LIABILITY FOR OFFERS IN THE PRIMARY MARKET

A MINI-DISSERTATION SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF LAWS (LLM) IN CORPORATE LAW (MND800)

UNIVERSITY OF PRETORIA (LAW FACULTY)

THEO NOKO SEANEGO

STUDENT NO. 24352889

NOVEMBER 2014

SUPERVISOR: PROFESSOR P.A. DELPORT

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DECLARATION OF OWN WORK

I, Theo Noko Seanego, declare that this paper titled “Liability for Offers in the Primary Market” is my own independent work and all the sources that have been used, quoted, referred to, have been indicated and acknowledged.

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Theo Noko Seanego

Date: ___________

ACKNOWLEDGEMENTS

I would like to thank my supervisor, Professor Delport for guiding me through the LLM Corporate Law degree and this paper, imparting his knowledge from which I learned and became a better attorney. It was not an easy process.

Thank you God, you made it possible!!!!

CHAPTER 1: Introduction and Research Question

1.1 Background

The Companies Act,[1] which came into force on 1 May 2011, introduced a significant number of changes to the 1973 Companies Act.[2] These changes, it would appear from day to day application of the Companies Act, have brought about a lot of benefits for the corporate world in general and have assisted is increasing economic activity. The changes include, among others, the introduction of Chapter 4 titled "PUBLIC OFFERINGS OF COMPANY SECURITIES" which consolidated all provisions relating to securities which were structured differently in previous legislation. It also removed some unnecessary administrative layers and processes.

1.2 Objective of the paper

The purpose of this paper is to analyse the provisions of Chapter 4 of the Companies Act in as far as liability for untrue statements in the prospectus is concerned. The paper will specifically deal with the prospectus and its requirements, materially untrue statements in the prospectus, who is liable, under what circumstances liability arises and the kind of relief that can be sought by the aggrieved party, being the investor.

1.3 Research question

This paper endeavours to outline the consequences of including untrue statements or omitting to include materially significant information in a prospectus.

1.4 Scope of the paper

In this research, the author will set out the liability and/or responsibility of various individuals involved in the preparing and registration of a prospectus.

1.5 Methodology

The research is done through reading various documents, books, legislation and case law. Some of the opinions expressed herein are those of the author, unless where otherwise indicated.

[1] Companies Act 71, 2008, as amended.
[2] Companies Act 61, 1973 (repealed).

1.6 Summary of Chapters

This research paper discusses Chapter 4 of the Companies Act,[3] in particular, liabilities in relation to public offerings in the primary market, with a bit of reference to the secondary market. The subject or research proposal is motivated by the economic developments in the corporate world and how the securities markets had to be structured after the global crisis. The Republic of South Africa ("South Africa"), with its developing legislation and practices, has managed to place itself in the same boat as developed countries in as far as corporate and securities markets are concerned.

In this research paper:

Chapter 1 deals with the background to this research, the research question, the objective of the research, the methodology and a summary of chapters.

Chapter 2 deals with the introduction and general discussion on the securities markets, prospectus and its requirements and public offers.

In Chapter 3 the author deals with statutory and common law liability and also do a bit of comparative of the South African law relating to primary offers with laws applicable in other jurisdictions, i.e. United Kingdom, United States and Australia. The choice of countries for the comparative study are based on the following: United Kingdom is a commonwealth country like South Africa, United States is a country where public offerings are prevalent and Australia, though regarded as a developed country compared to South Africa, the economic activity may be on the same level as South Africa. Various legislations from these foreign jurisdictions have been looked at and the writer has made an attempt to understand how these pieces of legislation are applied in their various jurisdictions.

Chapter 4 deals with recommendations on what could or should be done to ensure smooth enforcement of the laws relating to offers to the public, including judicial refinement of existing legislation to make the law clearer, with as less ambiguities as possible. Also, a suggestion on the harmonization of the securities laws internationally to allow for easy trade and better risk management.

[3] Companies Act 71, 2008, as amended.

CHAPTER 2: Securities Markets

2.1 Introduction and General Discussion on Securities Markets

The regulation of the securities market is largely the regulation of information relating to the selling and acquisition of securities. The process of selling and acquiring requires that information concerning issuers and their securities be disclosed to the prospective investors. Securities regulation seeks to regulate this disclosure in order to ensure a level playing field between issuers and their prospective investors. The House of Lords in Peek v Gurney[4] held that the objective of a prospectus was to enable investors to make an informed investment decision. In this case, the plaintiff/appellant, failed to take up shares when they were offered through a prospectus. He later acquired the shares on his own on the Stock Exchange without necessarily relying on the prospectus. He claimed to have been misled and deceived by the prospectus that the company had issued prior to the allotment of shares to people who subscribed. He acquired the shares way after the allotment was closed and the purpose of the prospectus was served. Both the trial court and the appeal were dismissed.

The securities market is a complex area of law which must be properly regulated. Such regulation should, at all times, strike a balance between encouraging economic activity and prudent risk taking by prospective investors. The regulation of securities markets, the importance of which cannot be over emphasized, is aimed at protecting those in need of protection, thereby minimising the high risks of abuse by the players in the market. In this market, risks are accentuated because the property being dealt with is invisible and intangible. This makes the property difficult to evaluate and the investor is more exposed to imprudent investments or deceit. Participants in the market, broadly speaking, include borrowers, lenders, financial intermediaries and brokers, among others. The securities markets, generally speaking, includes the primary and secondary markets, money and bond markets, spot, forward and derivatives market and various other markets, most of which do not fall within the scope of this paper. This paper focuses specifically at the primary market and related liabilities.

Most of the international corporate failures i.e. Enron etc. resulted from issuers attempting to maximise the price of their securities by creating wrong impressions about their financial health. This malpractice of misleading or providing untrue statements to prospective investors is sometimes a deliberate fabrication of material facts, while other times it is a product of recklessness or negligence on the part of persons involved in the preparation and issuance of a prospectus ("prospectus" and "disclosure documents" have some differences in their meanings which vary between jurisdictions. However they broadly represent the expression "disclosure in

[4] Peek v Gurney 1873 LR 6 HL 377.

the primary market". For convenience they will be used interchangeably in this research paper). Such a practice has a perilous impact upon the integrity of, and investor confidence in, the market. Though South Africa has not experienced a corporate failure, where a company ends up being wound down, due to selling securities based on untrue statements in a prospectus, there has been various corporate failures resulting from corporate fraud i.e. Macmed Health Group, Masterbond Group, Regal Treasury Private Bank, PSC Guaranteed Growth, Leisurenet Group, among others. Unfortunately, an analysis of what happened with these companies does not fall within the scope of this research paper.

Investors are expected to invest their savings in securities in reliance on the public disclosure made by the issuer. The issuer, being a company, uses various individuals/professionals in preparation to go public to raise funds. Although they are hired and accordingly paid by the issuer, they are ultimately intended to serve investors who are generally unfamiliar with the material information about the issuing company and the individuals behind it.

South Africa has, in recent years, gone through various legislative amendments and/or introductions of new legislation i.e. the Companies Act, the Financial Markets Act [5] which replaced the Security Services Act, [6] the Financial Advisory and Intermediary Services Act,[7] among others. The Financial Markets Act regulates the secondary market of listed securities. In particular, it regulates the security exchanges.

The legislative amendments and/or enactments in relation to the securities market were informed by, among others:-

- various hiccups experienced in applying the existing old legislation that was in place;
- the International Organisation of Securities Commissions' (IOSCO) policy documents aimed at improving and enhancing standards of regulation applicable to the securities markets;[8]
- the recommendations of the FSAP.[9] The South African financial services sector underwent the FSAP and the securities market regulation was found to be largely compliant with the IOSCO Principles. The recommendations seek to address the regulatory gaps identified by the assessment and to provide

[5] Financial Markets Act 19, 2012.
[6] Securities Services Act 36, 2006 (repealed).
[7] Financial Advisory and Intermediary Services Act 37, 2002.
[8] The reports, recommendations, as well as the Objectives and 38 Principles of Securities Regulation (IOSCO Principles).
[9] Financial Sector Assessment Programme, an International Monetary Fund and World Bank assessment of, *inter alia*, IOSCO members' level of compliance with the IOSCO Principles.

guidance as to the measures that can be implemented to ensure maximum compliance with the IOSCO Principles;

- the effects of the recent global financial crisis as well as the outcomes and strict timeline-based recommendations of the Group of Twenty Countries (G20), of which South Africa (represented by the Minister of Finance) is a member. The recommendations included the strengthening of regulation and supervision of the financial sector, strengthening of transparency and accountability, the enhancement of sound regulation, the promotion of integrity and stability in the securities markets and the reinforcement of international cooperation;
- developments in comparable jurisdictions, e.g. the United States, the United Kingdom and Australia;
- rules and recommendations of the International Institute for the Unification of Private International Law (UNIDROIT) Convention on Substantive Rules for Intermediated Securities aimed at improving the international legal framework for securities holding, transfer and collateralization. At the UNIDROIT's diplomatic conference held in Geneva in September 2008, South Africa made a commitment to adopt the final draft of the UNIDROIT.

