceptance of the offer is made during allotment of shares to the subscribers after the invitation to the public is over.⁴²⁰ Art 319 of the Commercial Code considers the act of the subscribers to the public offering as an ‘application to the shares’ not ‘acceptance’ to the offer. So the prospectus is not deemed an offer in the strict sense of the term rather it is an invitation to the public to subscribe to the shares.

If the prospectus is considered as an invitation, not in the strict sense of the term offer which is provided by the contract law, then does it mean that the issuers amend the prospectus until they made acceptance to the application (offer) made by the subscribers? This is because as far as the acceptance isn’t made by the founders or issuers, they don’t have contractual obligation for a contract is formed when both parties agreed. So in order to restrict the amendment of a prospectus according to the contract law, the issuers shall first accept the offer to shares. The problem is that it is not easy to determine when the application to shares by the subscribers is deemed accepted by the issuers. Is it at the subscribers meeting? Art 321 of the Commercial Code doesn’t make acceptance of the application as the purpose of the subscribers meeting. It rather impliedly assumes the subscribers have already known and the purpose of the meeting is to verify that the requirements relating to the formation of the company have been complied with; to draw up the final text of the memorandum and articles of associations; to approve contributions in kind and the share in the profits allocated to the founders; and to make all appointments. Hence, it becomes impossible to determine when the contractual

⁴¹⁸ Birhanu Gobeze, *Founders of Share Company: Their Roles, liabilities and Rights under the Commercial code of Ethiopia*, AAU, Law Faculty, unpublished (2006), P.18

⁴¹⁹ Goldring, G., “Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation”, *Columbia Law Review*, Vol. 81, No. 7 (Nov., 1981), p. 1524

⁴²⁰ Ibid

obligation of the parties is exactly completed. Had the time of acceptance and offer (completion of the contract) known, it would have been easy to proscribe unilateral amendment of the terms of the agreement, in this case the prospectus. So the issue of amendment of prospectus during the public offering process is not determined in the proclamation, commercial code and civil code of Ethiopia.

4.4.1.3. Withdrawal from Subscription

The other problem regarding the regulation of a prospectus is the issue of withdrawal from application for shares by the subscribers. Had it been clear that application for shares is considered as an ‘offer’, then Art 1693 of the Civil Code would have solved the problem. Art 1693(1) of the Civil Code states that an offer shall be deemed not to have been made where the offeree knows that it is withdrawn before he knew or at the time when he knows of the offer. This provision also applies where acceptance is withdrawn. But due to the failure of the legal regime to determine ‘offer’ and ‘acceptance’ in relation to public offering, the issue of withdrawal from subscription remains unsolved. In other jurisdictions, for example USA, investors can withdraw from subscription before the allotment of shares and determination of price is made.⁴²¹

In general, existing legal frameworks fails to address the issues raised in relation to the regulation of a prospectus. The absence of special securities law which specifically deals with specific issues, lack of judicial interpretation of the application of general contract law to public offering process and the ambiguity which surrounds the Commercial Code in relation to public offering process creates a vacuum for the founders, issuers and promoters to exploit innocent investors. The issue of content and form of a prospectus, amendment of prospectus, withdrawal from subscription, and allotment of shares remain unaddressed. These problems, I think, are like a time-bomb waiting to explode and affect the investors, the securities market and the economy as a whole unless appropriate measures are taken.

4.4.2. Marketing and Distribution of Prospectus

⁴²¹ Ellis, K., R. Michaely, and M. O'Hara, *A Guide to the Initial Public Offering Process*, Corporate Finance Review Vol. 3 (1999), p. 11

Commission agents widely participate in the delivery of prospectus. These commission agents which are participating in selling shares to the public include banks, stock brokers, Ethiopian Postal Service, Commercial Nominees and other business organizations.⁴²² For example Habesha Brewery S.C sold shares through Buna International Bank, Wogagen Bank, and United Bank. Ayat Share Companies offers shares to the public through United Bank, Awash International Bank, Nib International Bank, Wogagen Bank, and Commercial Bank of Ethiopia. Raya Beer S.C is also inviting the public to subscribe through Anbessa Bank, Wogagen Bank and United Bank.⁴²³

The banks involvement in securities activities as a stock broker, along with other commission agents, is appreciable and important to the development of capital market. Banks, through their branches, can easily reach the public across the country. For example, Commercial Bank of Ethiopia can serve and reach the majority of the public through its more than 300 branches scattered throughout the country.

However, the involvement of banks and other commission agents in selling shares to the public have limitations that should be addressed. The first problem is that commission agents don't provide the prospectus of the company to the public while they are soliciting and selling shares to the public.⁴²⁴ The Commercial Code requires the prospectus and the expert report to be made available to all persons who may wish to subscribe⁴²⁵ and the subscribers to declare that they read the prospectus and the expert report.⁴²⁶ In practice, almost all branch offices of the banks and other commission agents don't have any document except brochures to make available for the investors.⁴²⁷ The subscribers can only get a brochure which doesn't contain all material facts to assess the business and make an informed decision. These brochures contain information about unsubstantiated return and profit, unsubstantiated dreams in terms of technology input, return in capital, business location and quality. It is hardly possible to find facts stated in an objective manner which can lead to a rational decision.

⁴²² Ato H/Eyesus Nigatu, Accountant at Nib International Bank, Bahir Dar Branch, September 12, 2010

⁴²³ Ibid

⁴²⁴ W/t Absera Sheferaw, Manager of the Commercial Nominees, Bahir Dar branch, November 17, 2010

⁴²⁵ Art 318(2) of the commercial code

⁴²⁶ Art. 319(2) of the commercial code

⁴²⁷ Ibid

The second problem, which emanates from issuers and commission agents practice to offer and solicit shares to the public through oral communication, is the problem of selective disclosure. Most agents don't provide prospectus to the public. The nature of this kind of marketing opens a way for agents to be biased as to the kind of information disclosed to subscribers. The agents may reveal all material facts and risks to friends, relatives or any person whom they have a special relation but not to others. This information asymmetry may be reflected in the decision of investors to value the prospects of the business and may open a way for some advantaged persons to mislead and take advantage of investors. In addition, investors may lose confidence on the integrity of the market and refrain from investing their money, which ultimately affects the role that the securities market could play in the country.

The third problem in relation to distribution and offer of securities is the moral hazard associated with banks' involvement in the securities activities as a commission agent. National bank supervises the activities of banks regarding the health and soundness of the financial institutions and in case problems arise the public have legal as well as administrative remedies to redress the problem. On the other hand the national bank doesn't regulate the content of the prospectus and securities activities of banks as commission agent.⁴²⁸ However, the involvement of banks as a share broker coupled with their relation with the National Bank creates an image that publicly offered shares by the banks, as a commission agent, have equal protection and remedies like other activities of banks. This perception of the public may expose them to the ruthless exploitation and mischief of promoters and issuers. The perception that the public offering of shares by banks is regulated by the National Bank like other activities of banks may lead investors to rely on the National Bank and take excessive risk which ultimately affects their interest and the securities market. Banks which are deemed playing an important role in the economy may be caught intermediating the issuers to sell worthless and blue sky shares to the public.

⁴²⁸ A discussion with Ato Zerai G/wold , Legal Expert at the National Bank of Ethiopia, September 22, 2010

The other problem in relation to the failure to regulate the selling and distribution of prospectus is conflicts of interest which ultimately affect the investors and the efficiency and integrity of the market. The first conflict of interest is created when banks sell shares to the public on behalf of the issuers. On the one hand banks need the public to deposit the money which can be used for loan, from which banks earn their lion share profit. On the other hand banks have to disclose all material information to the public in order to sell shares. Due to the absence of prospectus provided to the public and the disclosure is mainly made through oral communication, banks may mislead the public not to buy shares by exaggerating the risk factors and/or undermining the opportunities and benefits of the investment. As a result the securities market may be inefficient to value the price of the share and investors may systematically be deceived not to benefit from investment.

The conflict of interest which emanates from the financing aspect of the commission agents may also lead to the misstatement of material facts. Agents derive their finance from issuers⁴²⁹ and they don't have any obligation to conduct due diligence report like other countries. They may strive to use the prospectus as a selling tool rather than a disclosure document. They may only select good news and omit risk factors against their fiduciary duty to disclose all material facts in order to sell shares to the public. The omission and misstatement of material facts affect the public to make an informed decision. The problem may distort the securities market and the public may lose confidence on the market to participate in investment.

