An International Comparison of Regulatory Regimes and Trading Structures: Seven Stock Markets, (Parts II and III)

Lori Semaan

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AN INTERNATIONAL COMPARISON OF
REGULATORY REGIMES
&
TRADING STRUCTURES:
SEVEN STOCK MARKETS
IMPLICATIONS FOR MARKET
EFFICIENCY & INTEGRITY

PART II: RELATIONSHIP BETWEEN
REGULATORY BODIES & LISTED COMPANIES

By Lori Semaan

UTS, School of Finance & Economics, Working Paper

Email: lori.semaan@uts.edu.au

Fax: 612 9281-0364

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Part II: Regulatory bodies & listed companies

RELATIONSHIP BETWEEN REGULATORY BODIES AND LISTED COMPANIES

The most relevant and interesting regulations regarding this relationship in the context of market efficiency and fairness concern the following:

- mandatory periodic and continuous disclosure;
- the institution of trade halts to disseminate information to the market;
- use of trade suspensions and delistings to discipline listed companies; and
- inspection and investigation of companies.

* Statement of research objective and acknowledgment of sponsorship is attached to Part I of the working papers.

1 COMPARATIVE PERIODIC REPORTING REQUIREMENTS

Table 1

<table>
<thead>
<tr>
<th>Regime</th>
<th>Audited Annual Financial Statements</th>
<th>Half-yearly reports</th>
<th>Quarterly Reports &amp; Other</th>
<th>Civil remedy if false or misleading</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASX</td>
<td>3 months -audit review</td>
<td>2.5 months</td>
<td>mining companies</td>
<td>Yes + continuous disclosure</td>
</tr>
<tr>
<td>JSX</td>
<td>4 months</td>
<td>4 (3) months</td>
<td>-60 days/ unaudited</td>
<td>Yes + continuous disclosure</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>3 months n/a</td>
<td>45 days</td>
<td>45 days</td>
<td>Yes</td>
</tr>
<tr>
<td>LSE</td>
<td>6 months</td>
<td>4 months</td>
<td>n/a</td>
<td>No</td>
</tr>
<tr>
<td>SEHK</td>
<td>5 months</td>
<td>3 months</td>
<td>n/a</td>
<td>No</td>
</tr>
<tr>
<td>TSE</td>
<td>3 months</td>
<td>3 months</td>
<td>n/a</td>
<td>Yes</td>
</tr>
<tr>
<td>BSE</td>
<td>Since 1995</td>
<td>3(2) months</td>
<td>n/a</td>
<td>No</td>
</tr>
</tbody>
</table>

1.1 What are the periodic reporting requirements?

All markets mandate audited annual reports and half-yearly reports (not necessarily audited), except NASDAQ which administers quarterly reports in lieu of half-yearly reports. Notice also that the JSX regime has the most onerous requirements; it administers quarterly and monthly reporting, in addition to the usual reports.

The lodgement period for reports also varies significantly. For annual reports, between 3 to 6 months after year-end, and for half-yearly reports, between 2.5 months to 4 months. However, there seems to be no relationship between the lodgement period and the auditing requirement, eg the ASX regime has the shortest lodgement period for half-yearly reports of 2.5 months and also requires an audit review.
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On the other hand, the LSE regime has the longest lodgement period of 4 months but does not require any auditing of the report.

Such variation in reporting requirements raises concerns regarding what is an ideal set of requirements for promoting market informational efficiency. It would seem that quarterly reporting is more timely and efficient than half-yearly reporting. However, the economic issue of costs versus benefits perhaps explains why the majority of regimes only institute half-yearly reporting. JSX’s situation, however, is unique: as a developing market, greater corporate disclosure is essential as the costs associated with a company failure are much greater in a developing market compared to a more mature market. For the purposes of market efficiency, a shorter time-frame for lodgement coupled with auditing requirements would be ideal. Notice that the ASX regime seems to satisfy such requirements most ideally in terms of its annual reporting and half-yearly reporting requirements.

1.2 Statutory civil and criminal liability

Criminal liability for non-compliance is recognised in all regimes examined. Civil liability for false or misleading statements, on the other hand, is available in only 4 regimes: ASX, JSX, NASDAQ, and TSE. ASX and JSX also provide civil remedy for breach of continuous disclosure regulations (discussed below).

It is perhaps helpful to mention here for the non-lawyers that the difference between civil and criminal liability is one of evidentiary burden. In Australia, for example, to bring civil action, one must prove on the ‘balance of probabilities’ that the impugned act was committed. On the other hand, to prosecute for criminal liability, the prosecutor must prove ‘beyond reasonable doubt’ (ie a higher evidentiary burden) that the impugned act was committed. Another distinguishing point, is that under civil liability the defendant is only liable for a monetary penalty in the form of damages suffered by the injured party, whereas criminal liability involves monetary fines and gaol sentences set by the government regulatory.

2 COMPARATIVE CONTINUOUS DISCLOSURE REQUIREMENTS

2.1 What are the continuous disclosure reporting requirements?

The continuous disclosure requirements for all regimes is premised on the concept of ‘material information’, which is similarly defined by all regimes: information which is not public knowledge and if known to the public may lead to a substantial movement in the security’s price.

2.2 What is the reporting time-frame?

It is interesting to note that the time-frame within which the information must be disclosed is not defined quantitatively for most (5) regimes. Rather a term requiring ‘immediacy’ is used, eg ‘promptly’ (NASDAQ), ‘immediately’ (ASX, TSE), ‘without delay’ (LSE), ‘reasonably practicable’ (SEHK). The JSX (2-5 days) and BSE (7 days), on the other hand, impose a quantitative deadline.

It is suggested that the rationale for the non-quantitative approach by the majority of regimes is to allow for due discretion in interpreting and applying the regulations in different situations by the relevant parties. However, this may be a disadvantage as the discretion may be abused. A good example involves a notorious listed Australian company. In February 1998, the company’s Chairman (which does not have power to act on a company’s behalf) disclosed to a company outsider confidential information without disclosing it to the ASX. A week later, the company’s board disclosed the same information to the exchange after having made a board decision on the matter. The ASX alleged that this breached continuous disclosure: the exchange should have been informed at the time the Chairman spoke to an outsider, although it was not a board decision. That is, the company abused the discretion entailed in the term ‘immediately’.