This research paper examines the statutory provisions concerning the liabilities of various persons for untrue statements in the prospectus that are issued by companies in raising capital from the public in South Africa. The research paper will also make reference to security regulation in other jurisdictions i.e. the United States, United Kingdom and Australia. It appears from all the countries chosen for preparation of this research paper that the aim of protecting unsophisticated investors is common. This also includes protecting the public against the insolvency of those who take money from them with the view of paying it back later. There is a risk that the institution may dissipate the money in the meantime and become insolvent with consequent loss to the public and collapse in confidence in the financial system.

In order to facilitate fair play between the issuer and the prospective investor, provisions governing disclosures around the world commonly require "full, fair, accurate and timely" disclosure of material or price sensitive information about issuers and the securities to be offered. This complies with some objectives of securities regulation recognised by the IOSCO, which include protecting investors, ensuring market fairness, efficiency and transparency.[10] Consistently, securities regulators all over the world are explicitly biased towards the weaker party, the subscribers to the securities, in recognition of the fact that the development of a

[10] Objectives and Principles of Securities Regulation - iosco
https://www.iosco**.org/library/pubdocs/pdf/**IOSCO**PD323.pdf** ***(accessed on 28 October 2014).***

securities market essentially requires investor protection.[11] The regulatory role in relation to public offerings is therefore concerned with the proper disclosure by issuers.

Securities, which are the main commodity dealt with in this paper, are defined in the Companies Act[12] as *"any shares, debentures or other instruments, irrespective of their form or title, issued or authorized to be issued by a profit company*".

It would appear the South African definition, above, does not differ much with definitions in other jurisdictions mentioned in this paper i.e. section 92[13] of the Australian Corporations Act 50 of 2001, the US Securities Act 1933[14] and section 142 (7)[15] of the UK Financial Services and Markets Act.[16] The UK Companies Act[17] definition includes options, futures and contracts for differences and all rights related thereto.

Before delving deep into the discussion on securities issued and/or offered by companies, it is politic to define what a company is. Section 1[18] defines a company as follows:-

> ***"company"*** *means a juristic person incorporated in terms of this Act, a domesticated company, or a juristic person that, immediately before the effective date-*
> *(a) was registered in terms of the-*
> *(i) Companies Act, 1973 (Act No. 61 of 1973), other than as an external company as defined in that Act; or*

[11] A number of studies suggest that an appropriate legal regime providing protection to investors is essential for the development of securities markets, internationally: For some of the studies, see R. La Porta, F. Lopez de Silanes and A. Shleifer, "What Works in Securities Law" (2006) 61 Journal of Finance 1; R. La Porta, F. Lopez de Silanes, A. Shleifer and R. Vishny, "Investor Protection and Corporate Valuation" (2002) 57 Journal of Finance 1147; A. Shleifer and D. Wolfenzon, "Investor Protection and Equity Markets" (2002) 66 Journal of Financial Economics 3; F. Lopez De Silanes, 'The Politics of Legal Reforms' (2002) 2 Economia 91; R. La Porta, F. Lopez de Silanes, A. Shleifer and R. Vishny, "Investor Protection and Corporate Governance" (2000) 58 Journal of Financial Economics 3; R. La Porta, F. Lopez de Silanes, A. Shleifer and R.W. Vishny, "Agency Problems and Dividend Policies Around the World" (2000) 55 Journal of Finance 1; R. La Porta, F. Lopez de Silanes, "Corporate Ownership Around the World" (1999) 54 Journal of Finance 471; R. La Porta, F. Lopez de Silanes and A. Shleifer, "Law and Finance" (1998) 106 Journal of Political Economy 1113; R. La Porta, F. Lopez de Silanes, A. Shleifer and R.W. Vishny, "Legal Determinants of External Finance" (1997) 52 Journal of Finance 1131; A. Shleifer and R.W. Vishny, "A Survey of Corporate Governance" (1997) 52 Journal of Finance 737.

[12] Section 1 of Companies Act 71, 2008, as amended.

[13] Securities means: (a) debentures, stocks or bonds issued or proposed to be issued by a government; or (b) shares in, or debentures of, a body; or (c) interests in a managed investment scheme; or (d) units of such shares; but does not include: (f) a derivative (as defined in Chapter 7), other than an option to acquire by way of transfer a security covered by paragraph (a), (b), (c) or (d); or (g) an excluded security. Note: A derivative does not include an option to acquire a security by way of issue (see the combined effect of paragraph 761D(3)(c), paragraph 764A(1)(a) and paragraph (d) of the definition of security in section 761A).

[14] Securities Act, 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.

[15] means investments to which this section applies. Although this definition does not say much, the context in which the securities are dealt with is similar to how they are dealt with in terms of the Companies Act 71 of 2008, as amended.

[16] Section 84 (2) of the Financial Services and Markets Act, 2000.

[17] Section 141 (4) (d) of UK Companies Act, 2006.

[18] Companies Act 71, 2008, as amended.

> *(ii) Close Corporations Act, 1984 (Act No. 69 of 1984), if it has subsequently been converted in terms of Schedule 2;*
> *(b) was in existence and recognised as an „existing company" in terms of the Companies Act, 1973 (Act No. 61 of 1973); or*
> *(c) was deregistered in terms of the Companies Act, 1973 (Act No. 61 of 1973), and has subsequently been re-registered in terms of this Act;*

The definition above is further augmented in Chapter 4 of the Companies Act to include foreign companies.[19]

Two types of offering discussed in section 99 (3) of the Companies Act 71, 2008, are dealt with below:-

2.1.1 Primary Market

This is the market for issue of new securities to borrow money for purposes of consumption or investment. Examples of primary market instruments include, among others, mortgage bonds.[20] The primary market includes both listed and unlisted securities. If listed securities are issued, then compliance with the relevant securities exchange (i.e. JSE) is a prerequisite as opposed to unlisted securities where a prospectus will be required.[21] The prospectus will be discussed in detail in paragraph 2.2 below.

2.1.2 Secondary market

This is the market where previously issued securities are traded. Though it differs from the primary market, the existence of a secondary market has the following effects, among others, on the primary market:-

- it provides investors (who purchased in the primary market) with the assurance that they will be able to dispose of their securities if they so desire;
- the secondary market can also assist the issuer of securities in determining the interest rates to be offered on new issues of securities.[22]

Similar to the primary market, the secondary market can trade in both listed[23] and unlisted securities.[24] Secondary offers of unlisted securities must be accompanied by either a prospectus that accompanied the primary offer or a written statement that complies with the requirements of section 101 (4) – (6). A Written statement is a synopsis/summary of the state of affairs of the Company and the particulars of the offer being made. Secondary offers made through a securities exchange do not

[19] Section 95 (1) (a) of the Companies Act 71, 2008, as amended.
[20] Fourie LJ, Falkena HB, Kok WJ (eds) (1999), 2nd Ed, 12.
[21] Section 100 of Companies Act 71, 2008, as amended.
[22] Fourie LJ, Falkena HB, Kok WJ (eds), *ibid* , 13.
[23] Section 95 (h) (ii) (bb) of Companies Act 71, 2008, as amended.
[24] Section 101 (4) – (6) of Companies Act 71, 2008, as amended.

qualify as offers to the public in terms of the Act. The above statement makes it necessary to explain briefly what qualifies as a public offer and what does not.