In general the lack of regulation of the distribution and delivery of prospectus to the public creates a favorable condition for the issuers, promoters and commission agents to exploit the public and distort the securities market for their own benefit.

4.5. Advertisement Regulation

A prospectus serves both as a disclosure document and a selling document. A proper balance should be kept while the prospectus is communicated to the public. Founders of a share company advertize an offer of shares to the public through different channels

⁴²⁹ Supra not at 422

including radio, television, news paper, oral communication, internet and etc. Advertisements are announcements relating to a specific offer to the public to promote the potential subscription of shares. These promotion and marketing of securities through different advertisements are not regulated in the Commercial Code and Civil Code. In some jurisdictions, for example, the US Securities Act of 1933 considers every notice, circulars, advertisement letter, or communication, written or video or television advertisement as part of the prospectus.⁴³⁰ Advertisements are subject to the requirement of prospectus. Hence, issuers are liable to the accuracy of the information disclosed in any means used to offer shares to the public.

In Ethiopia, the Commercial Code doesn't make clear whether oral solicitation, phone call, radio and television advertisements, brochure, email, letter or any other advertisements are part of the prospectus or not. One may also try to apply the contract law provisions as per Art. 1677(1) of the Civil Code which states that 'the relevant provisions of this title shall apply to obligations notwithstanding that they do not arise out of a contract'.⁴³¹ According to Art. 1686 of the Civil Code, no person is deemed to make an offer where he declares his intention but does not make his intention known to the beneficiary of the declaration or he sends to another or posts up in a public place tariffs, price lists or catalogues or displays goods for sale to the public. Hence, advertisements published in view of a public offer of securities are a mere declaration of intention not an offer in the strict sense of the term. So, issuers may deceive the public through different advertisements due to the failure of the laws of the country to address the issue.

4.6. Business Misconduct

4.6.1. Misrepresentation and Omission of Material Facts

The public offering process faces challenges due to lack of sufficient regulation of securities market in Ethiopia. In principle, companies willing to go public are required to disclose to all potential investors information which is necessary to make informed investment decisions. The Commercial Code falls short to regulate prospectus as a mechanism to bridge the asymmetric information between the issuer and the investor.

⁴³⁰ Supra note at 122

⁴³¹ Art. 1677(1) of the Civil Code

The failure of the Ethiopian legal regime governing the form, content, and manner of disclosure to the public leaves a favorable ground for issuers, founders, promoters and stock brokers to misrepresent and omit material facts.

The misleading statements and omissions observed from the market and prospectuses of companies impede investors to make informed decisions and distort the securities market to allocate resources efficiently. Issuers, founders, promoters or stock dealers make a statement, promise or forecast which they know to be misleading, false or deceptive material information. This helps the issuers and others to sell shares to the public or lure the public to subscribe based on such misleading facts. The extra-contractual law of Ethiopia incidentally prohibits providing false information and misrepresentation of facts to the public and inflicts damage. Since these provisions require prove of intention or negligence of the wrongdoer, it makes getting compensation difficult due to the nature of securities transaction and manner and standard of disclosure. And investors are not required to prove intention or negligence to claim compensation if the misconduct is done for the purpose of creating the impression and thereby inducing investors to subscribe or refrain from subscribing. The legal problems regarding liabilities will be discussed in the next sub section.

Issuers, founders and promoters conceal material facts in connection with a statement, promise or forecast made or disclosed to the public.⁴³² Some prospectuses don't disclose all material risk factors which are associated with the projections made by the issuers.⁴³³ Risks are the inherent nature of business; especially researches have shown that investing in an initial public offering is highly risky and volatile.⁴³⁴ So in order subscribers make an informed decision as to the value of the offer, issuers and founders should have to disclose the risks that they reasonably know.

Some observers of the securities market mentioned that risk factors which are concealed from the public include, but not limited to, undisclosed related party transactions,

⁴³² A discussion made with Ato Eshetu Erena, Head of the Legal Department Oromia International Bank S.C, March 19/ 2010

⁴³³ Ibid

⁴³⁴ Supra note at 110

undisclosed previous or current brushes with civil and criminal law, undisclosed tax and land lease liabilities, undisclosed court and labor disputes, undisclosed dispute with municipalities and undisclosed conflicts of interest arising from the involvement of issuers and founders in other competing but not openly disclosed businesses.⁴³⁵ In some countries concealing such material facts to the public entails civil and criminal liability. The Ethiopian Commercial Code does not expressly require the issuers to disclose risk factors to the public and hence it seems that concealment of such risk factors does not entail civil and/or criminal liability.

4.6.2. Selective Disclosure

The other problem which does not fully regulated in Ethiopia which is associated with public offering of shares is selective disclosure. Selective disclosure is when issuers or founders/agents of public companies disclose material non-public information to certain individuals. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in making a decision whether to buy or sell a share. Information is public if it has been disseminated in a manner reasonably designed to make it available to investors generally, otherwise it is non-public. Information is considered available to the public only when it has been released to the public through appropriate channels.

The problem stems from the inadequacy of regulation of promotion, distribution and disclosure of prospectus. Stock brokers and commission agents undertake their activities including disclosing information to the potential investors mainly through oral communication and phone call. The investors mainly rely not on the prospectus but the information provided by the founders and agents through oral communication and informal discussion. Material information which is not included in the prospectus might be disclosed to specific stock brokers or individual investors like friends, families or relatives, while other investors may not have such access.

The reason to regulate selective disclosure is to protect investors. Few investors who have access to material non-public information may take advantage at the expense of other

⁴³⁵ Supra note 432

investors who have no such information. Selective disclosure could lead to a loss of confidence by individual investors in the integrity of the securities market due to the information advantage enjoyed by the privileged few. As a result, selective disclosure is regulated in other countries, for example, Regulation FD (which stands for Full Disclosure) in USA is designed to address such problem.⁴³⁶ It requires that when senior officials of public companies intentionally disclose material non-public information to market professionals or individual investors, they must simultaneously disclose the same information to the general public. It further requires that when these senior officials unintentionally disclose material non-public information to market professionals and individual investors, they must promptly thereafter make the same information available to the general public. However, the Ethiopian commercial code does not regulate such business misconducts while the public offering process is favorable to selective disclosure.

4.6.3. Insider Trading

The existing legal, regulatory framework and practice might expose the process of public offering of shares to insider trading. The Ethiopian legal regime does not expressly prohibit insider trading. The inadequate disclosure of material information to the public and manner of marketing and distribution of prospectus seems the right environment for insiders to trade at the expense of the public. Trading on the inside information which is not disclosed to the public violates the principle of full, true and plain disclosure, as well as the principle that all investors must share equally in the risk and opportunity.

Those who trade on insider information have a duty arising of trust or confidence.⁴³⁷ Those who trade on inside information have a clear opportunity to obtain an economic advantage over other investors who do not have access to the same information. Legitimate investors will likely be unwilling to trade in a market where they perceive that other investors may have an advantage over them. So insiders may take advantage of

⁴³⁶ Supra note at 18, p. 132

⁴³⁷ Randolph P. Beatty and Ivo Welch, "Issuer Expenses and Legal Liability in Initial Public Offerings," *Journal of Law and Economics*, Vol. 39, No. 2 (Oct., 1996), p. 549

innocent investors and affect the integrity of the securities market due to the failure of the Ethiopian legal framework.

4.7. Liabilities for Business Misconduct in Public Offering

4.7.1. Civil Liabilities

This subsection examines the inadequacy and loopholes of the current civil liability provisions for the defects in public offering i.e. misstatement and omission of material facts in the prospectus, insider trading and selective disclosure. These sub sections do not talk about the liabilities of issuers and founders for their commitments made to third parties. Due to the early stage of the development of securities market in Ethiopia, it becomes impossible to gain experience from court and arbitration proceedings and judgments to study the adequacy of civil liabilities regimes. As an alternative, the paper examines the issue theoretically and references to the relevant laws of some countries will be made.

