DISCLOSURE-BASED REGULATION

There is a world-wide trend to move from merit-based towards disclosure-based regulation of listed issuers. This involves fundamental changes for regulators and regulated alike.

A number of stock markets within the Asia-Pacific region are moving from a merit-based to a disclosure-based approach to regulating their listed issuers. Examples are Japan, Hong Kong, Malaysia and Singapore. The US markets made a large step in this direction in the 1930s and are continuing to refine their approach. This article looks at the concept of disclosure-based regulation and how it is being implemented in different market environments.

Disclosure-based versus merit-based

In one form or another, there has been government regulation of financial markets for hundreds of years. Although some authorities[1] dispute the need for financial regulation, the consensus in virtually all financial markets around the world is that a complex structure of regulatory agencies, laws and rules is needed to maintain investor confidence and so enable the market to function. However, regulation can take different forms according to its governing philosophy or rationale.

One regulatory philosophy may be characterised as merit-based. In accordance with this philosophy, the regulatory authorities seek to protect the investor from abuse and ensure that the securities are offered to them at a fair price by intervening substantively in the offering process. The public offering, and listing, cannot proceed until the securities have been "approved" by the authority. Before giving such approval the authority will review the commercial terms of the offering, including the business prospects of the issuer and the offer price. Merit regulation has been defined as,

> " … a regulatory system that authorizes [the regulator] to deny registration to a securities offering unless the substantive terms of the offering and the associated transactions (i) ensure a fair relation between promoters and public investors, and (ii) provide public investors with a reasonable relation of risk to returns[2] ."

On the face of it, these are laudable aims. However, criticisms can be made of the merit-based approach. On what basis could a regulator decide whether the relation of risk to returns was "fair"? Such decision would depend on commercial judgement which a regulator may lack; even if he has it, why should his judgement be substituted for the judgement of the

1 Bentson, *Regulating Financial Markets*, 1998, page 23, states ".. regulation of financial services … should be limited to reducing negative externalities from government-provided deposit insurance, government-mandated third-party liability insurance, and lower-than-optimal public use of life insurance and annuities, and to protecting consumers from fraud, unfair dealing and invidious discrimination."

2 Sargent, *Report on State Merit Regulation of Securities Offerings* 1986 41 Bus. Law 785, at 829, quoted by Ho, *Public Companies and their Equity Securities (Ho)*, 1998, page 127.

promoter? Deciding the "fairness" of the promoter-investor relation may likewise involve the regulator in discretionary judgement. How can it be ensured that the regulator would apply such discretion even-handedly? And, more philosophically, is it right for the regulator to prevent two parties from transacting as they see fit? One opponent of merit regulation put it bluntly,

> "Simply stated, merit regulation unnecessarily constrains the freedom of people to do business as they see fit, discourages entrepreneurial initiative and impedes the flow of capital to its most efficient use[3]."

Disclosure-based regulation takes a diametrically-opposed approach. Under disclosure-based regulation, the issuer is required by the regulatory framework to make full disclosure of its affairs to the investor, and it is then up to the investor to take responsibility for his own investment decision. The regulator no longer intervenes paternally in the issuer-investor relationship, but concerns himself with the design and enforcement of a framework that will empower the parties to negotiate fairly with one another. A disclosure-based regime will mandate extensive disclosure by the issuer. However, it will not concern itself with the substance of these disclosures. Shortcomings of the issuer, provided appropriately disclosed, are not a bar to public offering: it is up to the investing public to make its own decision.

The disclosure-based philosophy can also be challenged. It may be asked, how can it be ensured that the disclosures the issuer makes are indeed fair? And as for investor self-reliance, in reality the issuer is much more powerful than most investors. How can fair negotiation between such unequal parties be assured? What are the consequences if the issuer does not disclose properly?

To answer these questions we can refer to a functioning disclosure-based regime: that of the US markets.