Unlisted secondary market offers must be accompanied by a prospectus that accompanies the primary offer or a written statement that complies with the provisions of the Companies Act.[25] If a written statement contains untrue or misleading information, liability will only arise if the written statement is issued in terms of section 101 of the Companies Act.[26]

2.2 Prospectus

2.2.1 What is a prospectus?

A prospectus is any prospectus, notice, circular, advertisement or other invitation offering any shares of a company to the public.[27] It is not an offer but a document that accompanies an offer.[28] The Companies Act[29] prescribes the prospectus requirements for public offers. A combination of factors is considered before one invests in securities, i.e. the financial performance of a company, prospective value, acquisitions (past, present and future), executive leadership, geo-political stability, market realities, among others. The above information is weighed and used as a form of crystal ball looking into the future performance of securities in the market. A prospective investor in the securities of a company is essentially making a judgment about the company's future prospects. The securities market is regulated and a prospectus is prescribed because the potential investors may be a wide range of persons, and thus may include the ill-informed and the gullible among the addressees as well as the experienced and the well-informed.[30]

When a prospectus is prepared, it must be based on the realities of the information mentioned above. Investors normally scrutinize the contents of the prospectus for predictions of future performance. The prospectus must comply with the requirements of section 100[31] and all the other requirements in the Companies Act.[32] A prospectus is a document that outlines the corporate, financial, legal and general position of the company/offeror. It must not be issued more than 3 months after its

[25] Section 101 (2) of Companies Act 71, 2008, as amended.
[26] Section 101 of Companies Act 71, 2008, as amended.
[27] Hahlo's *Company Law Through Cases (1999), 6th* Ed, 86.
[28] Cilliers and Benade *Corporate Law* (2000), 3rd Ed, 269.
[29] The prospectus requirements are clearly set out in sections 102 to 111 in detail but section 100 provides that every prospectus must contain all the information that an investor may reasonably require to assess (i) the assets and liabilities, financial position, profits and losses, cash flows and prospects of the company in which a right or interest is to be acquired; and (ii) the securities being offered and rights attached to them. Subparagraph (b) refers to prescribed specifications that the prospectus should adhere to. The prescribed specifications are contained in Regulation 54.
[30] Gower and Davies *Principles of Modern Company Law*, (2012), 9th Ed, 898.
[31] Companies Act 71, 2008, as amended.
[32] *Ibid.*

registration[33] as information may change rapidly and the info contained in the prospectus may have been overtaken by events and irrelevant.

It is important to note that parties to a securities transaction cannot contract outside the prescripts of the law to avoid being bound by the prospectus requirements.

One could argue that the section 95 (1) (h) (i) (dd) was meant to cover all forms of publication including radio and television announcements with the words “in any other manner” but there could be serious practical issues relating to this. It is close to impossible to conceive that that was the intention of the legislature. Unlike the US securities laws where it is specifically mentioned that a prospectus includes a communication by radio or television, the South African law has not developed to that level yet. This is one of the points which require judicial refinement in the near future. All we can do now is to play the waiting game.

An advert[34] which draws attention to an offer to the public must clearly states that it is not a prospectus, indicates where the prospectus can be obtained and contains no untrue statements or misleading in any manner. Should the advert not comply with the above mentioned characteristics, it would be regarded as a prospectus despite any statement to the contrary. The statement that the advert is not a prospectus is of no consequence. This means an advert could attract section 104 liabilities to the persons responsible for its publication or dissemination.

2.2.2 What is the purpose of a prospectus?

The cornerstone of securities regulation is disclosure. This is achieved by prescribing the required information and conditions related thereto. Some jurisdictions also provide for continued disclosure,[35] among others. The main purpose of a prospectus is to provide prospective investors with information that will enable them to make informed investment decisions. Current legislation in South Africa relating to the law of securities is geared towards bringing the South Africa’s securities markets in line with the practices in developed countries.

The preparation of a prospectus for issuing securities involves participation of a group of individuals comprised of, among others, directors of the company and the experts and other professionals (auditors, lawyers and other relevant professionals). Given the scale of the deceitful public issues of securities in the past, which resulted in the regulation of the securities market, it has been argued that the flotation of such

[33] Section 99 (11) of Companies Act 71, 2008, as amended.
[34] Section 98 of Companies Act 71, 2008, as amended.
[35] Continued disclosure is common in the United States (especially for foreign issuers) and Australia, *infra 55*.

a mass of essentially fraudulent securities was made possible because of the complete abandonment of standards of care, fair, honest, and prudent dealing.

As already mentioned earlier, a prospectus made must provide accurate and complete information to prospective investors, as required by the Financial Services Act. The securities markets change constantly due to market forces, global financial policies and sometimes due to circumstances, some of which are unforeseen i.e. the recent global crisis.

2.2.3 What are the Prospectus requirements and contents?

The content of the prospectus may differ depending on the nature of the securities offered and the profile of the addressee. Section 100 deals with prospectus requirements. Such requirements are specifically mentioned in the Companies Act Regulations 2011.[36]

2.3 Public Offer

2.3.1 What is an Offer?

An offer is defined in the Companies Act[37] as follows: **"offer"**, *in relation to securities, means an offer made in any way by any person with respect to the acquisition, for consideration, of any securities in a company.* The definition is too wide, the extent of which is not easily determinable due to the use of the

[36] Regulation 51:**General requirements for a prospectus** (1) Every prospectus must be produced in a style that satisfies the requirements set out in section 6 (4) to (6). (2) As far as possible the general matter of a prospectus must be presented in narrative form, and statistical matter must be presented in tabular form. (3) The information required by the Act and these regulations to be stated in a prospectus must—(a) be set out in print or type; (b) be not less conspicuous than that in which any additional matter is printed or typed; (c) be organised in accordance with the order, and use the headings, of the subparts and each of the regulations comprising Part C, as applicable in terms of regulation 55 or 56, as the case may be. (4) Every prospectus issued must— (a) state on its face that it is a copy of a registered prospectus; and (b) specify or refer to statements included in it specifying any documents required by the Act or this Chapter to be endorsed on or attached to or to accompany the prospectus when it is filed. Regulation 54: **General statement of required information** (1) Every prospectus must include—(a) all material information relating to the securities being offered including, but not limited to, the information specifically required in this Part; and (b) a narrative statement setting out—(i) the extent to which, and manner in which, the company has applied the principles of the King Report and Code; and (ii) the reasons for any instance of not applying the recommended principles in the King Report and Code. (2) If it is the intention to acquire a business undertaking or property with the capital raised by the offering, the prospectus must include a brief history of that business undertaking or property, including—(a) particulars of each business undertaking or property purchased or acquired, or proposed to be purchased or acquired by the company or any subsidiary of the company, if any part of the purchase price of that business undertaking or property is to be defrayed out of the proceeds of the issue; (b) the amount, if any, paid or payable in cash or securities for any such business undertaking or property, specifying the amount, if any, paid for goodwill; (c) the name and address of the vendor of the business undertaking or property; and (d) if there is more than one vendor, the amount payable in cash or securities to each vendor. (3) If the offer is not being underwritten, the prospectus must either—(a) include a statement by the directors setting out the manner in which, and the sources from which, any shortfall in the amount proposed to be raised by means of the offer is to be financed; or (b) state that the offer is conditional on the raising of the specified minimum amount.

[37] Section 95 (1) (g) of Companies Act 71, 2008, as amended.

words "offer made in any way". An offer must be in respect of particular securities.

The common law definition of offer does not include an invitation. Section 95 (1) (g) does not include an invitation either. Also, electronic offers which make reference to the link or site where a registration statement can be obtained is insufficient for compliance with section 101.[38]

2.3.2 What constitutes a public offer?

Section *95(h)* of the Act states that an offer to the public includes an offer of securities to be issued by a company to any section of the public, whether selected as holders of that company's securities, as clients of the person issuing the prospectus, as the holders of any particular class of property, or in any other manner, but does not include an offer made in any of the circumstances contemplated in section 96 or a secondary offer effected through an exchange[39].

It should be noted that in some countries, an offer becomes public depending on the number of persons to whom the offer was made.

In South Africa, the definition was tested in the Gold Fields Ltd v Harmony Gold Mining Co Ltd[40] where an offer was made to holders of the target company's shares without complying with the requirements for public offers i.e. the issuing of a prospectus. The offer in the above mentioned case was capable of acceptance by only the owners of property in Gold Fields, hence the dispute as to whether a prospectus was necessary or not. The case also resolved an important issue of subscription fee in that it was agreed that a share for share swop qualifies as subscription for shares. Shares do not exist until they are issued.[41] Before the shares are issued and subscribed for, there can be no talk of sale as there is nothing to buy. The company, whose shares have never been issued, cannot only issue shares for subscription and the sale will only happen in the secondary market.

Though the wording may differ slightly, the definition of public offer is almost similar to the definitions in the chosen jurisdictions i.e. section 82 of the Australian Corporation Act.[42] One thing that we need not lose sight of is the wording of subparagraph (dd) which reads "*in any other manner*". This too, is wide, in particular the use of the words in any manner", and its effect would be that all offers require a prospectus. This may not be the case since it is accepted that not everybody requires the information contained in the prospectus to make an investment decision. This is one of the issues which, despite it not having created an adjudication problem to date, need judicial refinement to achieve the desired effect and to avoid future misinterpretations.

[38] Companies Act 71, 2008, as amended.
[39] Yeats (2010) Acta Juridica, 117.
[40] Gold Fields Ltd v Harmony Gold Mining Co Ltd 2005 (2) SA 506 (SCA).
[41] Delport (2005) 17 SA Merc LJ, 388-394.
[42] Corporations Act 50, 2001.

2.4 Other Jurisdictions

2.4.1 United Kingdom

It should be recorded that the protection of investors in the United Kingdom was modeled as far back as 1844, which model the US Securities Act[43] is based on.[44] A new prospectus regimen became effective in the United Kingdom during July 1995, applicable to all securities being publicly offered for the first time in the United Kingdom. The new regimen completes the process of introducing the European Community's securities legislation program.