Both the analysis of the efficient market hypothesis and the arguments of the information economists reinforce the pivotal role of the liability rules in establishing an appropriate disclosure regime. Civil liability rules in this context are generally perceived to perform two functions. First, in providing compensation for those who have suffered loss and, second, in acting as a deterrence device to encourage persons involved in the process to comply with the law .⁴³⁸

Loss of investment is a common phenomenon in securities investment. And any law does not intend to provide a guarantee of return to investors. For example, in the United States the deterrence effect of the civil liability regime was considered to be of pivotal significance to the introduction of the securities laws.⁴³⁹ For a small investor the liability regime cannot provide a meaningful compensatory function because the cost of recovery of a claim would exceed the value of the loss suffered.⁴⁴⁰ The liability rules are well

⁴³⁸ Goklding G., Underwriters liability in Australian Securities Offering, 11 CO. & SEC. L. J. 401(1993), p. 406

⁴³⁹ Mahoney G. Paul, The Political Economy of the Securities Act of 1933, *The Journal of Legal Studies*, Vol. 30, No. 1 (Jan., 2001),p.1

⁴⁴⁰ Supra note at 438

placed to form a deterrence function to ensure the disclosure laws are observed or that there are no misstatements and omissions made during the offering process.⁴⁴¹

In Ethiopia, investors may invoke contracts and extra-contractual liability law to redress damages sustained in the process of public offering. Art. 1677 of the Civil Code states that ‘the relevant provisions of this title shall apply to obligations notwithstanding that they do not arise out of a contract’. So provisions regarding the defects in the formation of the contract can be applied to invalidate the contract in case issuers engage in fraud and false statement as per Art. 1704 and Art. 1705. The next subtitle of this paper discusses contractual liability of the issuers in detail.

The bases of extra contractual liability is fault liability. In fault liability the act or commission of wrongdoer may be intentional or based on negligence. The meaning of intention varies according to the context in which it is used. Intention exists where a person desires to produce a result forbidden by law and where they foresee it and carry on regardless of the consequences; where the defendant desires the consequences or where the defendant may not desire but foreseen the result of the action and omission⁴⁴². On the other hand, the defendant is deemed acted negligently if a person failed to act in a reasonable manner.⁴⁴³ Negligent exists where the defendant owed the plaintiff a duty, the defendant have breached that duty, the breach of that duty must be the actual as well as the “legal” the plaintiffs injury, and that injury must be one that the law recognizes and for which money damages may be recovered.⁴⁴⁴

Generally, for a person to be liable under extra-contractual law principles, he must fail to fulfill a duty owed another. Often this duty is expressed as a ‘standard of care’. Not every unfortunate result or accident represents a failure by someone to meet the applicable standard of care. The most common standard of care is the so-called ‘reasonable person’ or ‘reasonable man’, which is the general duty to take reasonable precautions to protect the interests of others from harm. The reasonableness of

⁴⁴¹ Ibid

⁴⁴² Michael A. Jones, Text book on Tort, (Oxford University Press,2002),p.9

⁴⁴³ Ibid

⁴⁴⁴ Ibid

precautions is evaluated under all the circumstances, including the costs of the precautions, and the social utility of the conduct at issue. The standard set is an objective one. The court will apply the test of what a 'reasonable man' would have done in the defendant's position. One effect of this test is that no account is taken of individual disabilities.

The plaintiff must also show the casual link between the acts or omission of the defendant is the proximate cause of the damages sustained in order to succeed in fault liability.⁴⁴⁵ Causation is a link between the defendant's conduct and the plaintiff's damage. To determine the cause for damage 'but for' test can be applied. The principle is that the defendant wouldn't have been injured but for the defendant's conduct.⁴⁴⁶

The paper finds that the Ethiopian laws governing civil liabilities for misconducts in public offering of shares are flawed in multifarious ways with weaknesses such as ambiguities and shortcomings in identifying potentially liable persons, high burden of proof, problems in enforcement and others. Such problems and weaknesses of liabilities create favorable conditions for the wrongdoers at the expense of the interests of investors who are exposed to the business misconducts and fraudulent activities of issuers and founders.

4.7.1.1. Who is liable?

Liabilities for business misconducts in public offering in any respect generally create deterrence for the wrongdoers. Civil liabilities have been imposed on certain persons for their misconduct in public offering process. The objectives of civil liabilities are to facilitate compensation for the investors and to deter the persons involved in the preparation and distribution of prospectuses from infringing legal requirements.

The effectiveness of civil liabilities depends on the legal regime's effectiveness in identifying liable persons involved in public offering. A public offering of shares involves several actors like founders, promoters, directors, lawyers, auditors and

⁴⁴⁵ Kidner, Richard, Case Book on Torts, (7th ed. Oxford, New York, Oxford University Press, 2002), p. 68

⁴⁴⁶ Ibid

investment advisors and stock brokers. Are all these persons liable to the business misconducts committed or omitted in the process of public offering?

Art 309(1) (c) of the Commercial Code states that the founders shall be jointly and severally liable to the company and third parties for any damage in connection with the accuracy of statements made to the public in respect of the formation of the company. The provision mentions founders as the only persons liable to the statements made.. As per Art.307 of the Code, persons who sign the prospectus, bring in contributions in kind or are to be allocated a special share in the profits, as well as any person, even though outside of the company, who has initiated plans or facilitated the formation of the company shall have the status of a founder. However, the article fails to clearly mention the lists of persons who are considered as founders in the offering process.

If ‘any person’ who has initiated plans or facilitated the formation of the company is considered as a founder, then should auditors, lawyers, investment advisors and stock brokers be responsible for wrongs committed or omitted in the process of public offering? The law defines founders broadly and it is unclear whether or not these people, such as auditors, lawyers, investment advisers fall within the ambit of this liability. The absence of specific mention of their liabilities in the provision, lack of judicial interpretation and lack of statutory definition of what ‘who has initiated plan’ and ‘facilitated’ mean leaves the dilemma unsolved. Some countries, like Malaysia, for example, impose liability on all persons involved in the preparation of a prospectus to compensate investors for damages resulting from false and misleading statements in the prospectus.⁴⁴⁷ It clearly identifies the liable persons and these persons are directors, promoters, principal advisers, underwriters, auditors and lawyers.⁴⁴⁸

An idea may be raised that underwriters, if any, should be held liable for their participation in public offering process for the following reasons. The experts are in a position to evaluate and investigate the accuracy of statements disclosed to the public.⁴⁴⁹

⁴⁴⁷ Pesis Sethsathira, Securities Regulation in Thailand: Laws and Policies, *4 Pac. Rim L. & Pol’y J.* (1995),p. 516

⁴⁴⁸ Ibid

⁴⁴⁹ Id, 517

Investors may reasonably rely on the expert reports regarding the accuracy of the statements and the soundness of the offer.⁴⁵⁰ In addition the position of the experts to impose their will on the issuers in order to ensure the accuracy of disclosure in prospectuses is also raised as a ground to hold the experts liable.⁴⁵¹

Strong arguments may also be forwarded to include auditors to be liable for the accuracy of the statements made to the public in relation to the offering, if the prospectus contains a financial assessment and report about the company and issuers.⁴⁵² Auditors assess the financial status of the issuers and companies and, hence, have great influence over the contents of the prospectus that may deceive investors.⁴⁵³ In addition studies have shown that liabilities imposed up on auditors increases their performance and become an incentive to work hard to verify the accuracy of the disclosure of material facts to the public.⁴⁵⁴ Due to an important role of auditors in the process of disclosure, some countries, like for example USA, has supported the view that auditors' involvement or participation in a fraudulent disclosure is sufficient to impose liability upon auditors⁴⁵⁵.