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2.3 Exceptions for confidential information

All regimes, except for TSE, JSX and BSE, provide for exceptions to continuous disclosure requirements. These exceptions concern confidential information or information which could prejudice a company's interests (e.g., a trade secret).

An always controversial question in this area is when the information ceases to be confidential. ASX and SEHK regulations allude that this would be when the information is being made available outside the company's directors, employees and advisers. However, in some circumstances, this still may not be clear enough. The above Australian case is also an example here. The company argued that the confidentiality exception ceased when the board of directors (as opposed to the Chairman) made the decision to disclose the information to the exchange, as any other party did not have capacity to act on the company's behalf.

Exemption to the continuous disclosure requirements for the TSE, JSX and BSE regimes, on the other hand, depends upon application to the relevant regulatory bodies and their exercise of discretion in each case. The advantage of this approach is that it may avoid the abuse of exceptions and enforces objectiveness in their application. It also avoids the litigating of issues such as whether the information was confidential in fact or in law (as demonstrated in the above Australian example). The disadvantage of this approach is that by having no formal, consistent criteria for exceptions, it may discourage the company from reporting as often as it should to the exchange.

2.4 Must the Company also disclose the information to the media?

Only 3 regimes place an express responsibility on the company to report to the media as well as the exchange: NASDAQ, TSE and SEHK. This seems to be a more cost-effective approach for the exchange, compared to other regimes where the exchange undertakes the responsibility of disseminating the information to the market (ASX, LSE, JSX, and BSE). A disadvantage may be lack of consistency in disclosure of information, as different companies will employ different methods of disclosing the information to the market.

3 TRADING HALTS

This is currently a developing area in research and practice and links up with the discussion on call-auction openings and opening algorithms (discussed in The Relationship between Regulatory Bodies and Brokers, under topic 3).

3.1 Which markets institute trading halts?

The ASX, TSE and LSE-SETS (October 1997) are the only markets which administer trading halts.

A trading halt is different to a trade suspension as it provides for price discovery by allowing orders to be entered into the system during the trading halt (i.e., the market reverts to the pre-open phase), whilst the material news about the security is being disseminated to the market. The trading halt is followed by the normal opening algorithm.

The ASX trading halt will last for usually 10 minutes (or, at maximum, the balance of the trading day) and can occur either where: (i) the company requests one for the reporting of price-sensitive information; or (ii) when the ASX considers there has been a disorderly market and is awaiting a response from the company. The LSE and TSE markets can impose trading halts for similar reasons.
The TSE trading halt will last until the end of the trading session (note, there are 2 trading sessions: morning and afternoon), during which an announcement is made by the company (not the exchange). Note, however, from June 1998, TSE trading halts will be lifted in 90 minutes after release of the news.

The LSE-SETS trading halt will last for a specified period determined by the exchange, during which an announcement is made by the exchange. Also note, unique to the LSE is the institution of automatic halts on the SETS order book if the price of the security moves by 20% (originally 10%) from its opening price. The halt will only last 10 minutes, during which time trading is permitted outside the order book by telephone (principal trades or crossings) as well as the input and deletions of limit orders in the order book. In other regimes, trades outside the maximum price limit orders are either cancelled and the market goes into a suspension (BSE, LSE); flagged within the system (ASX); or rejected by the system (SEHK). (See topic 3.6 in The Relationship between Regulatory Bodies and Brokers, which discusses maximum price movements.)

NASDAQ also institutes a 'trading halt' to disseminate information, although there is no technical difference from its trade suspension procedures (used for the purposes of stopping trade for a prolonged period). This is with the exception that upon the resumption of trading following a trade halt, there is a 5 minute period in which MMs can re-enter their quotes, ie there is some minor form of price discovery.

BSE is the only market examined which institutes circuit breakers for the remaining trading session if the difference between the highest and lowest prices on 2 consecutive days is more than 40%. Otherwise, there is no suspension in the market to disseminate information.

### 3.2 What do other markets do to disseminate information?

Other markets disseminate information via a trade suspension (JSX) or no procedure at all (SEHK, LSE-SEAQ, and BSE). Obviously, a trade halt is superior to a trade suspension where it can continue to facilitate for price discovery. On the other hand, having no procedure is not necessarily inefficient as there is both continual liquidity and price discovery.

### 3.3 No procedure to disseminate information - SEHK, LSE-SEAQ, and BSE

The SEHK is unwilling to 'suspend dealings following publication of an announcement in the press simply on the grounds of allowing that information to circulate through the market'. The LSE-SEAQ and BSE pursue similar policies. Although this policy does not seem on the face of it to be fair to all market participants, it is arguably more efficient compared to those markets which do allow trading halts, as it enforces continuous liquidity. Note, however, if the dissemination results in an disorderly market, then the market would be suspended.

The above policy argument is supported by research evidence regarding the ASX market by Frino and Winn (1996). In particular, Frino et al found:

- of the 32,000 news releases examined over 2.5 years, 21% resulted in trading halts;
- in 10% of the cases, however, the limit order book during the halt was empty which suggests that exchange officials may be overly cautious in assessing the market sensitivity of information releases;
- for the remaining 90% of cases, the trading halts were found to be associated with abnormally high bid-ask spreads, trading activity and excess volatility, which in fact hindered the price discovery process and increased the cost of trading; and
- for the ASX market at least, that further analysis of the conditions under which trade halts impede price discovery are required.

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1 SEHK Listing Rule 6.02 Note 1, and Practice Note 11.4

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Thus, perhaps it can be concluded that trading halts are good but not perfect for the purposes of market efficiency. Overall, the above discussion regarding trading halts is another demonstration of how regulations determine trading structures and can have economic consequence.

