

Comparing disclosure based regulation and merit based regulation finance essay



**ASSIGN
BUSTER**

\n[[toc title="Table of Contents"](#)]\n

\n \t

1. [Advantages of DBR](#) \n \t
2. [Time Frame for Shift to DBR](#) \n \t
3. [Table 2: Time Frame for Shift from MBR to DBR](#) \n

\n[/toc]\n \n

There are two basic models of regulatory system which is the supervision framework for securities market which is a merit based regulation and disclosure based regulation. These regulation systems are important to provide adequate investor protection and regulate business practices or codes of conduct that reduces systemic risks. There are several countries which have adopted the disclosure based regulation which are Malaysia, Hong Kong and Singapore. The countries which are still following the merit based systems are China and Philippines but to certain extent.[1]

MBR

The recognition of the need for a securities regulator to ensure investor protection and market integrity is located in the Securities Commission Act 1993 (SCA), under which the Securities Commission (SC) is established. Section 15(1) of the SCA requires the SC to, which control all matters relating to securities and to take all reasonable measures to preserve the confidence of investors in the securities market by ensuring sufficient security for such investors. The principal thrust of the regulatory framework currently applied by the SC is merit-based. Section 32(4) of the Securities Commission Act 1993 (SCA), give power that all proposals that involve issues or offers of <https://assignbuster.com/comparing-disclosure-based-regulation-and-merit-based-regulation-finance-essay/>

securities to the public be subjected to the SC's prior approval. The SC has the discretion to approve the proposals with such revisions and subject to such terms and conditions as it deems fit. The SC also has the power to reject corporate proposals if it is reasonably satisfied that these proposals are not in the best interest of the public company and/or the investing public[2].

Authorities regulate securities offering

Under the MBR, The authorities regulate the securities offering by protecting and shielding the investor by ensuring that the offering of the securities of the company's is judged by the authorities to be fair, just and equitable.

Under this approach, the regulators or the authorities would make an assessment regarding the company's viability, quality and capabilities of the company's management, its suitability for listing and taking regard of the public interest before approving any issuance proposal regarding the company's securities.[3]For example, section 34(4) of the SCA, issues or offers of securities is subjected to the approval from the SC.

Issuers and advisers disclose to authorities

Under the MBR model, the issuers and advisers disclosed all information regarding the company's business to the authorities or the market regulators. These are because under this type of model, the market regulator needs to approve first the securities before the investor can be allowed to invest in the company's. This is for the purpose to protect the investor.

Authorities' reviews investment merits of offering

<https://assignbuster.com/comparing-disclosure-based-regulation-and-merit-based-regulation-finance-essay/>

Regulators review each transaction according to its perceived merits. The evaluation is completed in two stages which is firstly, adequacy of disclosure is assessed then, and the merits of the transaction are subjected to value judgment. Merit-based regulation assumes that the market regulators are better informed than investors and can better decide the merits of transactions on their behalf.[4]These merit judgment is the indication whether the company's can provide safe securities in making business in order to protect the investment made by the investor.

Advantages of MBR Model

In merit based regulation, it is a paternalistic attempt to improve or to develop the fairness between the relationship between the sellers and buyers of the securities in the capital market. These models also act as a shield to protect the public investors from the risks involved in acting on impulse. This is because the authorities had made deep valuation and merits regarding the company's business in order to approve the securities issued by the company's.

This model or regulatory system is particularly suitable to be adopted for Malaysia's emerging capital market which has a large proportion of financially unsophisticated retail investors. This is also reduce or minimizing the possibility of promoters of public companies exploiting these less sophisticated investors to use as to their own advantages.

In the securities market, the Securities Commission is also able to ensure that mechanism in place is working well in order to prevent unscrupulous

and unethical practices in the issue or offer of the securities by the
<https://assignbuster.com/comparing-disclosure-based-regulation-and-merit-based-regulation-finance-essay/>

companies. By ensuring that the mechanism place is working, the investor would have minimized the risk of losing their investment by the unscrupulous and unethical practices of some company's who would provide false or inadequate information regarding their business.

But, the ultimate decision still lies within the investor. This is because the decision and the evaluation of the security offered lies with the investing public. The securities commission will not give a guarantee that the investment made by the investor would get a return or profit.[5]

The SC has the power to check and ensure that the securities that are offered by the issuers are fairly and reasonably priced.