Due to the role that they played in the process of preparing and distribution of prospectuses, some writers support the view that civil liability should also be imposed up on lawyers.⁴⁵⁶ Lawyers play an important role in ensuring the legal requirements that prospectus should contain, pointing at the flaws and shortcomings of the statement and above all, by not abating the issuer not to issue defective statement. As a result a strong position is held by some countries, like Malaysia, to impose civil liability up on lawyers regarding business misconduct in public offering.⁴⁵⁷

To conclude this sub-title, the Ethiopian Commercial Code doesn't make clear whether such persons are considered as a founder or not. However, some writers' trend in

⁴⁵⁰ Ibid

⁴⁵¹ Ibid

⁴⁵² Melissa Harrison, *The Assault on the Liability of outside Professionals: Are Lawyers and Accountants Off the Hook*. 65 *U.CIN. L. REV.*, 473(1997),p. 533

⁴⁵³ Ibid

⁴⁵⁴ Schwartz, R., "Legal Regimes, Audit Quality and Investment", 72 *Acct. Rev.* 385, (1997), p. 380

⁴⁵⁵ Ibid

⁴⁵⁶ Royce R. Barondes, *Professionalism consequences of Law Firm Investment: An Empirical Assessment*, 39 *AM.BUS.L.J.*379(2002),p. 382

⁴⁵⁷ Supra note at 447

interpreting Art 307 of the Code incline towards excluding underwriters, lawyers, auditors and other professionals who participated in the disclosure of information to the public from being liable for misconducts in the public offering process.⁴⁵⁸ This trend of interpretation may induce such persons involved in the making of the statement to commit wrongs and restrict the subscribers from claiming compensation.

4.7.1.2. Contractual Liabilities of Founders

The Commercial Code of Ethiopia makes the founders of a share company liable for commitments concluded with third parties regardless of whether the company is formed by public subscription or as between founders⁴⁵⁹. The precise scope of the interpretation of commitments should be seen in light with who founders are and case by case. As per Art 305(2) of the Commercial Code the company shall take over these commitments from the founders and refund the founders with all expenses where necessary for the formation of the company or approved by the general meeting of the subscribers. The right of approval or disapproval of the commitments entered in to by the founders is very important to safeguard the interests of the subscribers. This right of the subscribers to approve or otherwise of the contracts entered into by the founders is not contractual. It is rather a right which emanates from the Commercial Code.⁴⁶⁰

The founders remains liable to the third parties in case the company is not formed. Since there is no company to take over the commitments made by the founders, the third parties can claim their contractual rights from the founder who are jointly and severally liable. Art 308(3) of the Commercial Code states that where the company is not established for whatever reason, the subscribers shall not be liable for the commitments or expenses made by founders.

The kind of liability that should be imposed up on founders in relation to protection of investors from misrepresentation and omission of material facts which is based on the contractual relation between the investor and issuer is very difficult to establish. The

⁴⁵⁸ Id, p. 12

⁴⁵⁹ Art. 308(1) of the Commercial Code

⁴⁶⁰ Art 320- 322 of the Commercial Code

problem stems from the legal gap that exists as to the nature of the relationship between the founders and investors in the public offering process.

It is discussed in the previous subsections that the contract law falls short to address the issue raised with regard to whether invitation to subscribe and application to shares is strictly a contractual relationship or not. If it is argued that it is a contract, the difficulties and ambiguities in determination of issues like when the contract is deemed formed, the terms of the agreement, the issue of offer and acceptance with regard to public offering process and its repercussions up on amendment of the prospectus and withdrawal from subscription, and the resolution of the subscribers meeting and the interests of individual investors make to invoke contractual remedies, i.e. specific performance, cancellation and invalidation, almost impossible in the realm of public offering.

However, as per Art. 1704 of the Civil Code the contract may be invalidated on the ground of fraud where the issuer resorts to deceitful practices so that investors would not have entered into the contract, had they not been deceived. In addition the contract may be also invalidated where the issuer in bad faith or by negligence made false statements as per Art 1705 of the Civil Code. The effect of invalidation is primarily extinction of a contract. Invalidation is also followed by compensation that puts the victim in his original position. Ethiopian law of contract pursuant to Article 1817 shows that the compensation shall be aimed at reinstating the party in his original position. According to Art. 1815(1), the parties are required to be put in their original position before the formation of the contract.

If the founder arranges special contract, which are criminally prohibited, in order to lure the subscribers to subscribe shares, that special contract can be the ground to invoke the contract made by the subscribers. The grounds of the contract should be illegal and manipulative practice. Based on this manipulative contract made between the founders and the subscribers, the subscribers can cancel the contract and claim compensation. Absent such grounds, the determination of contractual liability of issuers and founders in relation to misrepresentation and omission of material facts, false and defective disclosure is very complicated.

4.7.1.3. Extra contractual liability

Investors are entitled to recover their loss or damages, sustained by subscribing to an IPO, from founders and issuers. Art 309 of the Commercial Code makes the founders liable for any damage in connection with the accuracy of statements made to the public in the formation of the company. Due to the failure of the Commercial Code to regulate the scope of the prospectus coupled with what constitutes 'statements made to the public' is not made clear, it is difficult to enforce this provision. In addition, this provision doesn't hold issuers and founders liable to the material statements they do not made except those that are required under Art. 318 of Commercial Code. And Art. 318 of the Commercial Code does not require all material facts to be disclosed and Art. 309(1)(C) requires the accuracy of the statements made, not to the statements that is not made, to hold founders liable. Founders may infringe their responsibility to provide accurate information not only made in the prospectus as is defined in the Commercial Code but also in broadcast advertisement, notices, news papers or magazines or in some other manner which are left outside the scope of the regulation of prospectus. Hence, Art. 309(1) (C) of the Commercial Code seems inadequate to entitle investors who sustain loss due to misconducts of issuers and founders. So other provisions of the extra-contractual liability law may also be involved.

The Civil Code contains provision which hold founders liable for their misconducts in the process of public offering. Founders of Share Company may be liable to the false information provided as per Art 2059 of the Civil Code. The provision states that a person who, intentionally or by negligence, supplies false information to another is held liable if he knows that the person to whom the information is supplied or another given person, will act up on the information and thereby suffer damage or he is bound by the rules of his profession to give correct information. The founders and issuers may also be liable for damage arising from infringement of the law according to Art 2035 and for the creation of false appearance as per Art 2058 of the Civil Code.

Problems invade the traditional tort remedies effectiveness in addressing defects in public offering of shares. The first problem is the requirement of proof of causation by the plaintiff. The subscriber must demonstrate that he has acted in reliance on the false

information. The mere fact that the false information is disclosed at the time of subscription is not suffice to prove that the issuer is at wrong. The requirement for proof of causation creates a burden up on investors to establish the chain of causation between the false information and the damage suffered. So in order the investor to succeed in tort action, the investor must show to the court that he knows of the false information and that information is the cause to subscribe.

Some countries abandon the requirement of cause in securities public offering cases. For example, Canada does not require the element of reliance (cause) on the defective disclosure for the purpose of claiming compensation.⁴⁶¹ Instead, the law provides that a purchase of securities offered to the public through a prospectus containing false information (misrepresentation) shall be deemed to have relied on such misrepresentation if it was a misrepresentation at the time of subscription and the investor has a right of action for damages. The U.S Securities Act, which directly deals with the prospectus, has imposed the onus of proof of investors' non-reliance on the disclosure up on the defendants.⁴⁶² In accordance with the act, the issuers have to prove that the compensation claimed by the plaintiffs is not the result of the defect of the prospectus. Thus, the plaintiffs need not prove their reliance on the impugned prospectus for the recovery of their loss or damage resulting from their subscription to a share.

Nevertheless the Ethiopian Civil Code still requires proof of cause to hold issuers tortuously liable which investors may fail to claim compensation. This is because in the first place it is the information asymmetry that exists between the issuers and investors that necessitate the intervention of the government to regulate the securities market. So requiring the investor to prove the existence of material information, which might even be in the hands of the issuer, and showing that the investor relies on that information is very costly and difficult. As the practice shows, the tendency of investors to rely on the reputation of the promoters, name and fame of the persons involved in the issue, rather

⁴⁶¹ Gillen, M., "The Role of Securities Regulation in Promoting a Competitive Capital Market", Commissioned by the Task Force to Modernize Securities Legislation in Canada May 25, (2006), p. 61

⁴⁶² Supra note at 18, p. 168

than on the quality of disclosures made in the prospectus coupled with limited disclosure made by the issuers renders proofing cause difficult.