4 SUSPENSIONS AND DELISTINGS OF LISTED COMPANIES
All exchanges have the power to suspend and delist their listed companies.

4.1 For what reasons will a company be suspended/delisted?
Common reasons given for a suspension/delisting are: (i) failure to comply with Listing Rules; and (ii) the prevention of an uninformed or disorderly market. It can be imagined that such criteria is vague and wide enough to incorporate most relevant events and allow exercise of due-discretion by the exchange.

It is also interesting to note that in addition to these wide criterion, the JSX sets out a list of specific conditions for which it can consider a company for delisting if it should fall into one of them, e.g. the number of shareholders is less than 100. This approach may have the advantage of minimising dispute and possible inconsistent use of discretion in determining whether the company falls within the wide scope of, say 'uninformed or disorderly market'.

4.2 Automatic suspensions
The ASX is the only exchange which administers automatic suspensions. This will be when the company fails to provide annual reports or pay listing fees. Note, a company cannot object as the regulations explicitly state that the ASX will not waive such rules. Such a policy has the advantage of deterring companies from being tempted to take advantage of the exchange's enforcement discretion.

4.3 Automatic delistings
Three exchanges administer automatic delistings: SEHK; ASX; and TSE. The reasons for the imposition of the sanctions are usually: prolonged suspension without appropriate action taken by company: SEHK, ASX, and TSE; or non-payment of fees: ASX and TSE.

Again, the advantage of automatic delistings is that it deters companies from taking advantage of the exchange’s enforcement discretion.

In addition to the above reasons, the TSE sets out a multitude of conditions under the "Criteria for Delisting of Listed Stock" under the Listing Rules any one of which will cause compulsorily delisting. These relate to: material violation of the Listing Agreement; lack of liquidity; discontinued dividends or continual negative equity; gross false statements in financial reports, and other. However, such highly specified criteria, however, may be too rigid. For example, one criteria is: no dividends for the past 5 years and excess liability (that is negative shareholder’s equity) for the past 3 years. Such a criteria, however, may well be a common trait to young, developing companies whose assets and investments are largely intangible, e.g pharmaceutical companies, technological companies. Other examples are: less than 4 million shares on issue; 70% or more of shares are held in the hands of a few shareholders. To this end, it is interesting to note that for a company to list on the BSE, it must offer only a minimum of 25% of its issued capital to the public, i.e. 75% can be held in the hands of a few private shareholders.
5.3 Do the securities commissions have power to publish investigatory findings? - 2nd column

Only 5 of the securities commissions examined have an express power to publish investigatory findings. This is not including the LSE and TSE counterparts.

5.4 Do shareholders have a statutory right to have the company affairs investigated? - 3rd column

Only 4 regimes give company shareholders a statutory right to have their company's affairs investigated. The LSE and BSE regimes have the most stringent requirements, requiring one-tenth of the company's membership to make the application. By comparison, the ASX's and JSX's requirements are more relaxed; the application can be made by any one shareholder.

Note also, the ASX regime is more robust, as it is the only regime which allows any aggrieved shareholder to apply for a range of court orders regarding enforcement of the ASX's rules (which we discussed in the opening Statement of Research Objective). The similar provision in the US regime (mentioned above) does not give the right to shareholders or the exchange; only the SEC has such right.
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PART III: RELATIONSHIP BETWEEN
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**RELATIONSHIP BETWEEN REGULATORY BODIES AND INVESTORS**

The most relevant and interesting regulations regarding this relationship in the context of market efficiency and fairness concern the following:

- prohibition of insider trading;
- prohibition of fraudulent and deceptive trading;
- regulation of short-selling;
- regulation of takeovers;
- investigation of company membership;
- large shareholder notices and ‘beneficial ownership’; and
- duty of company officers and large shareholders to report their share dealings.

*Statement of research objective and acknowledgment of sponsorship* is attached to Part I of the working papers.

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## 1 INSIDER TRADING

The insider trading regulations were perhaps the most distinguishing and interesting regulations found across the 7 regimes.

### 1.1 What is inside information?

'Inside information' for all regimes was found to be parallel to the concept of 'material, non-public information' (discussed under *The Relationship between Regulatory Bodies and Listed Companies*, under topic 2 (continuous disclosure)).

### 1.2 Who is an insider?

A significant distinguishing feature across the 7 regimes is how an 'insider' is defined. This information is tabled below.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>LSE</td>
<td>1. Yes 2. Yes</td>
<td>Not Specified</td>
<td>1. Yes 2. Yes</td>
<td>Yes + family members</td>
<td>Not Specified</td>
</tr>
<tr>
<td>SEHK</td>
<td>1. Yes 2. Yes</td>
<td>1. Yes- 10% 2. Yes</td>
<td>1. Yes 2. Yes</td>
<td>Yes</td>
<td>6 months</td>
</tr>
<tr>
<td>BSE</td>
<td>1. Yes 2. No</td>
<td>1. No</td>
<td>1. Yes 2. No</td>
<td>No + family members</td>
<td>Yes-time-length not specified</td>
</tr>
</tbody>
</table>
Five of the regimes pre-define their insiders as someone who has a relationship (direct or indirect) with the company. Notice that the LSE is the only regime which does not provide for retrospective application of the definition. Also, some definitions are wider than others, e.g. the LSE regime does not pre-define any shareholder as being an insider, although it is one of the two regimes (BSE is the other) which includes family members in its insider definition.

The other 2 remaining regimes, ASX and NASDAQ, adopt an extremely wide definition of an insider: persons who are in possession of material non-public information, i.e. the law quite deliberately does not ask from where the price-sensitive information come. This is more ideal because it allows regulators to dispense with the practical difficulties of proving the 'person connected' criteria, which can be technically avoided.

Notwithstanding the wording of the US law, however, the US Supreme Court still requires the establishment of a fiduciary link between the trader and the company. A key decision was US v Chiarella in 1980 which acquitted an employee who decoded takeover documents on a printing line.