Similar to South Africa, the regulation of securities in the United Kingdom applies to both listed and unlisted securities. Also, a prospectus is a prerequisite for issuing of securities in the public. A prospectus must contain prescribed information as set out in the London Listing Rules[45] in terms of section 84.[46] Non-compliance with such requirements may result in civil and criminal liability, which will be dealt with later.

The UK Companies Act[47] defines a public offer to include an offer made to a section of the public, however selected. This definition, like the South African Companies Act, is very wide as it provides that securities can be offered in any other manner.

2.4.2 Australia

The Australian securities market is regulated by two pieces of legislation, the Corporations Act[48] and the Australian Securities and Investment Commission Act[49] (this created the Securities and Investment Commission (ASIC) whose primary objective is to supervise the issue of securities). Section 111AF deals with securities to which a prospectus relates.[50] ASIC is the primary exchange in Australia though there are two other small secondary exchanges, the National Stock Exchange of Australia and the Asia Pacific Exchange. ASIC has issued market integrity rules which govern the conduct of applicants in the issue of securities.

Unlike the laws applicable in other jurisdiction mentioned in this research paper, Australia requires a registered prospectus for all offers of securities including the secondary market offers, irrespective of whether they are public offers or not. Also, one of the requirements in a prospectus is that it should contain a statement that talks to the capital adequacy of the offeror.

[43] Securities Act of 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.
[44] Gleeson and Bloomenthal (1999) 27 Denv. J. Int'l L & Pol'y 359 (1998-1999).
[45] London Listing Rules www.londonstockexchange.com (accessed on 28 October 2014).
[46] Section 84 of Financial Services and Markets Act, 2000.
[47] Section 756 of UK Companies Act, 1986.
[48] Corporations Act 50, 2001.
[49] Australian Securities and Investment Commission Act 51, 2001.
[50] These securities (except debentures or managed investment products) in a class of securities of a body are *ED securities* if (a) a disclosure document in relation to securities in that class has been lodged with ASIC under Chapter 6D; and (b) securities in that class have been issued pursuant to the disclosure document; and (c) after an issue of securities in that class pursuant to the disclosure document, 100 or more persons held securities in that class; and (d) securities in that class have been held by 100 or more persons at all times since the issue of securities referred to in paragraph (c).

Although the Australian laws prescribe the prospectus contents, they are not as specific as South Africa and other countries, like the United States. Reliance is more on the general reasonable investor disclosure test.[51] The information required includes assets, liabilities, financial position and performance, profits and losses, rights and liabilities, among others. Also, it must contain a statement which confirms that the entity has sufficient working capital to carry out its objectives relating to the offer.

2.4.3 United States

Generally, in the United States, six federal statutes govern securities issuance and trading.[52] The Securities Act,[53] in a registered transaction, covers false registration statements and civil liabilities relating to prospectuses and oral communications. Any violation of the disclosure obligations has severe consequences. Such liability is enforced by federal and state authorities, self-regulatory industry organisations i.e. FINRA, or through private law suits[54]. The paper focuses on liability for incorrect information in the prospectus.

In terms of section 2 of the Securities Act,[55] the term ''*prospectus'' means any prospectus, notice, circular, advertisement, letter, or communication, written or by, radio or television, which offers any security for sale or confirms the sale of any security*" while a registration statement which is a "*means the statement provided for in section 6, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference*". The definition herein is wide as it includes announcements by radio or television, among others. Although the South African definition of prospectus includes advertisement, it has not yet developed to the level of including announcements by radio or television in its definition of prospectus.

In the United States, companies with securities registered under the Securities Exchange Act, the secondary market, are subject to periodic reporting requirements, which for non-US companies such as the Company (or "foreign private issuers", as defined in the Securities Exchange Act) include Form 20-F and Form 6-K.[56]

[51] Wood (2007) *Regulation of International Finance*, 1st Ed, 182.
[52] Securities Act, 1933, as amended through P.L. 112-106, approved APRIL 5, 2012; Securities Exchange Act, 1934; Trust Indenture Act, 1939; Investment Advisers Act, 1940; Investment Companies Act, 1940 and the Sarbanes-Oxley Act, 2002.
[53] Sections 11 and 12 of Securities Act, 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.
[54] Scott *et al* (2012) *International Finance: Law and Regulation*, 3rd Ed, 104.
[55] Securities Act, 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.
[56] The ongoing reporting obligations of foreign private issuers are generally less onerous than the ongoing reporting obligations of US companies. The Company would lose its status as a foreign private issuer if more than 50% of its voting securities are held of record by US residents and either: (i) the majority of its executive

CHAPTER 3 Untrue Statements in a Prospectus and related liability

3.1. Introduction

The requirements laid down in the Companies Act in relation to the prospectus would be effectively meaningless if there were no consequences for non-compliance.[57]

The purpose of imposing personal liability for untrue statements is mainly to encourage compliance with the requirements of Chapter 4[58] and to protect investors from untrustworthy offerors. The Companies Act imposes personal liability to persons who compile and issue a prospectus. Section 104 specifically mentions the categories of persons who are liable[59] and the extent of their liability. It should be noted that the liability to compensate an investor that has suffered loss or damage as a result of the actions of the issuer is based on actual loss[60] sustained and cannot be based on one party wishing to draw blood from the other. A similar principle was applied in Thomson v Clanmorris.[61]

Liability can be attributed to:-

- any untrue statement where the person believes that statement to be true;
- any untrue statement purporting to be a statement by an expert or a statement contained in what purports to be a copy of the extract from his report or valuation;
- an untrue statement purporting to be made by an official person or a statement contained in what purports to be a copy of or extract from a public official document.

Untrue statements attract both civil (statutory and common law) and criminal law.

Section 104 refers to securities offered to the public both for subscription (which is believed to be offer made on behalf of the company[62] in the primary market) and for sale (which is believed to be offer for the sale of unlisted securities in the secondary market). Concerns on this paragraph, in particular, the reference to sale in the informal secondary market is that a prospectus is cannot be issued three months

officers or directors are US citizens or residents; (ii) more than 50% of its assets are located in the United States; or (iii) its businesses are principally administered in the United States.

[57] Cassim *et al* (2012) *Contemporary Company law*, 2nd Ed, 664.

[58] Companies Act 2008, as amended.

[59] Persons liable in terms of section 104 are , every -
(a) person who becomes a director between the issuing of the prospectus and the holding of the first general shareholders meeting at which directors are elected or appointed; (b) person who has consented to be named in the prospectus as a director, or as having agreed to become a director either immediately or after an interval of time; (c) promoter of the company; or (d) person who - (i) authorised the issue of the prospectus or, under this Act, is regarded as having authorised the issue of the prospectus; or (ii) made that offer to the public, is liable to compensate any person who acquired securities on the faith of the prospectus for any loss or damage the person may have sustained as a result of any untrue statement in the prospectus, or in any report or memorandum appearing on the face of, issued with, or incorporated by reference in, the prospectus.

[60] Delport *et al* (2011) *Henochsberg on the Companies Act 71 of 2008*, 1st Ed, 392.

[61]Thomson v Clanmorris [1900] 1 Ch 718 (CA) at 726).

[62] Section 95 (1) (i) of Companies Act 71, 2008, as amended.

after it was registered as its contents may have been overtaken by events. This may not be a concern if the securities are sold before 3 (three) months lapses. This is one of the clauses that require judicial refinement i.e. by adding registration statement in relation to sale in the secondary market, not through an exchange. Other jurisdictions like the United States already provide for statutory liability for both a prospectus and a registration statement.

It should be noted that liabilities for untrue statements in the prospectus go beyond the provisions of section 104. This because the section 77 (3) (d) (ii) liability for directors and prescribed officers apply over and above section 104. Also, liability is jointly and several or, as provided in the Act[63] but the right to contribution is not allowed if a person is guilty of fraudulent misrepresentation, see Pretorius v Natal South Sea Investment Trust.[64] Proof that the presenter knew that the presentation is false is important.

3.2. What are untrue statements?

Companies who wish to offer their securities to the public normally consider the effects of information contained or to be included in the prospectus before they make a decision as to how much or how little can be shared with prospective investors.