The other problems that challenges investors to claim compensation is the requirement of proof of the state of mind of issuers. In order to hold issuers liable based up on fault, the investor shall prove the ‘intention’ or ‘negligence’ of the issuer. For example, Art 2059 of the Civil Code states that a person who intentionally or negligently supplies false information is tortuously liable. The plaintiff has to prove the ‘intention’ or ‘negligence’ of the issuer in order to get compensation. However, in securities litigation, since it is difficult to prove intention and negligence, some countries like the U.S Securities Act of 1933, does not require the plaintiffs to prove the state of the mind of the issuer.⁴⁶³ The traditional approach of the Ethiopian extra-contractual law is not sufficient to redress damages in relation to defects in the public offering of shares. Especially, the requirement to prove state of mind (‘intention’ or ‘negligence’) and causation impedes the success of the investors claim for compensation.⁴⁶⁴

4.7.2. Criminal Liability of Business Misconduct

The question of why do the market misconducts of founders and market intermediaries are subject to criminal liability should be answered. The argument has already been put that the criminal sanctions in relation to the public offering process or the prospectus is considered as primarily performing a deterrence function.⁴⁶⁵ The generally held view is that the imposition of criminal sanctions in relation to founders’ activities should be seen as advancing deterrence goals. To the extent that the criminal sanction for prospectus laws pursues a deterrence function, it is appropriate that the criminal remedy is imposed at a level to achieve appropriate deterrence. For the typical professional person subject to a criminal prosecution, the consequences of that prosecution being undertaken (irrespective of the outcome of the proceedings) are potentially devastating in terms of

⁴⁶³ Ibid

⁴⁶⁴ Ibid

⁴⁶⁵ McAdams “The Appropriate Sanctions for Corporate Criminal Liability: An Eclectic Alternative”) 46 *Uni Cin L Rev* 989 (1977), p. 992

career.⁴⁶⁶ As such, it can be expected that the threat of prosecution itself imposes a significant degree of deterrence on participants involved in the capital raising process.

In some countries criminal liability is imposed upon persons violating the securities law. For example, the US Securities Act of 1933 Section 24 imposes criminal liability upon ‘Any person who wilfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who wilfully, in a registration statement filed under this title, makes any [misstatement] shall upon conviction be fined. The fine is US\$10,000 or imprisonment for 5 years or both’. Breach of trust, fraudulent misrepresentation, omission of material facts and false information in the securities market is not only civil wrongs but also considered as offenses against the society.

The Commercial Code does not impose any criminal liability up on founders and securities intermediaries in relation to market misconducts. However, the Ethiopian Criminal Law contains some provisions which might be applied on the conducts of founders and intermediaries in relation to their conduct in the securities market. Art 675 and Art 676 of the Criminal Code punish founders if they abuse or misappropriate the subscribed capital of the company by breaching their fiduciary obligation. Disclosing false information to the public to enrich is also punishable according to Art 718 of the Criminal Code. However, the Criminal Code does not fully cover all market misconducts of issuers and securities intermediaries. It is not clear, for example, omission of risk factor in the prospectus is a crime or not.

4.8. Institutional structure of IPOs Regulation in Ethiopia

4.8.1. Public Regulation

Currently there is no public authority actively regulating the public offering process in Ethiopia to protect investors and ensures the integrity of securities market.⁴⁶⁷ For that matter, the agency which is responsible to regulate the public offering process in Ethiopia is not specifically identified. The current practice of public offering process enforcement

⁴⁶⁶ Ibid

⁴⁶⁷ An interview to Ato H/Eyesus Nigatu, Accountant at Nib International Bank, Bahir Dar Branch, September 12, 2010

relies on the traditional approach of civil laws and remedies. These traditional remedies constitute the civil claims of private parties based on private laws including agency law, contract law, extra- contractual liability law, and enforcement of property law. There are predominantly two views regarding the public authority which should regulate the securities market. The first line of argument purports that it is the National Bank which should regulate the securities market and participants.⁴⁶⁸ Other individuals point at the Ministry of Trade under its Office of Commercial Register to take responsibility to regulate securities market and its participants.⁴⁶⁹

4.8.1.1. National Bank

The first line of argument supports the National Bank to be and is a responsible ‘Mega-Regulator’ to regulate the securities market along with banks and insurance companies.⁴⁷⁰ The integration of the regulation of securities market, banks and insurance companies under a unified megaregulator has its own advantages and disadvantages. The previous chapter of this paper theoretically discussed the arguments in favor and against the establishment of a unified megaregulator and reviewed the experience of FSA, which is outside of the National Bank.

The holder of the view that it is the National Bank is the responsible organ to regulate the securities market raises the following reasons. First, historically, National Bank, as the then state Bank of Ethiopia pioneered the establishment of a share exchange department in 1960.⁴⁷¹ A share dealing which was introduced in 1960 had the objectives to mobilize the equity capital from a broad range of sources and spreading ownership over wider variety of individual and institutions. In the subsequent years, due to other financial institutions joined the share brokerage and dealing business and the considerable expansion of the stock market, the National Bank of Ethiopia took the imitative to set up the share dealing group in February 1965. The National Bank played an important role as a chair man of the group and set the groups trading rule. So due to this historical role

⁴⁶⁸ A discussion with Ato Anteneh Mengistu, Legal Directorate Director at the Ministry of Trade, September 10, 2010

⁴⁶⁹ A discussion with Ato Zerai G/wold, Legal Expert at National Bank of Ethiopia, September 23 2010

⁴⁷⁰ Supra note at 470

⁴⁷¹ Study Report on the Establishment of a Stock Establishment in Ethiopia (First Draft), National Bank of Ethiopia, July, 1999, Addis Ababa

some individuals insist that it is the responsibility of the National Bank to regulate the securities market in Ethiopia.

The second reason which claims that it is the National Bank which has the duty to regulate the securities market mentions that the National Bank is, under its legal proclamation, the regulatory and supervisory authority for the country's financial sector including securities offering and trading. Art 14 of the National Bank Establishment Proclamation No. 591/2008 states 'the National Bank shall license and regulate banks, insurance companies and other financial institutions in accordance with the relevant laws of Ethiopia'.⁴⁷² Other financial institutions include microfinance institution, postal saving, money transfer institutions and other similar financial institution's established in accordance with the appropriate law of Ethiopia and as determined by the National Bank⁴⁷³. Since securities firms are traditionally considered as financial institutions, there is a strong position that National Bank should regulate them as well.

Another argument in favor of National Bank to regulate the securities firms, intermediaries and market is provided in terms of its broad objective and role of financial sector development.⁴⁷⁴ The National Bank is charged by the Proclamation with the task of taking appropriate measures and reforms that are conducive to the progressive development of the financial sector⁴⁷⁵ and healthy financial system⁴⁷⁶. The financial system consists of the banking, insurance and securities markets and firms. As a result the National Bank, under its statutory authority, is expected to initiate and undertake the necessary measures to develop the securities market.

However, there is a different view that the regulation of the securities market, especially the regulation of disclosure and distribution of prospectus in order to protect investors, isn't the policy and responsibility of the National Bank. Some officials of the National Bank mentioned that protecting investors through disclosure of information, registration

⁴⁷² Art 14 of the National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008

⁴⁷³ Id, Art 2(10)

⁴⁷⁴ Supra note at 470

⁴⁷⁵ Supra note at 474, Art 4

⁴⁷⁶ The first paragraph of the preamble of the National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008

and licensing of participants, establishing orderly market rules, etc is the mandate of the Ministry of Trade under its Office of Commercial Register.⁴⁷⁷

4.8.1.2. Ministry of Trade under Office of Commercial Register

The other group of persons supports the idea that it is the Office of the Commercial Register which has a duty to regulate the securities market.⁴⁷⁸ This view rejected the first argument based on the objective of the National Bank to regulate banks; hence it seems the argument purports objective based regulation. On the one hand the National Bank has an interest in regulating banks to ensure their health and soundness of the operation in order to ensure the stability of financial system as a whole. On the other hand, Commercial banks are now participating in distribution of shares to the public due to their economy of scale in having different branches throughout the country. The banks participation in distribution of prospectuses and shares to the public as a commission agent subjects them to the securities regulation in order to protect investors and ensure the efficiency of securities market. As a result banks are required to comply with the rules and regulations of the securities law and to the supervision of securities market regulatory authority. In the end banks become the subject of two regulatory authorities, i.e. the National Bank and the Securities Regulatory Authority, which have different regulatory objectives and different approaches to achieve their goals, which is discussed in chapter three of this paper.