Such width in the application of the Australian law can, however, give rise to unpredictable results. A well-known recent Australian example involves the now notorious Mount Kersey Mining Ltd. In April 1998, insider trading charges were laid against a MPI Pty Ltd director and a broker from JB Were. The charges related to alleged trading in Mount Kersey's shares (a listed company) which was linked only geographically to the source of the market-sensitive information, MPI Pty Ltd, a non-disclosing entity which was not required at all to disclose the information to the ASX, although the director and the broker charged were aware of the information. If conviction is successful, such a result could give rise to implications that new regimes for the disclosure of information held by non-listed companies will have to be developed. It would also imply that those not legally responsible to disclose information may technically be so.

1.3 What are insiders prohibited from doing?

All regimes, except TSE, recognise 3 offences relating to the use of inside information: (a) trading; (b) procuring; and (c) communicating. The TSE regulations do not prohibit the actual passing on of inside information, i.e. "tipping", although first-hand tippees are prohibited from using the information. Thus, it is feasible for pre-defined insiders in the TSE regime to pass information to private recipients, who could in turn transmit it to unrelated third parties, who would not fall within the prohibitions.
## 1.4 Comparative Penalties

The comparative results regarding penalties across the 7 markets are also interesting.

<table>
<thead>
<tr>
<th>Regime</th>
<th>Fine (@20/03/98)</th>
<th>and/or</th>
<th>Imprisonment</th>
<th>Civil (and other decentralised) remedies available</th>
<th>Convictions</th>
</tr>
</thead>
</table>
| ASX    | • AUD 200,000 (individual)  
        • AUD 1,000,000 (company) | and/or  
        • 5 years | Yes (ASIC can also exercise civil action) | 3 (since 1991) |
| SEHK   | • Repayment of profit  
        • penalty is 3 times the amount of profit | and/or  
        • None | Yes (only Tribunal can exercise civil action) | 8 (since 1991)  
        3 (1974-90) (Civil only) |
| BSE    | (INR 500,000)  
        AUD 20,000 | and/or  
        • 1 year | Yes (Only SEBI can exercise civil power) | 1 (on appeal) |
| JSX    | (15b rupees)  
        AUD 2,500,000 | and  
        • 10 years | Yes (BAPEPAM cannot exercise civil action) | 0 (since 1990) |
| TSE    | (JPY 500,000)  
        AUD 5,882 | and/or  
        • 6 months | • Yes (MOF cannot exercise power)  
        • disgorgement by company | 8 (since 1989) |
| UK/LSE | unlimited fine | and/or  
        • 7 years | No  
        • 10 years | 23 (1980-94) |
| US/    | • (USD 1,000,000)  
        AUD 1,500,000 (individual)  
        • (USD 2,500,000)  
        AUD 3,800,000 (company) | and/or  
        • 10 years | • Yes (SEC can also exercise action)- up to treble the profits/loss avoided  
        • 10% bounty  
        • disgorgement by company | 50 (1980-88)  
        77 (1994-97)  
        1989-93: not known |
| NASDAQ | | | | |

Observe that 5 of the regimes impose a fixed fine: ASX, JSX, NASDAQ, BSE and TSE. By contrast, SEHK and LSE impose an unlimited fine which depends on the profit earned/loss avoided and which is more ideally effective, i.e. a fixed heavy fine is no disincentive if the profit made/loss avoided can be much greater.

The potential weakness of fixed fines is alleviated by the possibility of imprisonment sanctions. Notice that the SEHK does not have an imprisonment sanction, as the insider trading law in Hong Kong is administered by a Tribunal and not a court (in contrast to other countries). Hence, being found guilty of insider trading by the HK Tribunal does not result in a conviction. Recall, however, that SEHK has unlimited fines. Notice also, the TSE regime has only 6 months imprisonment and BSE only has a maximum of 1 year.

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1 The Secretary of State can currently authorise a person to bring a private prosecution. However, civil rights of action will be available under the new Financial Services Authority structure, under the Financial Regulatory Reform Bill (1998)(UK).
2 In January 1999, Japan will strengthen the penal regulations for insider trading; maximum prison sentence will be 3 years and maximum fine will be JPY 3 million (individual) and JPY 300 million (company).

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The shortcoming of limited fines is also alleviated by the availability of statutory civil procedures for aggrieved persons and/or the securities commissions. Only the LSE does not have some form of civil sanction. The ASX, NASDAQ, TSE and JSX are the only regimes which provide 3rd parties civil rights of action. Recall that the advantages of civil liability (compared to criminal liability) are that: (i) the evidentiary burden is lower than it is for criminal liability; and (ii) the person found guilty would usually have to pay damages which is usually measured as the amount of profit/loss avoided, irrespective of the criminal fine.

1.5 Statistics

The statistics regarding convictions are quite interesting. For example, the TSE regime has had 8 successful convictions of insider trading since it was prohibited in 1989. Contrast this with the ASX regime which has only had 3 convictions in the entire history of the legislation which was introduced well before 1989 and whose law has had much wider application since 1991 than that of TSE. Note, however, a regime’s political will, market size and enforcement resources also need to be considered before judging the effectiveness of its insider trading regulations.

1.6 Company’s ability to disgorge short-swing profits

Another significant distinguishing feature regarding insider trading regulations is the right of the company to disgorge short-swing profits, which is defined in the relevant regimes as profits from a purchase or sale within 6 months.

Only 2 regimes examined, TSE and NASDAQ, give companies the discretionary power to disgorge short-swing profits made by company officers and large shareholders (10%). This power can be exercised irrespective of the intention of the company officer or shareholder (although there are exceptions for bona-fide activities, eg dividend reinvestment plans, stock option plans, etc). The advantage of this hard-and-fast approach is that it regularly turns the company’s mind to the issue and gives it the option to take action in each case, without having to undertake the onerous difficulty of satisfying the evidentiary burden at law.

Also, in both regimes a shareholder is entitled to bring a suit on the behalf of the company where the company itself fails to bring such a suit within 60 days. However, this may not be effective because of the costs and administration burdens involved. Further, in each regime the securities commission can monitor the use of this power as it is the regulator which receives the company officers’ and shareholders’ notices regarding their share dealings. In fact, in the TSE market the securities commission is required to monitor the company’s use of this power. Note also, the Law in both regimes does not specify whether the company is required to compensate the other party (to the trade) with the disgorged profit.