The amount of information and the materiality thereof determines whether such information can be said to be untrue or not. Untrue statements, as defined in the Act[65] are misleading statements, in form and context, in the prospectus or written statement. The definition of untrue statements includes an omission[66] which is calculated to mislead. This includes statements incorporated by reference.[67] Every material detail in the written statement or prospectus must be accurate and there should be no omission[68] of information that may affect the nature, extent and any benefits or disadvantages attached to the securities that are being bought. Before statutory requirements were introduced, the nature degree/extent of disclosure to be made in a prospectus was set out by Kindersley VC in New Brunswick & Canada Railway & Land Co v Muggeridge[69] when he said

> "*Those who issue prospectus, holding out to the public the great advantages which will accrue to persons who will take shares in a proposed undertaking, and inviting them to take shares on the faith of the representations therein contained, are bound to state everything with strict and scrupulous accuracy, and not only to abstain from stating as facts that which is not so, but to omit no one fact within their knowledge, the existence of which might in any*

[63] Section 104 (6) of Companies Act 71, 2008, as amended.
[64] Pretorius v Natal South Sea Investment Trust 1965 3 SA 410 (w) at 415.
[65] Section 95 (1) (p) of Companies Act 71, 2008, as amended.
[66] Section 95 (4) of Companies Act 71, 2008, as amended.
[67] Section 95 (3) of Companies Act 71, 2008, as amended.
[68] In TSC Industries v Northway 426 US 438, 444 (1976) it was decided that an omission becomes relevant if it is of such a character that it would have been considered important by a reasonable shareholder.
[69] New Brunswick & Canada Railway & Land Co v Muggeridge (1860) 1 Drew & Sm 363 (Ch) at 381–382.

> *degree affect the nature, or extent, or quality of the privileges and advantages which the prospectus holds up as inducement to take shares"*

The omitted information should not be prescribed in the Companies Act or the 2011 Regulations[70] for it to result in an untrue statement. It becomes untrue merely because it is a material omission of information that could have influenced the investment decision had it been included in the prospectus.

Both in terms of statutory and common law, an omission may amount to an untrue statement.[71]

3.3 Liability for untrue statements: Statutory & Common Law

In order to make the discussion below easy to comprehend, it is necessary to explain and/or distinguish between statutory and common law. Statutory law is adopted through a legislative or enactment of legislation or issue of regulations while common law is law created from cases or precedents. In the event that a court is presented with a case, whose facts are different from any case that has been dealt with before and where there is no clear legislative provision dealing with such facts, judges have a duty to make a ruling on the matter, thereby creating a precedent.

3.3.1 Common law

At common law, civil liability is based on the law of delict and misrepresentation. This means for a claim to succeed, all the elements of delict (including fault, wrongfulness, negligence etc) must be proved. In Trustees For The Time Being of Two Oceans Aquarium Trust v Kantey & Templer (Pty) Ltd[72] a claim for economic loss was unsuccessful as the appellant could not establish that what was alleged to be wrongful amounted to negligent conduct.

Liability is based on pure economic loss[73] and not fixed as per statutory law. Also, a plaintiff can succeed in a damages claim if he can prove that such damages were suffered as a result of the delict committed. The causation (link) between the alleged negligent conduct and the damage suffered must be established. In Minister of Justice and Constitutional Development v X[74] the appeal was dismissed and the decision of the trial court was confirmed because the negligent conduct of the appellant was wrongful and there was a link between the negligent conduct and the damages suffered. Causation was also taken into account in Long and Another v Jacobs[75] were the damages suffered were linked to the negligent conduct of the appellant. In this case, even though the compensation included past and future

[70] Companies Act Regulations of 2011;

[71] Hahlo's *Company Law Through Cases, ibid*, 91.

[72] Trustees For The Time Being of Two Oceans Aquarium Trust v Kantey & Templer (Pty) Ltd (545/2004) [2005] ZASCA 109; [2007] 1 All SA 240 (SCA) (25 November 2005).

[73] Van Der Linde (2008) 20 SA Merc LJ, 440.

[74] Minister of Justice and Constitutional Development v X (196/13) [2014] ZASCA 129 (23 September 2014).

[75] Long and Another v Jacobs (145/11) [2012] ZASCA 58 (2 April 2012).

income and damages, it not clear to the author of this research paper whether everything had been taken into account i.e. an estimate as to how the injuries sustained could affect the respondent's life span. The case is silent of that point.

In Cape Empowerment Trust v Fisher Hoffman Sithole[76] the appellant failed to establish the link between the alleged damage and the negligent misstatement by the respondent's representative. The damage, if any, was too remote to the alleged negligent statement. The appeal was dismissed.

Liability can also be based on fraud. A shareholder/investor induced by fraud of an agent/promoter of the company to acquire securities in it may rescind the contract. However, there are divergent views on the extent of the legal recourse that the aggrieved investor may exercise. The decision in Houldsworth v City of Glasgow Bank[77] that the investor/claimant cannot simultaneously abide by the contract and sue for damages has been criticised vehemently, with reasons, by Professor Gower. In the ninth edition of Gower & Davies on '*The Principles of Modern Company Law*", Professor Gower reaffirms his dislike of this decision, which he regards as anomalous. The said decision, which has the effect that a shareholder who has been induced to subscribe for shares on the faith of a fraudulent statement in a company prospectus cannot sue the company for damages unless he also rescinds the contract of, allotment, is, as Professor Gower says, " entirely contrary to the, normal rules of the law of contract, for one can recover damages for fraud without also rescinding the contract". The two reasons advanced by Professor Gower for his views are:-

- section 2.2[78] gives the court a discretion in appropriate cases to substitute damages for rescission, a provision included largely for the benefit of the misrepresentors;
- The right to rescind expires more quicker than the right to claim damages (the right to rescind can be barred).

The author of this research paper understands where Professor Gower comes from. It is so for the reasons already advanced and also because if a person is misled into buying securities in a company but cannot claim damages suffered as a result of such acquisition without rescinding the contract of acquisition, then that person's rights are not properly protected.

The common law liability for misleading statements in the prospectus is not excluded. In the event of an omission of material information, the onus/burden of proof in terms of common law lies with the plaintiff who will have to prove that the information omitted would have influenced the decision to invest or not and that it was calculated to mislead.[79]

Delictual liability claims for damages can be made against directors and experts of a company. Directors can also be held liable for negligence with regard to the preparation of the prospectus. This common law liability is over and above statutory liability mentioned below. As a director of a company, one must always exercise due

[76] Cape Empowerment Trust v Fisher Hoffman Sithole (200/11) [2013] ZASCA 16 (20 March 2013).
[77] Houldsworth v City of Glasgow Bank (1880) 5 App Cas 317 (HL).
[78] Misrepresentation Act of 1967.
[79] Broome v Speak (1903) 1 CH 586.

diligence and care in performing their duties. In Bayer South Africa (Pty) Ltd v Frost,[80] the court held that, untrue statements in the prospectus give rise to a delictual claim for damages if the untrue statements were made fraudulently or negligently.

Fraudulent misrepresentation could result in the winding up of a company as in Pinfold and other v Edge to Edge Global Investments.[81]

3.3.2 Statutory law

Statutory civil liability is particularly important where liability under the common law tort of negligence is avoided by the strict requirements of proximity, foreseability, causation and reliance in South Africa, and most probably in the other three jurisdictions mentioned herein. Generally, liability arises from reliance on untrue statements and misleading omissions.[82] It should be noted that for liability to exist, there must be a link between the untrue statement and the damage suffered. This means the plaintiff/claimant (who is the investor) will carry the burden to prove that he relied on the untrue statement or misleading omission. The principle in Macleay v Tait[83] is very clear in this respect.

Statutory law was created so as to allow an aggrieved investor to recover damages resulting from untrue statements from a director or any person responsible for the content of the prospectus. All that the aggrieved investor has to prove is reliance on the untrue statement in the prospectus.[84] In terms of statutory law, if a statement made in the prospectus is, in fact, untrue, the onus/burden of proof rests with the defendant to defend himself [85] by proving that the statement was not made fraudulently.

In terms of the Companies Act, compensation is for actual loss suffered and such liability is in addition to any other law or common law or in terms of other provisions of section 218.[86]

Section 105[87] deals with liability of experts and other people whose names, material and statements have been included in the prospectus. The liabilities mentioned in this paragraph do not exclude other director's liabilities in terms of section 77(3)(d)(ii).[88] There are also criminal liabilities attached to untrue statements in a

[80] Bayer South Africa (Pty) Ltd v Frost 1991 (4) SA 559 (A) at 560.
[81] Pinfold and other v Edge to Edge Global Investments 2014 (1) SA 206 (KZD).
[82] Cilliers and Benade, *ibid* , 274.
[83] Macleay v Tait [1906] AC 24 (HL).
[84] Cilliers and Benade, *ibid*, 275.
[85] S v National Board of Executors Ltd 1971 (3) SA 817.
[86] Companies Act 71, 2008, as amended.
[87] *Ibid*.
[88] *Ibid*.

prospectus.[89] Section 106 relates to responsibility i.e. an expert consenting to their statement being published in the prospectus, that expert shall be solely responsible for such statement.