US experience

Prior to the 1930s, securities regulation in the US was handled by the states, which operated merit-based regimes – the so-called "blue sky" laws, the first enacted in Kansas in 1911, which sought to protect investors from fraudulent schemes that were, in the words of one judge, no more than so many feet of blue sky. But this regulatory effort did not prevent the flotation of a mass of essentially fraudulent securities. In the words of the congressional report, "alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of the security[4]."

In the aftermath of the Wall Street Crash it was felt that federal securities regulation was necessary, and that a new regulatory approach was needed. In his speech of 29 March 1933 proposing the new legislation, President Roosevelt outlined the new disclosure-based philosophy.

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[3] Campbell, *An Open Attack on the Nonsense of Blue Sky Regulation* (1985) 10 J. Corpn. Law 553 at 565, *quoted by Ho, page 131.*

[4] Quoted by Johnson, *Corporate Finance and the Securities Laws*, 1990, page 2 *(Johnson)*

> "Of course, Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn a profit.
>
> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
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> This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence[5]."

One element of the regime established by the 1933 act, the so-called "truth in securities act", was to specify the disclosure contents, ie the items of information the issuer had to disclose. The requirements of this and the 1934 act were eventually consolidated in 1982 in the Integrated Disclosure System.

A second thrust of the act was precisely to put the burden of telling the whole truth upon the seller of the securities. Section 11 of the act provides that a person acquiring a security covered by a registration statement who suffers a loss may sue the issuer, its directors, its officers who sign the registration statement, underwriters and accountants and other experts named in the statement, if,

> "…any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

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5 H.R.Rep. No. 85, 73rd Congress, First Session 2 (1933), quoted by *Johnson*, page 3.

Characteristics of the US Disclosure-based Regulatory Regime

Characteristic	United States
Legalistic approach	
1. Public company norms embodied in ...	Securities law
2. Statutory liability for misleading or fabe disclosure	Clear and enforceable
3. Main driver of issuer compliance	Investor (through law suits)
4. Legal system facilitates investor action against issuer	Yes (class actions, contingency fees)
5. Main regulatory role played by ...	Statutory agency (SEC)
6. Regulatory decisions are made by ...	Agency executive officers, or courts
7. Regulator's own powers to prosecute issuers	Strong
8. Regulator's sanctions for non-compliance	Strong (can include civil and criminal prosecution, deregistration, bar from office)
9. Regulatory decisions	Are published on named basis and retained in public archive
10. Waivers from regulation	Rationale is published and available as precedent (no-action letters)
11. Sponsors/underwriters	No sponsor in US. Underwriters are registered as dealers and their activities subject to regulatory supervision
12. Pre-vetting of public documents:	
• IPOs	Yes
• Secondary offerings	Often no
• Announcements	No
Disclosure system	
13. Degree of detail	High
14. Channels for dissemination	Good (wire services, EDGAR)
15. Coherence over time	Higher: subsequent filings are intended to keep initial filings current under the "Integrated Disclosure System"
Others	
16. Supporting institutions	Many: investor associations, professional bodies, self-regulatory organisations (NASDAQ), legal firms specialising in investor actions, investigative media
17. Supporting legislation	Freedom of Information Act mandates high transparency in government institutions

The latter part of this section, namely the duty not to omit facts required for completeness of understanding, is in practice the most onerous. The principal defence to an action under section 11 is due diligence; however, such defence is not available to the issuer.

The Securities and Exchange Act of 1934 established a strong federal securities regulator in the Securities and Exchange Commission (SEC)[6]. The SEC reviews the registration statement, but its review is essentially to ensure that the required disclosures are in place, and when satisfied the SEC does not approve the registration statement but merely declares it effective. The SEC reviews subsequent disclosures by the issuer only selectively. The SEC will usually decline to advise the issuer on subsequent disclosures, insisting that the issuer form its own view and take responsibility for it. After the initial public offering, the SEC's main role is to hold the ring while the issuer and the investor negotiate with one another freely.