This argument supports the twin peaks model. The first peak, which is similar to prudential regulation authority, is to regulate the financial institutions to ensure their health and soundness by the National Bank. This is because protecting investors is not the objective of the National Bank. The other peak of the regulatory authority is designed to protect investors through the necessary orderly market rules, like for example disclosure requirement. As a result, it is not the National Bank which has the duty to regulate prospectus but the Office of Commercial Register. So, according to the second line of argument, two authorities having different objectives should exist, i.e. the National Bank and Office of Commercial Register.

⁴⁷⁷ Supra note at 471

⁴⁷⁸ Ibid

The reasons to hold the office of the Office Commercial Register as the body which is responsible to regulate the public offering process are the following. Art 323 of the Commercial Code states that the memorandum of association, the articles of association, the prospectus, the minutes of the subscribers' meeting and all complementary documents shall be deposited in the commercial register. Hence it is the responsibility of the Office of Commercial Register to supervise whether the disclosure made is sufficient or not and to take the necessary measures to develop it.

In addition, according to Art 12 of the Commercial Registration and Licensing Proclamation, the legislature empowers the Office of the Commercial Register to give permission to start the formation of share companies by offering shares to the public. The very purpose of this provision is to protect investors from fraudulent and dishonest founders and promoters. So, it seems that the legislature grant the responsibility to regulate public offering of shares to the Office of Commercial Register. However, the counter argument to this reasoning is forwarded by an official in the Ministry of Trade.⁴⁷⁹ He mentioned that the insertion of the provision to give permission to start the formation of Share Company through public offering of shares is not made with appropriate research and it was the reaction of the government to the pressure of the people and the media. Even the Proclamation does not give any guideline how to implement this provision. So this sub article can't fully settle the jurisdictional confusion of the regulation of the securities market and firms.

4.8.2. Self Regulatory Institutions

Self regulatory institutions play an important role in the regulation of securities market. In Ethiopia, even though, different professional and industry associations exist like for example national and regional Chamber of Commerce, Law Bar Associations, Accounting Professional Associations, and Industry Associations, they don't regulate their members in relation to their members' involvement in securities market. The self regulatory organizations are usually tasked with one or more areas of administration over which they will exercise a degree of oversight under the framework of regulations of the

⁴⁷⁹ Anonymous

securities industry. The SRO is separate and distinct from the government regulator although the regulator will exercise an oversight and authorization function. Exchange SROs, securities dealers and brokers associations, and Central securities depositories and clearing agencies associations are the main SROs in the securities market. SROs Provide guidance, best practices, or set other standards for members.

Even if, the most common form of formal SRO in the securities markets arena still is a securities exchange, it is not yet established in Ethiopia. The most important role that Exchanges could play in the regulation of securities market are through listing standards to regulate the quality of listed companies, the disclosure provided by these companies, and the corporate governance practices that listed companies follow. The regulation of broker-dealers and regulation of trading are also important functions that an Exchange could play. Self regulatory institutions are not playing their part in the development of securities market in Ethiopia.

In general there is no public authority which is currently regulating the public offering process and the market conducts of the participants. The participation of trade and professional associations in the regulation of their members in the securities market is also nonexistent. This problem poses a great danger to the securities market whereby the founders and issuers may not withhold themselves to sell a building which exists in the blue sky through public offering of shares.

Chapter Five

Conclusion and Recommendations

5.1. Conclusion

Securities market in Ethiopia is characterized by the absence of professional promoters, underwriting agencies, market intermediaries, organized market, regulatory bodies, and rules and regulations. Initial public offering is when a company or a company under formation offer common shares to the public for the first time. Companies going public can be promising start-ups or old, established corporations engaged in restructuring programs requiring new capital injection. Regulation of IPOs refers to the set of rules, controls and processes, established by public authorities, with the aim to prohibit certain behavior, decision making and transactions in the public offering process, and to ensure that the securities market to be fair, transparent, efficient and effective and free from manipulation and fraud.

The ultimate significance of the regulation is to make the securities market play a vital role in the economic growth, development and strength of free market. Securities market is recognized as an effective way of raising capital for commercial enterprises, and at the same time providing an investment opportunity for individuals and institutions; contribute to mobilization of domestic savings and remittances by enhancing the set of financial investments available to savers to diversify their portfolios and doing so, they provide an important source of investment capital at relatively low cost; contribute to economic development by enhancing the liquidity of capital investments; to redistribute wealth to achieve distributive justice; enhance corporate governance; and eases the burden of and excessive reliance on bank loan.

In order to get this benefits the securities market should insure that investors are protected and the securities markets should be efficient. Otherwise, investors may be unwilling to participate in investment and the market may fail to discharge its resource allocation function. So the goals of the securities regulation are to protect investors and ensure the securities market is efficient. The securities laws of different countries prescribe rules and

regulations and establish institutions to enforce securities law and regulate the public offering process.

Compared to other jurisdictions, in Ethiopia there is no 'securities law' as such enacted to regulate and establish a body which supervises the securities market. Different classes of laws which traditionally regulate private activities of individuals are the primary source of laws to regulate the public offering process. The Commercial Code, the Civil Code, Commercial Registration and Licensing Proclamation, Fair Trade Practice Proclamation, and other private laws are the legal sources to address issues in the public offering process. These laws which are supposed to regulate the securities market and participants are unclear and inadequate. This loophole in the legal and regulatory aspects of the public offering process may become a favorable ground to the founders, promoters and issuers and marker intermediaries to distort the market and manipulate investors.

The first problem to this regard is the failure of the government to give due attention to develop and regulate the securities market. Securities market can't develop without the proper legal and institutional infrastructure. The government does not consider the securities market as a policy priority to establish a policy framework, legal and institutional infrastructures. Despite the failure of the government, the practice shows that primary market is growing in importance as it provides a good source for corporate financing, an alternative to the private and bank financing. The provision of funds through public offering to finance domestic capital formation is increasingly being recognized as a key factor bearing upon the prospects for long-term economic growth in the country. Faced with the reality of a much reduced supply of bank loans due to loan ceiling from previous sources (such as commercial banks), companies in the country are giving increased attention to equity financing through public offering of shares as a way of improving domestic resource mobilization, enhancing the supply of long-term capital and encouraging the efficient use of existing assets. And it is witnessed that there is sharp increase in companies which offer shares to the public to subscribe in order to finance huge projects. Ethiopia being one of the least developed countries in the world has to make every possible endeavor to efficiently mobilize the available capital. Nevertheless, the failure of the government to

come up with sound legal and institutional infrastructures to boost investors' confidence through appropriate standards and to ensure the integrity of the market deters the investors to actively participate in the primary markets.

The law is inadequate to protect investors from misleading, manipulative or fraudulent practices by dishonest promoters, worthless securities, insider trading, market manipulation which includes front running or treading a head of and the misuse of client assets; as well as to ensure the securities market is fair and free. The existing legal and institutional infrastructure of the country neither prescribes rules of conduct for issuers and intermediaries nor establishes an institution to regulate the market. The provisions which are supposed to regulate the market fall short to address the issues in public offering process.

The first problem is the inapplicability of approval requirement designed to give permission to start the formation of a share company through public offering. Art 12(5) Proclamation No. 686/2010 empowers the Commercial Register to give permission for the founders to start the formation of share companies through public offering of shares. This provision, however, neither set the standards to give permission nor expressly delegate power to the Office of Commercial Register to enact further guidelines and directives. As a result the provision has not yet implemented and the public offering process is being undertaken without any approval and registration of prospectuses and shares and without approving the integrity and capability of founders and promoters. This problem deters the public to actively and widely participate in investment and affects the integrity of the public offering process.

Poor disclosure and prospectus regulation is one of the main problems associated with public offering of shares. A good disclosure practice is essential to bring transparency in the securities market. Inadequate disclosure practices and poor transparency discourage potential investors from investing in the securities market. In order to secure investors' confidence and commitments, a flow of information is a must as investors can make informed decisions in securities market only with adequate information.