It is interesting to contrast the above approach with the less rigid precautions used in other regimes, eg SEHK and LSE. require company directors to follow a code regarding the use of inside information. In other markets, eg Australia, listed companies usually administer their own internal compliance procedures regarding the use of corporate inside information.

2 FRAUDULENT & DECEPTIVE SECURITIES TRADING

Regarding other forms of fraudulent and deceptive securities trading, the regulations across the 7 regimes were more or less similar.

All regimes were found to prohibit some form of:
(i) misleading and deceptive conduct;
(ii) market manipulation;
(iii) false trading and market rigging;

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(iv) the making of false and misleading statements; and
(v) fraudulent inducement of persons to deal in securities.

All regulations were found to be deliberately wide and vague in order to cover all relevant scenarios. A trivial but somewhat interesting distinction is the TSE's prohibition of the employment of battery, assault or intimidation in the above context.

Regarding BSE, where such activity is suspected, the BSE actually intervenes in the market of the security, eg circuit filters are reduced to make it difficult for manipulators to change the price within a short time and additional exchange margins are imposed. Where such activity affects the liquidity-efficiency of a security's market, than the minimum-intervention approach taken by other regimes is perhaps more ideal, ie investigations and trade halts where suspected market manipulation/fraud results in an uninformed and disorderly market. The BSE situation is compounded by the inefficiency associated with a paper-based trading system, which was discussed in the Relationship between Regulatory Bodies and Brokers, under topic 4.

### 2.2 Penalties

<table>
<thead>
<tr>
<th>Regime</th>
<th>Fine (AFR@20/01/98)</th>
<th>and/or</th>
<th>Imprisonment (maximum)</th>
<th>Civil penalty for aggrieved investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>JSX</td>
<td>(15b rupiah) AUD 3,000,000</td>
<td>and/or</td>
<td>10 years</td>
<td>Yes, not BAPEPAM</td>
</tr>
<tr>
<td>ASX</td>
<td>AUD 200,000</td>
<td>and/or</td>
<td>5 years</td>
<td>Yes (ASC can also exercise)</td>
</tr>
<tr>
<td>TSE</td>
<td>(JPY 3,000,000) AUD 35, 294</td>
<td>and/or</td>
<td>3 years</td>
<td>Yes (MOF can also exercise)</td>
</tr>
<tr>
<td>LSE</td>
<td>unlimited fine (if indictment as opposed to a summary conviction)</td>
<td>and/or</td>
<td>7 years</td>
<td>Not specified</td>
</tr>
<tr>
<td>SEHK -market manipulation (Securities Ordinance)</td>
<td>(HKD 50,000) AUD 9,800</td>
<td>and</td>
<td>2 years</td>
<td>Yes (SEHK cannot exercise)</td>
</tr>
<tr>
<td>SEHK -fraudulently inducing another to trade (Protection of Investors Ordinance)</td>
<td>(HKD 1,000,000,) AUD 196,078</td>
<td>and/or</td>
<td>7 years</td>
<td>No</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>(USD 1,000,000) AUD 1, 500,000 (individual)</td>
<td>and/or</td>
<td>10 years</td>
<td>Yes (SEC can also exercise)</td>
</tr>
<tr>
<td></td>
<td>(USD 2,500,000) AUD 3,787,878 (company)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BSE</td>
<td>(INR 500,000) AUD 20,000</td>
<td>and/or</td>
<td>1 year</td>
<td>Not specified</td>
</tr>
</tbody>
</table>
3  SHORT SELLING

'Short-selling' turns on the concept of ownership. It is the action of selling a share which is not owned. It is the reversed economic act of selling a commodity after it is bought. Thus, the regulations here are mainly concerned with the unusual temporal gap between the buying and selling activity. (During this time, the trader borrows the security from the broker/institution for a fee.)

Whilst no specific regulations were found for short-selling in the LSE regime, short-selling is found to be prohibited outright in the TSE and JSX markets, the rationale been to avoid risk of settlement default. However, short-selling can provide liquidity and help establish fair prices, which is why its not prohibited in all regimes. A study by Berkman and Eleswarapu (1997) (discussed below) supports that short-term traders have a positive influence on the value of securities by adding liquidity to the market and that this can outweigh any efficiency benefits from curbing speculation.

The main requirement underlying short selling for 3 other regimes, namely SEHK, NASDAQ and ASX (BSE is discussed separately below) is: the short-seller must be able to deliver the security at the required time without undue inconvenience. ‘Undue inconvenience’ is an important element here as a number of regulatory elements stem from this concern. These include:

1. the restrictions on the price at which the short-sale could be done:
   a. NASDAQ: cannot sell below 1/16<sup>th</sup> point above the best current bid (if the market is in a bearish mode);
   b. ASX: cannot short sell lower than the last reported sale;
   c. SEHK: does not specify any such requirement here.

2. the restriction on the list of securities which can be short sold
   The ASX and SEHK impose such restrictions. Obviously, one characteristic which will determine whether a security can be short-sold in these markets is its liquidity. Regarding NASDAQ, only Nasdaq National Market securities can be short sold.

3. the requirement to take margins
   The ASX is the only regime which requires the broker to report short-sales daily to the exchange and to take a 20% margin of the contract from the client.

4. the requirement to report short-sales
   This is essentially a transparency issue which is worthy of discussing.

Currently, the ASX and BSE require daily reporting of net short-sale positions (ie uncovered short-sales), whereas the SEHK and NASDAQ brokers are only required to report total short-sale positions at the time of reporting on a periodical basis. Note, NASDAQ disseminates this information to the public on a monthly basis (mid-month), whereas the SEHK does not. (Note, in all markets, short-sale trades must be characterised as such when they are entered/reported to the system.)