3.4 Who is liable?

In South Africa, liability for untrue statements arises where the purchaser/investor can prove reliance on such untrue statements or misleading omissions. The situation is different in the United States[90] in that the purchaser/investor does not have to prove reliance on the untrue statement or misleading omission for liability to exist. In the event of an investor suffering loss as a result of untrue statements in the prospectus, then the directors or any person who became a director filling a casual vacancy after the prospectus was issued will render himself or herself liable.[91] However, there are defences available to such a person i.e. if the person can prove the absence of misconduct and negligence.

The investor can claim actual damages and/or loss suffered, including legal costs incurred.

3.5 Defences and exclusion of liability

The Companies Act provides for exclusions of liability[92] for untrue statements under the following circumstances:-

- with regard to every untrue statement, no liability if the person can prove that he had reasonable grounds to believe and did actually believe that the statement was true, up to the time of allotment and acceptance of the offer;
- with regard to untrue statements purporting to be a statement by an expert or the statement contained in what purports to be a copy of the extract from his report or valuation, no liability if the person can prove the following:
    - the prospectus fairly represented the expert's statement or that it was a correct and fair copy of an extract from the expert's report or valuation;
    - that he had reasonable grounds to believe and did up to the time of issue of the prospectus believe that the expert was competent to make the statement;
    - the expert has given his consent to the issue of the prospectus;

[89] Cassim *et al, ibid,* 668.
[90] Sections 11 and 12 of the Securities Act of 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.
[91] Van Der Linde (2008) 440 at 446.
[92] Section 104 (3) of Companies Act 71, 2008, as amended.

  - ○ that the consent had not been withdrawn before the filing of the prospectus for registration or that he did not know, before allotment or acceptance, that the consent had been withdrawn (if it had).

- with regard to untrue statements purporting to be made by an official person or a statement contained in what purports to be a copy of or extract from a public official document, no liability if it can be proved that it was a correct and fir representation of the official person's statement or a copy of or extract from the public document;

- where a person has consented to be a director and subsequently withdrew the consented the prospectus was issued without his/her consent;

- where a prospectus was issued without the knowledge and consent of the person and on becoming aware of the issue, forthwith gave reasonable public notice that it was issued without his knowledge and consent.

3.6 What relief can be sought?

Chapter 7 provides for remedies and enforcement generally. The Companies Act has to a large extent decriminalized corporate law and applies administrative enforcement in the place of criminal sanctions. The administrative enforcement is meant to ensure compliance instead of punishing the offenders. The Companies and Intellectual Property Commission[93] has the power to receive, investigate and resolve compliance issues. A compliance order may be issued against a company or against an individual if the individual was implicated in the contravention of the Companies Act. A compliance order may be challenged before a Companies Tribunal[94] or court. If the non-compliance continues, CIPC may apply to court for an administrative fine or refer the matter to the National Prosecution Authority as an offence. CIPC may also apply to have the company dissolved.

Statutory Penalties for untrue statements are deal with in sections 214(1)(d) read with section 216. Section 216 (a) provides that a person convicted of an offence in terms the Companies Act for contravening section 214(1) is liable to a fine or to imprisonment for a period not exceeding 10 years or both. Section 216(b) provides that for any other liability, the person will be liable to a fine or imprisonment not exceeding 12 months or both.

Common law penalties are based on actual damages suffered.

[93] Established in terms of section 185 of the Companies Act of 2008.
[94] Established in terms of section 193 of the Companies Act of 2008.

3.7 Other Jurisdictions

3.7.1 United Kingdom

3.7.1.1 General

The provisions governing the liability for untrue statements in the prospectus (sometimes referred to as defective prospectus) in the United Kingdom developed through case law. Historically, knowledge by the issuer that the information contained in the prospectus is untrue or not played a major role in determining liability. In Derry v Peek[95] the defendant's prospectus contained untrue information relating to a right. The Plaintiff lost the case only because he was unable to prove that the defendant made the misrepresentation knowingly and recklessly. It should be noted that the case happened prior to the new developments in law. Reactions to the decision in the above case resulted in the passing of the Director's Liability Act[96] which bases liability on negligence.[97] It would appear the case above exposed the inadequacy of common law as a remedy for investors who suffer loss as a result of misleading statements in prospectuses. Currently, there may be absolute liability on the issuer, regardless of knowledge.

Civil liability is the United Kingdom is based on the provisions of 90 (1)[98] which provides as follows:

> "*Any person responsible for listing particulars is liable to pay compensation to a person who has— (a) acquired securities to which the particulars apply; and (b) suffered loss in respect of them as a result of— (i) any untrue or misleading statement in the particulars; or (ii) the omission from the particulars of any matter required to be included by section 80 [general duty to disclose in listing particulars] or 81 [supplementary listing particulars]*".

Section 79 (3) provides that the persons who are responsible for the listing particulars (the prospectus contents/requirements in this research paper) will be determine by the Treasury through regulations.[99]

3.7.1.2 Who is liable?

It should be noted that liability relating to misrepresentation or untrue statements in the prospectus extends to persons other than the issuer, i.e. directors, managing underwriters, co-managers, auditors, lawyers and other experts. Section 90 [100] provides for compensation to any person who may have acquired securities but suffered loss as a result of the untrue or misleading statements in a prospectus.

In the past, it was almost impossible to hold accountants and lawyers liable for negligent misstatements in disclosure documents until 1964[101] when the House of

[95] Derry v Peek (1989) 14 APP CAS 337.
[96] Director's Liability Act, 1890.
[97] Gower and Davies, *ibid* , 930.
[98] Financial Services and markets Act, 2000.
[99] Prospectus Regulation 2005 and Prospectus Regulation 2011.
[100] Section 90 of Financial Services and markets Act , 2000.
[101] Fleming (1990) 106 Law Quarterly Review 349.

Lords in Hedley Byrne & Co v Heller & Partners[102] pronounced that investors who relied on the negligent misstatement and ended up incurring loss in their investment are entitled to sue accountants regardless of the existence of privity of contract.[103] The House of Lords held that all persons who provide a statement owed a duty to any third person with whom a special relationship existed. The House of Lords approved an earlier dissenting opinion of Lord Denning given in 1951 in Candler v Crane Christmas & Co[104] that accountants owe a duty "to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts." Although the phrase "special relationship" had not been defined, the House of Lords held that special relationship existed owing to the fact that the defendant voluntarily assumed the responsibility of making accurate disclosures to the public. It would appear the ruling was applied broadly in the United Kingdom and gradually the scope and meaning of the phrase "special relationship" changed from the concept of "voluntary assumption of responsibility" by gatekeepers (a term used to refer to auditors, lawyers and underwriters) to "reasonable reliance" of a third party, and then to "foreseeability" which was first introduced in 1978 in Anns v Merton LBC.[105] The crucial factors, namely "causation" and "reliance", were often found to be extremely difficult to prove against the defendants. Hence, it has been argued that the judicial decisions in effect narrowed down the scope of gatekeeper liability for negligent misstatements. Under common law, an auditor could be held liable for misstatements only if it could be proved that he knew that the audited work would be communicated to non-client third parties and that those non-clients would rely on the work in relation to a financial transaction. The above, according to the author of this research paper, could create problems since what happens to the audited work after it is delivered to a client is not known or decided by such auditor.

Though there are still some ambiguities and/or vagueness regarding the liability of lawyers and auditors, some regulations/legislative provisions attempted to clarify the position. Their liabilities for defective prospectuses are now governed under the Financial Services and Markets Act[106]as amended by the Prospectus Regulations.[107] Rule 5.5.3(2) of the prospectus rules lists the persons liable for a defective prospectus in consistence with section 84(3).[108] According to this rule, in addition to the issuer and its present and proposed directors, "each *person* who accepts, and is stated in the *prospectus* as accepting, responsibility for the *prospectus* ", and if not listed otherwise in this rule, each person who has authorised the contents of the prospectus is liable for defective disclosures. However, Rule.5.5.8 provides that:

> "*A person who accepts responsibility for a prospectus … or authorises the contents of a prospectus … may state that they do so only in relation to specified parts of the prospectus, or only in specified respects, and in that case the person is responsible under those paragraphs only to the extent specified and only if the material in question is included in (or substantially in) the form and context to which the person has agreed".*

[102] Hedley Byrne & Co v Heller & Partners [1964] A.C. 465 HL.
[103] Napier (1998) Accounting Organisations and Society 105, 111.
[104] Candler v Crane Christmas & Co [1951] 1 All E.R. 426 CA.
[105] Anns v Merton LBC [1978] A.C. 728 HL.
[106] Financial Services and Markets Act, 2000.
[107] Prospectus Regulation *ibid*.
[108] Section 84(3) of Financial Services and Markets Act.

The above rule may limit the liability of auditors and lawyers, but it does not absolve them from civil liability.

A contradiction or confusion happens where Rule 5.5.9 of the Prospectus Rules provides for an exemption of lawyers and auditors by providing that "*nothing in the rules in this section is to be construed as making a person responsible for any prospectus by reason only of the person giving advice about its contents in a professional capacity*."