The main instrument to implement the issuers to disclose information to the public is prospectus. The regulation of prospectus has legal as well as practical problems. First, the Commercial Code does not fully regulate the content and form of the prospectuses. The Commercial Code does not fully require the disclosure of all material facts to the investing public in order to make an informed decision. The potential legal, financial and business risks, information about the issuer and promoters, financial information which includes audited report and management's discussion and analysis of financial condition and results of operations, outstanding litigations and government approvals, and any other information which is deemed material to make an informed decision should have been part of the prospectus rule. In addition the Code doesn't make clear whether oral solicitation, phone call, radio and television advertisements, brochure, advertisement, email, letter or any other means used to offer a share to the public is part of the prospectus or not.

The issue of amendment to the documents offered to the public in case a new development occurs which are detrimental to the issuers, investors and the public at large is not regulated. The law doesn't set rules which, in the one hand, enable the amendment of the prospectus to include the new development, and on the other hand, ensure the issuers not to exploit the public under the pretext of amendment. The issue of when and how the subscribers can withdraw from subscription isn't addressed in the legal frameworks.

The research also finds out problems in the process of promotion and distribution of shares to the public. The provisions that require the offer to public subscription to be made in prospectus and the issuers' and commission agents' duty to deliver the copy of the prospectus to the public are not respected. The commission agents which sell share to the public do not provide prospectus to the public and they primarily rely on the oral communication and advertisements made through radio, TV and rumors. The practice of promotion and distribution of prospectuses and the invitation to the public has also witnessed the problem of selective disclosure, the moral hazard associated with banks' involvement in the securities activities as a commission agent, the conflicts of interest between the interests of the issuers and the interests of banks which are participating as a

commission agent on behalf of the issuers, and also the problem of conflict of interest which emanates from the financing aspect of the commission agents and their fiduciary duty to the public to disclose all material facts.

Misrepresentation and omission of material facts is also another issue which doesn't fully addressed by the relevant law. The practice shows that issuers, founders, promoters or stock dealers make a statement, promise or forecast which they know to be misleading, false or deceptive material information and conceal any material facts in connection with related party transactions, previous or current brushes with civil and criminal law, tax and land lease liabilities, court and labor disputes, dispute with municipalities and the conflicts of interest arising from the involvement of issuers and founders in other competing but not openly disclosed businesses. The law also fails to regulate the issue of insider trading and selective disclosure. This business misconducts affect investors and erodes the integrity and development of the securities market.

The existing legal framework available to redress the wrongs committed in the public offering process falls short to compensate the victims and deter unnecessary market conducts. The paper finds out that the Ethiopian laws governing civil liabilities for misconducts in public offering of shares are defective in multifarious ways with weaknesses such as ambiguities and short comings in identifying the relevant laws, in identifying potentially liable persons, high burden of proof, and problems in enforcement. Such problems and weaknesses of liabilities create favorable conditions in favor of the wrongdoers at the expense of the interests of investors who are exposed to the business misconducts and fraudulent activities of issuers and founders.

Currently no agency is responsible to regulate the public offering process in Ethiopia. The securities market has no specific authority designed to regulate it. The current practice of public offering process enforcement relies on the traditional approach of civil laws and remedies. These traditional remedies constitute the civil claims of private parties based on private laws including agency law, contract law, extra-contractual liability law, and enforcement of property law. There are different arguments with regard to the responsible organ regarding the regulation.

5.2. Recommendations

5.2.1. General

Ethiopia is now registering impressive economic growth for the last decades. With in the realm of free market economy, the government considers the private sector as the main actors of economic growth, which necessitates adequate availability of investment capital. However, the shallow and under developed nature of the financial sector is deemed a hindrance to raising long-term finance. So the government, in order to sustain such development, has to mobilize every capital to fuel such economic growth. The flourishing capital market can provide alternate means of raising long term finance. Therefore, the government should encourage the development of the capital markets industry as a way of generating long-term capital and broaden the availability of funds for investment purposes to sustain such economic growth. The government should be cognizant of and double its effort to reap the benefits of capital market.

Capital markets help mobilize domestic savings, hence facilitating the reallocation of financial resources from dormant to more productive activities. Capital markets provide an avenue for the distribution of wealth to the public through encouraging the public to participate in the ownership of these companies. The privatization process can be made in a way that helps to broaden the asset base by providing a means through which ordinary citizens can acquire a share in the privatized companies. Companies may have the opportunity to raise long-term finance through equity and debt financing (issuing shares and debentures respectively). The capital raised through the issue of shares, bonds or other instruments, can be invested by the company to expand production, invest in more efficient productive processes and improve competitiveness. This increased investment by companies will lead to employment expansion, income generation, and with a larger percentage of the population earning incomes, savings and consumption will increase resulting in a cycle of increased investment, increased production, enhanced economic growth and wealth creation. The full disclosure and merit requirements, companies are encouraged to observe better accounting and management practices, may lead to good corporate governance.

So the government should take necessary policy and legal measures in order to develop the capital market. The policy measures play a key role in the development of the capital markets. Investors require confidence, protection and information to participate in the market. In addition, fiscal incentives like tax incentives, reduction in import duties, and reduction in licensing fees, and other policy measures encourages companies to go public which enable the saving public get access to participate in a wide variety of investment.

The government should exert its effort to develop the capital market through building capital market infrastructures. The market infrastructure may take three forms. First, the government should work for the development of the institutional infrastructure. These institutional infrastructures provide the operational basis for the market and include intermediaries that provide trading, investment management and financial advisory services; market and market-related service providers for stock exchanges, over-the-counter markets, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody; and providers of ancillary services such as accounting and auditing, legal advice, and financial valuation and debt rating services.

The second part of the market infrastructure is to establish the regulatory authorities. The regulatory bodies may constitute the government body that has the power and responsibility to supervise the market, and self-regulatory organizations such as stock exchanges, accounting standards boards, and accounting and auditing professional associations and similar organizations. It also includes their rules and regulations, procedures, and facilities such as stock exchange listing and trading rules or accounting and auditing standards, plus the monitoring and enforcement of these rules.

The last one is to enact appropriate laws which provide the basis for the operational and regulatory framework. The securities and other laws should be enacted to provide for property rights, contractual relationships, process of incorporation, and rights and responsibilities of participants in the market. The securities law should also establish and specify the powers and responsibilities of the government supervisory authority and self-regulatory organizations.

In general for the healthy and sound operation of the capital markets, the government should take policy measures and enact laws to ensure the existence of a sound fiscal and monetary policy, effective legal and regulatory framework, secure and efficient settlement and custodial system, effective information disclosure system, a diversified investor base, and favorable tax and other policies.

5.2.2. Strengthening Regulation and Supervision: Securities Markets Authority

Until now there is no any public authority responsible to regulate the securities market. The securities law should establish a public authority to regulate the securities market. The objectives of the authority should be to create an appropriate investment environment, boost confidence, and reinforce an organized, fair, transparent securities market, set disclosure standards to public companies, and ensuring the protection of investors from market misconducts. To achieve these objectives and others, the authority should have granted sufficient power and resource. It should issue the required rules and regulations for the implementation of the provisions of Securities Market Law. The functions of this government authority should be;

- ✓ to regulate and develop the capital market, and to seek to develop and improve the practices of entities involved in securities trading;
- ✓ to protect investors in securities from unfair and unsound practices, or acts involving fraud, deceit, cheating, manipulation or insider trading; maintain fairness, efficiency and transparency in securities transactions;
- ✓ to regulate and monitor the issuance of and trading in securities; examines applications for authorization to conduct securities business, including dealing, managing, arranging, advising and custodial services, as well as to license and supervise the trading activities of stock exchanges, brokers and other intermediaries and professionals;
- ✓ to regulate and monitor the full disclosure of information pertaining to securities and their issuers, the dealings of informed persons and investors, and specify and provide the information that should be disclosed by participants in the market to the general public.

- ✓ In addition the authority should have to review applications for the issuance and offering of shares to the public to ensure their compliance with the appropriate securities law and its implementing Regulations, as well as to review listing of securities and to ensure the compliance of listed companies with the initial disclosure requirements, if a stock exchange is established.

The authority should also have an enforcement power to investigate and prosecute violations of the securities law and its implementing Regulations, to settle disputes that may arise among participants in the securities market, and to investigate investors' complaints and follow up on their settlement.