The above differences in reporting requirements raise the question as to whether short-selling should be transparent, ie reported to the market at all. Such a question was researched in a paper by Frino and McCorry (1996). Frino et al compared share price movements on the ASX and the NYSE. Note, at the time of research the ASX was actually disseminating short-sale information on a trade-by-trade basis (signal) to the market, although this is no longer the case. The NYSE, on the other hand, only required and still does require monthly reporting of total short sale positions. Frino et al found that significant negative price movements were associated with the reporting of large short positions in stocks on the ASX market. Frino et al contrast these results with US research undertaken by Angel (1995), who found that there were
no significant price reactions on the NYSE when the actual trade occurred; although other US academics have found that there were negative price adjustments when monthly short-sell positions on the NYSE were disseminated to the market.

The above results suggest that the market immediately learns of adverse information when short-sales are reported. This warrants the conclusion that the reporting of short-sales enhances information efficiency and makes good practice.

Regarding the BSE market, there is no short-selling as such, due to the unusual trading-settlement cycle of the BSE (see discussion under topic 4 of the paper *The Relationship between Regulatory Bodies and Brokers*). This is compensated for by a form of forward trading, ie ‘Badla’. Badla is where transactions (both sales and purchases) in Group A securities can be carried forward from one settlement date to another, subject to a maximum of 90 days, by paying a fee to a stock financier (a *budliwala*) who settles the transactions on the investor’s behalf. Note, Group A securities constitute about 80% of the trading volume on the BSE. More specifically, imagine an investor who wants to carry forward their settlement of a purchase transaction. The investor sells the shares to the Budliwala at the end of the account period (ie Saturday morning) at the ‘making-up’ price (less a margin, which is typically 15%) and simultaneously repurchasers the shares at the same price at the next account period. The making-up price is determined by the BSE and is usually close to the price on the settlement day. The purchaser uses this money to help pay for the purchase in the next account period, after the Budliwala deducts a financing charge of 1-2% for the period.

In early 1997, a securities lending scheme was introduced in the BSE market to provide for lending of securities through an approved intermediary. This also provides an avenue for investors to earn additional return by lending them. (As at March 1997, two applicants were granted authorisation to act as an approved intermediary.)

Originally, Badla was prohibited in December 1993 to restrict speculative trading when the market was experiencing a down fall due to the collapse of the Mexican peso which had implications for emerging markets. This ban was lifted in 1995, although Badla would operate in a more restrictive modified form.

The banning and reinstatement of Badla on the BSE provides a favourable backdrop against which to examine the effect of short-term traders on share prices and market liquidity. One such examination was carried out by Berkman and Eleswarapu (1997). Berkman et al found that on the announcement of the ban, the Badla stocks (Group A) experienced on average, in the 3 weeks following the announcement, negative abnormal returns of 15%, compared to non-Badla stocks (Group B). There was also a significant decline in the liquidity of the Badla stocks: 72% lower for the period April to December 1994 compared to the corresponding period in 1993. Correspondingly, the announcement of the reinstatement in 1995 of a modified Badla was associated with a significant positive return of a similar amount. Berkman et al results suggest that short-term traders are actually perceived by the market as playing a significant positive role. Overall, such results suggest that the allowance of short-term trading may add to the efficiency of those particular markets that prohibit it (TSE, JSX) or allow for it in a restrictive form (BSE). The paper also supports the positive implications of organised derivatives trading on the market for the underlying securities. To this end, it is also worthwhile noting here that India does not have an organised options and futures market, ie leveraged trading is only possible through the Badla system.
Table 4

<table>
<thead>
<tr>
<th>Regime</th>
<th>Percentage threshold</th>
<th>Is target company to be notified before announcement?</th>
<th>Target shareholders must be issued written offers?</th>
<th>How long is the offer to remain open?</th>
<th>Procedure includes shares that offeror has a beneficial interest in?</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASX</td>
<td>20%</td>
<td>Yes</td>
<td>Yes</td>
<td>1-6 months</td>
<td>Yes</td>
</tr>
<tr>
<td>JSX</td>
<td>20%</td>
<td>No</td>
<td>No-media publication only</td>
<td>1-3 months</td>
<td>No</td>
</tr>
<tr>
<td>NASD</td>
<td>5%</td>
<td>No</td>
<td>Optional</td>
<td>20-no maximum</td>
<td>only shares of 'persons acting in concert'</td>
</tr>
<tr>
<td>LSE</td>
<td>30%</td>
<td>Yes</td>
<td>Yes</td>
<td>21-60 days</td>
<td>only shares of 'persons acting in concert'</td>
</tr>
<tr>
<td>SEHK</td>
<td>35%</td>
<td>Yes</td>
<td>Yes</td>
<td>21 days-60 days</td>
<td>only shares of 'persons acting in concert'</td>
</tr>
<tr>
<td>TSE</td>
<td>5%</td>
<td>No</td>
<td>Yes</td>
<td>20-60 days</td>
<td>only shares of 'special related persons'</td>
</tr>
<tr>
<td>BSE</td>
<td>10%</td>
<td>Simultaneous disclosure to the company, regulatory bodies and the public</td>
<td>Yes</td>
<td>30 days</td>
<td>only shares of 'persons acting in concert'</td>
</tr>
</tbody>
</table>

4.1 At what percentage are the takeover provisions triggered? - 1st column

The takeover provisions for each regime are triggered at different percentage levels: 5% (NASDAQ, TSE); 20% (ASX, JSX); 35% (SEHK); 30% (LSE); and 10% (BSE). Such wide variation is interesting where the objective of each regime’s takeover provisions is to ensure a fair and orderly market. Perhaps the explanation is more historical as opposed to economics driven. This may have implications for market efficiency.

Note in particular, the low thresholds in the TSE and NASDAQ markets at 5%. (Note, however, the TSE regulations relate to takeover bids conducted off-market, ie one can buy as many shares as one wants on the market without complying with takeover procedures. Bear in mind here the common inter-shareholding between companies that takes place in Japan.) This is interesting given that large shareholder reporting requirements are also triggered at the 5% threshold in both markets. It is also interesting that these 2 markets, which rank in the top 4 in the world, make it harder to accumulate an interest in a company. It is also interesting to note that LSE, which also ranks in the top 4, seems to be in favour of takeovers.