However, the SEC does have significant enforcement powers. It can take go to court to seek injunctive relief, for example to compel violators to disgorge profits or rescind transactions. The SEC can also go to court to seek civil fines or to bar or suspend any person from serving as a director or officer of the issuer. Criminal actions are referred to the Department of Justice. The SEC also possesses administrative remedies - some actionable at sittings of its own Administrative Law Judges, a kind of internal court system. These include the power to impose fines on securities professionals, to enter cease and desist orders for any violation of US federal securities laws, and to disbar professionals such as accountants from appearing before it.

The US disclosure-based regime thus comprises, not only detailed requirements as to the contents of disclosure, but strong enforcement mechanisms to ensure that issuers actually comply with the requirements. Of the two enforcement mechanisms, the SEC and private action under section 11, it is the latter, private action, that is generally regarded as the most important. Given the vast scale of the US markets, and the tradition of small government, the reach of the federal securities regulator, notwithstanding its powers, remains limited. Yet through section 11, the US Government in a sense empowered the entire investing population as regulatory agents in their own right.

What of the inequality between the investor and the issuer, ie the fact that most issuers are much richer and more powerful than most investors? Such inequality is addressed by general features of the US legal system that empower the individual litigant: the ability to conduct class actions[7] and the acceptance by lawyers of contingency fees.

Fees are a deterrent to litigation. Under the British system, for example, the plaintiff has to fund his lawyer up front, and if he loses the case will have to pay the costs of the defendant as well – a double blow. However, under the US contingency fee system, the plaintiff pays no upfront costs nor is he liable for the costs of the defendant. Bringing a suit in effect costs the plaintiff no more than his effort. The cost of the case is born by his lawyer who recovers it out of the eventual award to the plaintiff[8]. The system thus depends on the willingness of law

[6] The state securities commissions nonetheless continued in their role and it was not until 1996 that their role in respect of exchange-listed securities ceased (see One World, Regional Monitor, issue 30, May 2000).

[7] Virtually all actions under section 11 are class actions, *Johnson*, page 205.

[8] A member of the Plaintiff's Bar estimated to the author that the law firm's share would typically amount to 20 to 30% of the total award to the plaintiff.

firms to invest resources in a case for the considerable period that may elapse before settlement or judgement.

To these officially-sanctioned enforcers of good disclosure in the US markets – the SEC and private investors - should be added a third: the market itself[9]. Accustomed to the high standards of disclosure generally prevailing in the market, analysts are swift to pounce on issuers that are less forthcoming, and investors may "punish" these issuers by selling their stocks. One study[10] finds an inverse correlation between disclosure level and cost of capital in the US market.

Is the US system a wholly disclosure-based one? At the federal level, the regime may be described as strongly disclosure-based. However, the individual states retain their blue sky laws which govern non-listed issues of ; securities. And the stock exchanges impose significant quantitative and qualitative requirements to screen out issuers which they believe are not suitable for their respective markets. The US system thus has a disclosure-based foundation but substantial merit elements are built upon it.

Disadvantages of disclosure-based regulation

There are potential disadvantages to a disclosure-based approach. It relies on litigation, and so may be less palatable to certain cultures. Since it relies on indirect measures, ie actions by private individuals rather than direct action by the regulator, US-style disclosure-based regulation may be less suitable in markets where the framework supporting such indirect measures is lacking. The US system relies heavily on the professionalism of the various advisers to the issuer, the integrity of the legal system, the institutions of class action and contingency fees. These are not features of every market.

The system may also generate excessive disclosure difficult for the lay investor to understand. This problem has been recognised by the US authorities, and has been addressed, with some success, by a Plain English campaign. The physical mechanisms for collecting and disseminating disclosures are also important, although in the day of the Internet these are coming within reach even of developing countries.

A further potential disadvantage would be frivolous litigation, ie claims against the issuer which are without merit but which the issuer is nonetheless forced to settle in order to avoid negative publicity. This has been perceived to be a problem even in the US environment. The Private Securities Litigation Reform Act of 1995 was intended to restrict the filing of frivolous suits.