Rules 5.5.8 and 5.5.9 need to be clarified as there seems to be some ambiguities and/or contradictions. Judicial refinement may be necessary to ensure a smooth application and enforcement of the rules.

3.7.1.3 Defences

A defendant can escapes liability in terms of section 90 (1)[109] if he can satisfy the court that he reasonably believed that there were no misstatements or omissions and that he had done all that he could reasonably be expected to ensure that there were not any, and that, if any came to his knowledge, they were corrected in time or the claimant acquired the securities with knowledge of the falsity of the statement or of the matter omitted.[110] This is also referred to in paragraph 2 of schedule 10 of the Financial Services and Markets Act of 2000.

3.7.1.4 What relief can be sought?

Non-compliance with such requirements may result in civil (statutory and common law) and criminal liability.

Section 91 provides for money as a form of compensation for anyone who has suffered loss due to untrue statements in a prospectus. The value of such compensation will be at the discretion of the presiding authority, taking into account what is appropriate.

In terms of common law, there can be a claim for damages or a claim for rescission of the contract. The only problem here is that sometimes rescission only may not suffice to make up for the loss or damage suffered, as mentioned earlier in this research paper.

Though criminal law plays a very limited role in the securities market, there could be criminal sanctions where the penalty can be a fine or imprisonment not exceeding two years or both.

[109] Financial Services and Markets Act of 2000.
[110] Gower and Davies, *ibid* , 933.

3.7.2 Australia

3.7.2.1 General

Generally, there is a scarcity of cases concerning liability based on untrue statements in the prospectus in Australia, including liability for professionals participating in the prospectus. The first major attempt to ascertain the scope of misstatement liability in Australia was made in 1970 in Mutual Life & Citizens Insurance Co Ltd v Evatt[111]. In this case, the High Court of Australia set out the first legal test for the liability of professionals for misstatements (misstatements generally not necessarily in the prospectus). The High Court established three conditions for the existence of the duty to care of professionals owed to third parties. The conditions are: (1) the professional realises or ought to realise that the third party/investor will rely on his (professional) skill and judgment; (2) the third party intends to act upon the information embodied in the statement; and (3) the reliance of the third party is reasonable[112]. The third party in this leading case received information through a direct request as opposed to public disclosure. Hence it does not represent typical third-party claims based on misrepresentation as mentioned in Esanda Financial Corp Ltd v Peat Marwick Hungerford[113], which is regarded as the most influential decision on liability for professionals. The High Court of Australia in Esanda Financial matter significantly narrowed down the liability of auditors in that there was reliance upon an audited account to a company which went into liquidation. Then the creditors claimed that the auditors owed a duty of care to all creditors of the liquidated company, because they (the auditors) did foresee or ought to have reasonably foreseen that creditors would rely on the accounts audited by them. The court unanimously held that in order to impose liability on auditors, two requirements are to be satisfied. They are the foreseeability of harm and the relationship of proximity. These are difficult to prove, because of which the decision in effect limits the scope of liability for professionals. Moreover, it concerned the creditors, rather than shareholders whose claim might be even weaker as a residual claimant in the event of liquidation. The case was lodged under section 1006 of the repealed Corporations Act[114] which was similar to section 729 of the current Corporations Act[115].

Section 728 of the Corporations Act provides that:

> "*A person must not offer securities under a disclosure document if there is:*
>
> *(a) a misleading or deceptive statement in: (i) the disclosure document; or (ii) any application form that accompanies the disclosure document; or (iii) any document that contains the offer if the offer is not in the disclosure document or the application form; or (b) an omission from the disclosure document of material required by section 710, 711, 712, 713, 714 or 715; …"*

[111] Mutual Life & Citizens Insurance Co Ltd v Evatt 1970 122 CLR 556.
[112] *Ibid*.
[113] Esanda Financial Corp Ltd v Peat Marwick Hungerford 1997 188 CLR 241 at 255.
[114] Corporation Act 109, 1989, repealed.
[115] Corporations Act 50, 2001.

Notwithstanding the provisions above, section 729(1) sets out the liability for disclosure document by reference to the victim's right to recover for loss or damage resulting from such contravention. This could create confusion section 728 in that 728 specifically mentions the persons liable and liability emanating from their contravention or involvement in the contravention of the said section while section 729 provides that there will be liability whether the person commits or was involved in the contravention or not. This is a matter that requires judicial refinement to avoid problems in the future.

3.7.2.2 Who is liable?

In Australia, the persons potentially liable for the content of a prospectus include the person making the offer, each of the company's directors and proposed directors, the underwriters, a person who is named in the prospectus with their consent as having made a statement that is included in the disclosure document or having made a statement that a disclosure document is based on or any person who is involved or participates in the contravention of section 728 (12). Liability only becomes relevant if the prospectus contains a misleading or deceptive statement or the prospectus omits a material that is required under the Corporations Act.[116] A person who suffers loss or damage as a result of a contravention of Corporations Act[117] can recover the amount of the loss or damage from the persons mentioned above.

3.7.2.3 Defences

A person eligible to be held liable for as mentioned in paragraph 3.7.2.2 above can be exempted from liability if he can show that despite reasonable diligence he could reasonably believe and did believe that the statement was accurate and that there were no omissions rendering the statement misleading.

3.7.2.4 What relief can be sought?

A person who suffers loss or damage may rely on the provisions of section 729 (1) which provides that he may recover the amount of the loss or damage. The hope is that the aggrieved person will be placed in the same position that he would have been in had he not been misled into buying securities relying on untrue statements.

There is no clearly specified office for criminal liability for untrue statements but the provisions of section 1311 of the Corporations Act as well as chapter 2 of the Criminal Code Act 1995 deal with criminal liability, in general.

[116] Corporations Act 50, 2001.
[117] Section 728(1).

3.7.3. United States

3.7.3.1 General

Civil liabilities for untrue statements in a prospectus are dealt with in sections 11, 12 and 15 of the Securities Act.[118] Section 11 deals with registered public offerings, whereas section 12(1) is concerned with offerors or sellers of securities, who make the offer in breach of the registration and prospectus requirements. Section 12(2) imposes liability on those who offer or sell securities using a material misstatement regardless of whether or not the offer is registered or exempted. The word seller includes underwriters. Although section 12 deals with selling or offering of securities or with misstatement in prospectuses for initial public offerings (IPOs) as held by the US Supreme Court in 1995 in Gustafson v Alloyd,[119] it is concerned with the liability of sellers only.

The United States have liability based on omission[120] of material information from the disclosure documents. The standard to determine how material the omission is was set in TSC Industries v Northway, Inc*.[121].* An omission would be material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly influence in the investment decision. In terms of the Securities Act[122], any person who offers or sells securities in the United States by the means of a "prospectus or oral communication" that includes a material misstatement or omission will be liable to the purchaser of the securities unless, at the time of the purchase, the purchaser knew of such misstatement or omission.

3.7.3.2 Who is liable?

Section 11(b)–(e)[123] imposes liability on: (b) all directors; (c) all prospective directors who consented to be director; (d) every accountant and expert who has consented to being named as either to have prepared or certified a part of the registration statement; and (e) every underwriter for their respective portions based on their underwriting agreement. The above includes any person who signs a prospectus in which there is a material misrepresentation or omission. Section 11 does not require a showing of fraudulent intent or even negligence on the part of the defendant or reliance on the part of the plaintiff. Consequently, the issuer is essentially liable for "material" misstatements or omissions in the registration statement, unless it can prove that the plaintiff knew of the misstatement or omission and nonetheless purchased the securities. Although liability is generally joint and several, there are

[118] Securities Act of 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.
[119] Gustafson v Alloyd 513 U.S. 561 (1995).
[120] Section 95 (4).
[121] TSC Industries v Northway Inc 426 U.S. 438, 444 (1976).
[122] Section 12 (a) (2).
[123] Securities Act of 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.

exceptions, first, if a person has been named as having prepared or certified a certain part of the statement, that person is liable for misstatements, if there are any, only in that specific part, secondly, each underwriter is responsible for the specific part of the whole offer that they have underwritten. So underwriters can be obviously caught, but the liability of lawyers and auditors remain vague to some extent unless they are found to have prepared and certified certain parts of the prospectus.

Section 12 imposes civil liability on sellers for selling or offering by means of misstatements in a prospectus or oral communication.

Section 15 imposes civil liability on those who control the persons liable under sections 11 and 12. It appears this section was enacted specifically to curb the possibility of corporations using other that they control, as directors who, on instruction from the persons controlling them, would sign registration statements so that the control person could avoid liability.