4.2 Is the bidder required to notify the target’s board before the announcement? - 2nd column

It is interesting to note that only 3 regimes, LSE, SEHK, ASX, require the bidder to first notify the target’s board. This is then followed by a public announcement. Obviously, this approach attempts to give the target company time to prepare a response.

The JSX, TSE and NASDAQ regimes, on the other hand, require a public announcement to be first made before serving any documents on the target company. This approach attempts to be an equitable one (ie everyone receiving the information at the same time) at the expense of catching the target company by surprise.
The **BSE** pursues a different approach where simultaneous disclosure is to be made to the regulatory bodies, the target company and the public.

In all regimes, all takeover documents must be lodged with the securities commission and the making of misleading statements and omissions is prohibited.

### 4.3 Are target shareholders required to be issued a written statement of offer? - 3rd column

Five of the 7 regimes examined require that all target shareholders be issued a statement of offer: **ASX, SEHK, LSE, TSE** and **BSE**. The **NASDAQ** regime makes this requirement optional: either a public announcement or a written offer has to be made. The **JSX** regime, on the other hand, only requires the offer to be published in 2 newspapers. **Whilst the approach of the first 5 regimes is more equitable, the JSX and NASDAQ approach is more cost-effective for obvious reasons.**

### 4.4 How long is the offer to remain open? - 4th column

The offer period varies across the 7 regimes examined. Essentially a longer time-frame is ideal as it gives shareholders more time to make an informed decision. On the other hand, a longer time-frame carries with it the risk for the bidder that market conditions can change swiftly to their disadvantage. **This actually raises the research implication that the longer the minimum offer period the lower the takeover premium will be, ie a takeover offer is equivalent to a put option (ie an option to sell) which the bidder carries the cost burden of. The longer the time for the option granted, the greater the cost of the put option and so the lower the takeover premium.**

### 4.5 Are associates' shares or shares the bidder has a beneficial interest in included? - 5th column

Only in 2 regimes do the percentage thresholds include shares which the bidders has a beneficial interest in: **NASDAQ** and **ASX**. On the other hand, the requirements of the other regimes only cover shares of persons acting in concert with the bidder (**SEHK, LSE** and **BSE**) or persons the bidder has a special relationship with, eg kinship (**TSE**). **The concepts of 'special related persons' or 'persons acting in concert' may not be as wide reaching as 'beneficial interest'.**

It is of merit to mention here that one possible explanation for the difference in the **ASX** and **NASDAQ** markets is that the regime's large shareholder requirements (discussed below) are regulated under the same laws as takeovers are; whereas the other regimes seem to administer a separate Code for the takeovers market. **This demonstrates the advantage of the integrated legislative approach of the ASX and NASDAQ regimes. Given that large shareholders notices are a preemptive control measure for unfair takeovers, it is ideal that the 2 regulatory issues are regulated for under the one piece of legislation.**

### 5 INVESTIGATION OF COMPANY'S MEMBERSHIP

The investigation of the company's membership is relevant as a measure against evasion of takeover requirements through indirect ownership. Only 4 of the 7 regimes, **SEHK, LSE, ASX** and **BSE**, expressly provide for such an investigation.
### Table 5

<table>
<thead>
<tr>
<th>Regimes</th>
<th>Parties who can investigate</th>
<th>Parties have retrospective investigatory power?</th>
<th>Parties who can request an investigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEHK</td>
<td>• company&lt;br&gt;• commission</td>
<td>Yes- 3 years</td>
<td>shareholders&lt;br&gt;(one-tenth of company’s capital)</td>
</tr>
<tr>
<td>LSE</td>
<td>• company&lt;br&gt;• commission</td>
<td>Yes- 3 years</td>
<td>None</td>
</tr>
<tr>
<td>ASX</td>
<td>commission</td>
<td>No</td>
<td>• any shareholder&lt;br&gt;• company</td>
</tr>
<tr>
<td>BSE</td>
<td>Central Government</td>
<td>Not specified</td>
<td>None</td>
</tr>
</tbody>
</table>

### 5.1 Which parties have the power to investigate company membership? - 2nd and 3rd columns

In the SEHK and LSE regimes, companies have an independent power to investigate membership. These companies also have an explicit retrospective power to investigate any person who was ‘interested’ in the company shares in the last 3 years. Companies in the ASX regime can only request the commission to undertake such an investigation on its behalf. Regarding the BSE regime, there seems to be no provision for the company or shareholder to apply for such an investigation. The securities commissions\(^3\) of all 4 regimes have an investigatory power.

The SEHK and ASX regimes also give company shareholders a statutory right to request an investigation. The SEHK regime, however, requires the application to be made by members holding not less than one-tenth of the paid-up capital, whereas the ASX regime has a more relaxed approach under which any shareholder can make an application. *In the wake of modern corporate governance, the ASX’s approach appears to be more ideal.*

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\(^3\) In the LSE market, the power resides in the State (Treasury) not the securities commission (FSA). In the SEHK market, the power resides in the government’s financial secretary. Similarly, in the BSE, it is the Central Government and not the commission which administers companies.
6 LARGE SHAREHOLDER NOTICES REGARDING BENEFICIAL OWNERSHIP

All regimes administer some form of notification requirements for large shareholders, including notification of changes in their interests. These regulations are essentially a measure of control against disorderly and unfair market takeover practices.