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[9] One US investment banker suggested to the author that in 80% of cases the overriding driver of good disclosure in the US markets is the issuer's concern, not about litigation, but the market's reaction.

[10] Botosan, *Disclosure Level and the Cost of Equity Capita*l, Accounting Review, July 1997, page 323.

Disclosure-based regulation in Asia

There is a general trend in the region from merit- to disclosure-based regulation.

Singapore Driven by the 1997 Asian financial crisis, Singapore launched a fundamental review of its financial sector. The May 1998 report of the Government-initiated Corporate Finance Committee characterises the then-governing regulatory philosophy as "somewhere between merit and disclosure, but with a tendency towards the merit. The Committee was of the view that it was necessary to adopt "…a predominantly disclosure based philosophy of regulation to promote Singapore's growth as an international capital centre, and to foster a market-driven environment, with greater efficiency, innovation and entrepreneurship."

The committee saw the need for fundamental changes in the policy and legal framework to support the new philosophy. These changes include the establishment of a strong legal obligation for issuers to disclose, investigative and enforcement powers vested in the securities regulator, and adequate civil remedies for investors. Noting that instituting rights of class action would encourage frivolous litigation, the committee proposes instead to provide the securities regulator with the power to take up civil actions where it is in the public interest to do so. Exchange practices are to be codified to promote transparency and certainty. The Monetary Authority of Singapore is to become the primary securities regulator, largely subsuming the role of the Stock Exchange of Singapore.

Japan In 1996, the Japanese Prime Minister issued a directive concerning financial system reform, the so-called "Big Bang". In June 1997, the Securities and Exchange Council (renamed Financial System Council in June 1998) published a report[11] setting out its recommendations. The thrust of reform is very broad; however, one important thrust is a change in regulatory philosophy from a paternal approach in which regulators vet and approve each new instrument to one in which investors have the freedom to choose based on full disclosure of information, and take responsibility for their choice. The market is thus to become the main disciplinary force. A number of reforms are proposed to realise this philosophical change. They include relaxation of restrictions on new types of securities, improvements in accounting standards and auditing practices, strengthening of penalties for insider dealing, improving access to disclosure information, providing mechanisms for settlement of civil disputes, and educating investors, for example through encouraging the formation of investment clubs. Some of these measures have been enacted.

Hong Kong The Stock Exchange's 1998-2001 Strategic Plan sets the goal of seeking to evolve the issuer regulatory regime towards a more disclosure-based model. The new Growth Enterprise Market (GEM) launched by the exchange in November 1999 seeks to foster a culture of self-initiative on the part of issuers and sponsors to fulfil their responsibilities without relying on the exchange. On GEM, disclosure requirements are tightened, reporting being quarterly instead of half-yearly, and within 45 days after the period end instead of 3 months.

Malaysia Formerly a highly merit-based regime, in which the authorities had a major role in determining the price and recipients of share issues, Malaysia is in the process of implementing a five year plan, running from 1996 to 2001, to move to disclosure-based

[11] *Comprehensive Reform of the Securities Market – For a Rich and Diverse 21st Century",* Securities and Exchange Council, June 1997.

regulation. The Securities Commission is established as the main securities regulator, and the role of other regulators, such as the stock exchange, is reduced or refocused. SC is given greater surveillance and enforcement powers, investors are provided with civil remedies, standards and best practice guidelines are introduced, and educational programmes are launched for investors.

Conclusion

The concept of disclosure-based regulation entered the world in the US in the 1930s. It was a radical departure from the pre-existing US regime which was merit-based and was felt to have failed investors. Since then, the US system has undergone substantial reforms and refinements, but is still largely governed by the disclosure-based philosophy. Asian regulators contemplating a move away from merit-based traditions have a wealth of experience to refer to in the US case.

by Matthew Harrison

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