I think this institution should be accountable to the National Bank of Ethiopia for the following reasons. First, if securities firms and banks are regulated by a different authority, due to fragmented supervision there might be group-wide risks that may not be adequately addressed by specialist regulators. Financial and price stability couldn't be ensured without taking in to consideration the activities and risks of the securities markets and industry. Second, National Bank could help generate economies of scale as a larger organization permits finer specialization of labour and a more intensive utilization of inputs like cost savings on the basis of shared infrastructure, administration, and support systems. Third, this authority could also get access to the acquisition of information technologies developed by the National Bank, which become cost-effective only beyond a certain scale of operations. Finally, it can also avoid wasteful duplication of regulation and research and information-gathering efforts conducted by the National Bank and Securities market regulator for their own purposes. Being the securities regulatory institution accountable to the National Bank increases coordination and communication and allows them to avoid duplication of regulation and research and information-gathering efforts.

5.2.3. Approval of Public Offering

The securities authority should have the authority to review and approve the prospectus of companies engaging in a public offering. No offering should go forward until the authority has completed its review and given the company the authority to proceed. The

power of the authority should be to review whether the prospectus satisfies disclosure and complies with merit requirements. Since in Ethiopia companies go forward without a sponsoring underwriter, issuers have the full right to prepare a prospectus and make a public offering of their securities in the way they like. So the adoption of merit review could help develop a degree of public confidence in the offering process. If the public was aware that the agency was screening offerings not only on the basis of disclosure but also in terms of economic viability, there might be more willingness to invest in new offerings. The authority should bar an offering by a company that is too high risk to be viable, or by a company with inexperienced management, which could affect public confidence in the entire market. Detail regulations should be passed by the regulatory authority.

5.2.4. Disclosure Regulation

The existing legal framework doesn't sufficiently regulate the disclosure of material facts relevant to make an informed decision by investors. Public disclosure of relevant information about securities is important for both pricing efficiency and market confidence. If investors are to make sound judgments about the value of securities, they must be fully informed of relevant facts. The Securities Law and subsequent regulations enacted by the regulatory authority should mandatorily require the following information to be disclosed to the public. First, the prospectus should disclose all risk factors associated with the investment. Investors should be given notice of speculative risks and those relating to the company's financial condition, its business operations, its reliance on management and the terms of the offering. Each risk factor should be stated in a concise paragraph and relate to a specific problem faced by the issuer or arising on account of the offering. Second, the prospectus should disclose all information about the company like the address of the principal office of the company and any significant subsidiaries; the general nature of the company's business; when it started operations; where it was organized; the location of its principal plants or offices, if any; and other information necessary to describe the material aspects of the company. Third, the prospectus should disclose the financial history and condition of the company. The information should include the company's assets, liabilities and cash flow and whether it has had any earnings. In addition, reasonably current financial statements of the company prepared in

accordance with generally accepted accounting principles should be provided. In addition, any pending litigation or municipal investigation as well as the manner and term of offering should also be made disclosed to the public.

5.2.5. Publication and Advertisements

A law should be enacted to regulate the publication of the prospectus and advertisements of a public offering. The prospectus shall be published before the opening of the offering procedure in a daily newspaper of nationwide circulation, or on the website of the issuer, or of the broker/dealer. It helps the general public to easily get access to the information disclosed. The prospectus shall be made available to the investors up on their request before the offering process is begun. The text and format of the prospectus published and made available to the public must at all times conform to the original approved prospectus, if the public authority approves prospectus before distribution. It shall be distributed free of charge at all sales locations, offices of commission of agents, at the issuer's registered office or in any designated areas.

The law should also address how advertisement should be made in public offering of shares. The information contained in an advertisement shall not be inaccurate, or misleading. This information shall also be consistent with the information contained in the prospectus, if already published, or with the information required to be in the prospectus, if the prospectus is published afterwards. And the advertisement must be clearly recognizable as such. In any case, all information concerning the offer to the public disclosed in an oral or written form must be consistent with that contained in the prospectus.

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5.2.6. Self Regulation

Since trade and professions associations are not playing their part in the development of an efficient and effective securities market, the government should encourage them to involve in the regulation of their members and activities in relation to securities market. A stock exchange should also be established for it provides liquidity and information to the investors in addition to its role in regulation of public companies through its listing and disclosure requirements and corporate governance standards. In addition, a proper policy and legal framework shall be devised by the government in collaboration with industry and professional associations. The associations should also take the initiative to establish rules and regulations governing the conduct of member firms and persons participated in securities market; supervise members and markets to monitor compliance with the rules and enforce compliance with the rules by investigating potential violations and disciplining individuals and firms that violate them.

5.2.7. Promoting and Regulation of Intermediaries

The capital market can't fully develop and efficiently operate without strong intermediaries. In a well developed capital market intermediaries include stockbrokers, subbrokers, share transfer agents, bankers to an issue, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, depositories, custodians of securities, credit rating agencies and other such intermediaries who may be associated with the securities market in any manner. These intermediaries play an important role for

the functioning of the securities market. So the government should undertake measures to develop them and enact laws to regulate them. Registration requirements, qualification tests and capital adequacy requirements could be in place as an instrument of regulation.

5.2.8. Accounting and Auditing Standards

The issuers of securities may disclose the various types of financial statements and reports in a manner which are not clear and understandable to the ordinary investor. The failure to have a standardized financial statements and reports may open a way to the issuers to conceal material facts. To alleviate this problem a regulation and standardized form should be prepared for accountants and auditors to prepare financial statements and reports that present objective, unambiguous and complete economic facts of the existence and operations of the company. In order to minimize the dangers of bias, misinterpretation, inexactness and ambiguity, accountants and auditors should be made to adopt generally accepted accounting and auditing principles or standards while disclosing information to the public.

5.2.9. Delivery and Settlement of Shares

Investors in securities have expressed concern about purchasing securities but not receiving either their certificates or their dividends. Appropriate legal and infrastructure should be in place to address poor shares transfer, registration and custody.

5.2.10. Mass Education

Appropriate securities law should be enacted to grant power to the public regulatory authority to enhance public education and create public awareness about the securities, securities market and the participants. Mass education of the public, regarding such matters as the nature of stock, the rights of shareholders, the payment of dividends, how stock appreciates, how the market works, and how securities are traded , is one of the most effective regulatory tools. So the authority should have the responsibility to educate the public. As a result the public has clear picture of the nature of the investment and the risks that are involved in public offering. Otherwise, the public may be reluctant to engage in securities purchases or trading because of a fundamental lack of understanding of the investment or the process.

5.2.11. Promotion of Institutional Investors

Currently, it is the private individuals who are actively participating in subscribing to public offerings. Institutional investors like pension and retirements plans, social institutions, universities and any other institutions should be promoted to participate in public offering. So, appropriate legal and policy measures should be taken to encourage these institutional investors to contribute their part for the development of securities market.

5.2.12. Addressing Market Misconducts

All information which is material to enable a reasonable person to make an informed investment decision must be disclosed. Market misconducts like omission and misstatement of material facts, deceit, selective disclosure, insider trading, and market manipulation should be prohibited and appropriate laws and regulations should be enacted to address such problems. The Securities Law should provide for criminal and civil penalties for failing to disclose material facts or making untrue statements of material facts or if the issuers and intermediaries engage in market manipulation. Investors who purchase a security from a company which fails to disclose a material fact or made an untrue statement of material fact in connection with the sale of that security will be able to sue the for the issuers for compensation. Additional remedies like criminal prosecution including fine and imprisonment and administrative measures like barring public offering and fine should also be imposed up on the issuers who violate the law. In relation to this, the law should abandon the requirement of e proof of causation and intent by the plaintiff in extra-contractual law litigation to facilitate compensation to the investors.

Over the last few years, there have been substantial activities in public offering. Primary market is becoming an important source for long term investment. But there are still many issues to be addressed to make it more efficient in mobilizing and allocating capital. Investor confidence in the securities market is very low. This must be regained in order to encourage capital mobilization through primary market issues. Further strengthening of investor protection, and improvements in transparency, corporate governance, and monitoring will be necessary. The capital market infrastructure, such as

accounting standards and legal mechanisms, should be improved to develop the market. In addition appropriate policy and legal measure should be taken to encourage corporate firms to go public and mobilize savings and allocate resources.

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