### Table 6

| Regime | Percentage threshold | Time-frame | 1. Beneficial ownership included?  
2. Interest held by relative included? | Parties to be informed |
|--------|----------------------|------------|-----------------------------------|---------------------|
| ASX    | 5%                   | 2 days     | 1. Yes  
2. No | • company  
• exchange |
| NASDAQ | 5%                   | 10 days    | 1. Yes  
2. No | • company  
• exchange  
• commission |
| TSE    | 5%                   | 5 days     | 1. Yes  
2. Yes | • company  
• exchange  
• commission |
| JSX    | 5%                   | 10 days    | 1. No  
2. No | • commission |
| LSE    | -3% (material interest)  
-10% (interest) | 2 days     | 1. premised on 'interest in company share per se'  
2. Yes | • company  
• exchange |
| SEHK   | 10%                  | 5 days     | 1. premised on 'interest in company share per se'  
2. Yes | • company  
• exchange |
| BSE    | 5%                   | 4 days     | 1. Yes  
2. No | • company  
• exchange |

**6.1 What is the reporting threshold? - 1st column**

The percentage ownership threshold varies across the different regimes examined. The ASX, NASDAQ, TSE, JSX and BSE regimes administer a 5% ownership interest threshold, whereas the SEHK regime administers a 10% threshold. The LSE regime, on the other hand, administers a two tier threshold requirement: a 3% ‘material interest’ threshold and a 10% ‘interest’ threshold. *It is questionable whether the additional complexity of LSE’s requirements is necessary given that when the regulations were examined there was merely an artificial distinction between the terms ‘material interest’ and ‘interest’.*
6.2 What is the reporting time-frame? - 2nd column

The reporting time-frame also varies: 2 days (ASX, LSE); 4 days (BSE); 5 days (TSE, SEHK); and 10 days (NASDAQ, JSX). For the purposes of promoting information efficiency, more timely and consistent reporting is ideal. To this end, the ASX requirements are the most ideal.

6.3.1 Procedure goes behind nominal shareholding to identify beneficial ownership? - 3rd column

The procedures for all regimes, excluding JSX’s, attempt to go behind nominal shareholdings to identify beneficial (true) ownership; although some regimes adopt a wider approach than others.

All regimes include in the concept of beneficial ownership: the power to vote; and arrangements or agreements pertaining to the vote attached to the shares. Such notions are inherently wide enough to include all relevant scenarios concerning market transparency in the context of corporate control. Note, the LSE and SEHK regimes seem to adopt a wider approach than the others. Their concept of ‘beneficial interest’ is not premised on the notion of ‘voting power’, but premised on the vague notion of ‘interests in the company’s shares’ per se. This actually raises the question as to, say whether dividend interests alone (eg in installment warrants) are enough to attract these beneficial ownership regulations.

6.3.2 Does the procedure extend to shares held by relatives - 3rd column

Only the TSE, LSE, and SEHK regimes expressly deem interests in the shares held by family relations (spouse or child) to be held by the large shareholder. Also, the ASX, LSE and SEHK regimes expressly disregard restrictions on shareholding interests in determining beneficial ownership.

Obviously for the purposes of market transparency, the scope of beneficial interest should be as wide as possible but also coherent. The LSE and SEHK regulations, which adopt a vague and wide scope, could be too onerous to be practicable.

For the JSX regime, beneficial ownership requirements were not found to be specified in the law. (Note, however, English translations were relied upon.)
7 DUTY OF COMPANY OFFICERS AND LARGE SHAREHOLDERS TO REPORT SHARE DEALINGS

All regimes examined impose some form of duty on certain company insiders, namely company officers and large shareholders, to report their share dealings. These duties are essentially a measure of control against insider trading and other fraudulent trading practices.

Table 7

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ASX</td>
<td>directors</td>
<td>14 days</td>
<td>1. Yes 2. Yes</td>
</tr>
<tr>
<td>JSX</td>
<td>directors</td>
<td>10 days</td>
<td>1. No 2. only shares of certain family members</td>
</tr>
<tr>
<td>LSE</td>
<td>directors</td>
<td>14 days</td>
<td>1. Yes 2. Yes</td>
</tr>
<tr>
<td>SEHK</td>
<td>directors</td>
<td>5 days</td>
<td>1. Yes 2. Yes</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>• officers</td>
<td>15(^{th}) day following month of dealing</td>
<td>1. No 2. Yes</td>
</tr>
<tr>
<td></td>
<td>• shareholders (10%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TSE</td>
<td>• officers</td>
<td>10 days after close of month</td>
<td>1. No 2. Yes</td>
</tr>
<tr>
<td></td>
<td>• shareholders (10%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BSE</td>
<td>directors</td>
<td>Not Specified</td>
<td>1. Yes 2. Yes</td>
</tr>
</tbody>
</table>

7.1 Which parties are required to report share dealings? - 1st column

Five regimes only require company directors to comply with such reporting: SEHK, JSX, LSE, ASX, and BSE.

The requirements of the TSE and NASDAQ regimes, on the other hand, require company officers and principal shareholders (10% of outstanding equity) to make such reports. (Note the historical link between these 2 regimes.) The wider approach of the TSE and NASDAQ regimes is arguably more ideal, as company officers and large shareholders are equally likely to have access to and take advantage of inside information. On the other hand, it can entail an administrative burden in large organisations. However, in other regimes, eg ASX and LSE, it is typical for companies to require such reporting by their officers by way of internal compliance procedures.
Part III: Regulatory bodies & investors

7.2 What is the reporting time-frame? - 2nd column

The time-frame within which such information must be reported varies across the different regimes; between 5 days (SEHK) after such dealing, to the 15th day of the month following the month of such dealing (NASDAQ). Obviously, the more timely the requirement, the more ideal it is in the context of information efficiency.

7.3 Do the reporting requirements extend to shares that insiders have a beneficial interest in? - 3rd column

The scope of the reporting requirements of all regimes, excluding JSX, extend to shares which the insiders have a beneficial interest in (discussed above). The scope of the reporting requirements for the JSX regime is more circumscribed. The JSX regulations only include shares and options of certain family members (which can be easily evaded).

7.4 Do the reporting requirements include share interests in companies associated with the company? - 3rd column

Only 4 regimes extend the reporting requirements to companies associated with the insider's company: SEHK; LSE; ASX; and BSE. This is interesting to note as this particular regulation is important and necessary in the context of insider trading evasion; it is reasonably arguable that such insiders can easily obtain inside information from related companies.
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