Professionals who participate in the preparation of an offer are also liable for untrue statements in the prospectus. Section 11 (4) specifically deals with liability for "accountant" and makes "every accountant" and any person any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement …". This is wide enough to also include lawyers involved in the preparation of a prospectus. The United States legislation is covers liability for auditors better than the other jurisdictions mentioned in this research paper. The court in Admiralty Fund v Hugh Johnson & Co[124] suggested with regard to accountants' liability that they cannot avoid liability even if they follow generally accepted accounting standards, but knowingly or recklessly fail to disclose the truth.

Besides being liable in terms of section 11, underwriters are also liable as sellers in terms of section 12.

3.7.3.3 Defences

Section 12 also provides a due diligence defence for any person (including the issuer) who can sustain the burden of proving that the person did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. Despite a due diligence, a person can be exempted from liability if he can show that he reasonably believe and did believe that the statement was accurate and that there were no omissions rendering the statement misleading. The Securities Act makes provision for the standards of reasonability[125].

Section 12(a)(2) requires the "material misstatement or omission" in the prospectus or oral communication to be proved. Although reliance on the defective

[124] Admiralty Fund v Hugh Johnson & Co 677 F. 2d 1301, 1313 (9th Cir 1982).
[125] Section 11 (b) and (c).

communication does not necessarily have to be shown under s.12(a)(2),[126] some causal relationship between the disclosure and the investment decision is required.[127] However, the Congress amended this section in 1995 by adding s.12(b), which allows the defendant to prove in defence that the loss suffered by the plaintiff was caused in part or full by factors unconnected with the misstatement.

3.7.3.4 What relief can be sought?

Issuers of securities in the United States may have potential liability under a common law theory of deceit. It is likely that the plaintiff in a securities action would make such claims, which arise out of the laws of each of the several states, in addition to their United States federal securities law claims. It is worth noting that in connection with such state common law claims, a plaintiff would not be precluded from seeking punitive damages in addition to actual compensatory and consequential damages.

In general, a purchaser entitled to recover under Section 12(a)(2) may recover the consideration paid for such securities, with interest, from the seller, less the amount of any income received thereon, upon the tender of such security (i.e., effectively a “put right”), or damages if such purchaser no longer owns the security.

There may also be enforcement proceedings the outcome of which is often the issuance of a “cease and desist order” enjoining the defendant from further violations of the applicable law or regulation (and further violation of which would constitute criminal contempt). For more egregious violations the SEC might also impose fines. In the event of a “wilful” violation, the case may be turned over to the Department Of Justice for criminal prosecution, where penalties may include, in addition to criminal fines, imprisonment. If a person is found quilty of an offence relating to untrue and misleading statements, shall upon conviction be fines not more than $10 000 or imprisonment not exceeding 5 (five) years or both.

3.8 Issues relating to securities regulations

3.8.1 Section 104 (1) issue

As mentioned earlier, a prospectus is a prerequisite for making primary offers by companies. It should be noted that primary offers are offers of securities which have not been issued by the company. Section 104 (1) refers to subscription and sale. The issue in relation to sale of securities is that the sale is not always based on a prospectus as the securities would be sold in the secondary market. A company cannot sell its own shares but can only offer

[126] Johns Hopkins v Hutton 422 F. 2d 1124 (4th Cir. 1970).
[127] Jackson v Oppenheim 533 F. 2d 826 (2d Cir. 1976).

them for subscription. Another issue relating to the above section is provisions of section 104 (1) (d) (ii) which provides that any person who made an offer to the public shall be liable to any person who acquired securities on the faith of the prospectus for any loss or damage sustained as a result of untrue statements in the prospectus. This, strictly interpreted, could mean the company shall be liable for such loss and damage as it will be the one issuing /offering securities in the primary market. Similarly, section 12 (a) (2)[128] provides that any person who offers or sells securities by means of a prospectus will be liable to the purchaser unless the purchaser knew of the misstatement or omission. This means the position with regard to subscription and sale in the United States is similar to the situation in South Africa.

3.8.2 Other issues

The concerns/questions emanating from the exemptions above are as follows:

- If there is no liability based on the exemptions above, what happens to the investor who has suffered damages or loss due to his reliance on the untrue statement?
- Shouldn't there be a verification requirement, in South Africa, prior to filing the prospectus to avoid situations where the issuer is not aware of the withdrawal of the consent? It can be in the form of a due diligence questionnaire immediately prior to confirming of filing the prospectus. It should be recorded that the due diligence defence exists in other jurisdictions i.e. the United States and Australia. A due diligence defence is available to directors, prospective directors, other signatories, experts and underwriters, but *not* to the issuer. The defence is available if after "reasonable investigation", the defendant had reasonable ground to believe and belief in fact that the statements made in a registration statement at the time it became effective were true and there were no material omissions of fact required to make the statements not misleading.[129] The standard of "reasonable investigation" is that required of a "prudent man in the management of his own property". The remedy available to the purchaser under Section 11 is damages as measured by the decline in the value of plaintiff's securities, but defendants can reduce damages by showing that other factors contributed to the loss in value of plaintiff's securities

- Regarding the issue of giving "reasonable" public notice that he was not aware or had no knowledge that the prospectus was going to be issued,

[128] Securities Act of 1933, as amended through P.L. 112-106, approved APRIL 5, 2012.
[129] The application of the defence also depends on whether the defendant is deemed to be an expert and whether the material misstatement or omission was made in an "expertised" or "non-expertised" portion of the registration statement.

potential problems may arise i.e. what is reasonable public notice? Will it still be reasonable if made after the investors have accepted the offer *and* suffered damage or loss? Won't directors abuse this by agreeing to the prospectus being issued and upon acceptance, give a public notice that they were not aware?

The above clarity seeking questions need to be addressed through the judicial refinement process. Also, the Companies Act is silent on "ambiguous statements" in the prospectus. Various provisions mentioned in this research paper, from local and foreign legislation proved to be ambiguous or confusing. These should be clarified to avoid different interpretations, which in some cases, may require the application of the *contra proferentem* rule.[130]

With regard to the three foreign jurisdictions mentioned herein, there have been some inconsistencies and ambiguous with regard to some provisions relating to liability, more especially liability for professionals involved in preparing and registering a prospectus i.e. some provisions absolve professionals from liability if they are providing mere professional services and there will be general liability in the same legislation which covers all participants. There is a lot of uncertainties which can be clarified by amendments to the existing legislation or passing of new legislation, especially because some of the applicable legislations have been there for a very long time.

[130] The rule of construction that a contract shall be interpreted against the party responsible for the drafting or preparation of the contract. The rule may apply to documents relating to offers to the public.

CHAPTER 4: CONCLUSION AND RECOMMENDATION

The foregoing discussions demonstrate that gatekeepers (lawyers, auditors and underwriters) have a vital role to play in assisting their clients (companies) both in the contravention of, as well as compliance with, the requirements of corporate disclosure in the primary market. How they will deal with their clients and the potential users of their works largely depends on their honesty, sincerity, diligence and professionalism. Their clients may hire them partly for compliance with or partly for contravention of the disclosure requirements, or for both. Their services in practice across the globe show that they are helpful for their clients in doing both i.e some of the corporate failures in South Africa resulted in one of the professionals committing suicide to avoid prosecution.

Civil liability provisions in all the jurisdictions mentioned in this paper have two major objectives: first, compensating investors for economic injuries and secondly, compelling companies to comply with the law to avoid losses that may arise from contravention of the prospectus requirements. In addition, one of the primary purposes of civil liability is creating deterrence, which can be both specific and general. However, the direct liability of issuers does not create adequate deterrence for repeat or individual potential wrongdoers. Instead, the liability of gatekeepers is thought to be an effective means of deterring wrongdoing by companies, as can be inferred from some corporate scandals in the past.

Since most of the public offers are cross-border transactions, what is needed, as already mentioned in the research paper, is an appropriate international legal regime providing protection to investors globally. This is essential for the development of securities markets. It can be achieved by harmonise all legislation relating to financial systems and their regulation to avoid international legal collision between/among different jurisdictions caused by technicalities different methods of applying the legislation. This will also ensure that penalties for wrongdoers are aligned and the severity of such penalties is the same. It may not be an easy task but it is achievable like all other organizations that have been formed i.e. Collaborative African Budget Reform Initiative, G20 and various intellectual property treaties and organisations that have been concluded among different countries.

Whatever happens with regard to securities, be it harmonization or passing of new legislations, it must not hamper economic activity. Basically, the participants and the legislature must guard against:

- over regulation, which may affect the frequency and structure of transaction and have a negative effect on the economic activity in the securities market;

- over-reliance on regulation which could make investors assume that the Government will rescue them in which case they become careless in making investment decisions.

The suggestion above will assist in creating and maintaining investor confidence in securities markets and the integrity of the marketplace in which the investing public put their savings for profits. This integrity is assessed by reference to the environment of fair-play that can be created and promoted by appropriate legal and regulatory regime and their effective enforcement by competent authorities.

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