Disadvantages of MBR Model

This is regards to the public interest where the public investor would make their decision in investing their money in the company's based on the SC. The approach of MBR posed a problem of moral hazard. This is because when the market regulators or the SC gives their approval of the merits of a particular company, it exist danger that investors will perceive that the corporation will be a good investment as the SC had given their approval after making some merits regarding the business of the company's. This would lead to an impression whereby the investor did not need to individually evaluate the merits or risk of investing in that company. The investor would totally leave it to the market regulator to make the research.

By using these models, the regulatory approach of MBR restricts entrepreneurs and investor's choice in making decision in choosing the right

company to invest by limiting the scope of investment that is offered to them. This is because only SC will give and provide the necessary approval in order to make the issued security to be approved. If the company's does not comply the guideline given and the SC does not approve the issue offered, thus limiting the option available to the investor in investing their money.

This approach also denies certain ventures of access to public funds unless the issuer of securities agrees to modify their offering according to the prerequisite set by the SC. The issue that always arises is that the SC and the issuers of securities tend to have conflicting views as to how and the extent to which a proposed venture or transaction will be beneficial to investor in general.

The SC is also known to be more conservative in its judgment and normally will not approve highly risky securities to be offered to the public. The merit based regulation also provided that by giving much protection to the investor, this will take the bargaining power from the securities offeror or issuers and the power will be switch to the investor instead. The protection is significant because the issuers of the securities need to raise funds at a substantial discount from the actual price of their securities. From this

Market philosophy, this " over-protection" of the investing public had compelled issuers to raise funds at a substantial discount from the actual value of their securities or add to the perception of initial investors that they would be " guaranteed" a premium when the corporate body is launched onto the marketplace.

Basic principle of DBR

The basic principle of DBR is the need for the issuers and intermediaries offering securities to provide investors with sufficient, accurate and timely disclosure of all relevant information regarding the company's business, prospects, finances and the terms of the securities in order to allow investors to better evaluate the risks and merits of their investment.[6] This is to allow the investor to make their own informed investment decisions. Usually is done through the use of prospectus which focuses whether the companies comply with the standard of disclosure required. For example, in Malaysia, the companies that is listed in Bursa Malaysia, one of the listing requirements of the standard disclosure is to have at least two annual reports that can be inspect by the investors in order to make their decision to invest. The investor are expected to carry out their own due diligence or with the assistance of expert or professional such as lawyers and accountant because the investor hold a higher level of responsibilities in evaluating the risk or particular offering based on the disclosed information before investing.[7]

Authorities regulate disclosure of information in securities offering

Under DBR, the regulation of the disclosure or the standard of the disclosure in securities offering is on the authorities where the authorities will provide the guidelines for the company in disclosing the relevant information pertaining the company's business, finances, prospects and terms of securities. The burden is put on the issuers of the securities and advisers and not on the authorities.

Issuers and adviser disclosed to investor

Under the model Of DBR, the issuers of the securities will provide sufficient information according to the Securities Commission Guidelines regarding the disclosure of information regarding their business. The advisers which are normally experts or professionals such as accountants, lawyers and other technical experts need to have play their role in the preparation of prospectus for the investing public. These are because each of these adviser or experts can be held liable for a defective prospectus under the DBR. The due diligence process is for the purposes of preparing good and complete prospectus and involves performing reasonable investigate work in order to determine that the prospectus does not contain any material omission or false information. Financial advisers and experts in particular are expected to have a very high standard of reasonable care. An adviser has an obligation to make a reasonable investigation not just for the purpose of its own due diligence defence but also as a duty to the investing public who will be relying on the opinion and recommendations of the advisers. In order to minimize their potential risk, the expert of professionals must make due diligence enquiries.[8]

Investors determine investment merits of offering

In the DBR System, the investor cannot expect that the securities regulator to protect them forever. In order to invest, the investor cannot invest blindly. The investor must make their own research and collect data and information regarding the company's business. Investors have to evaluate and assess

the merits of any security being issued or offered before making any investment decision

It would become more apparent that investors would have to change their laid-back attitude. They can no longer take for granted that securities being issued or offered have already passed the regulators' investment merit review. Instead, the information necessary for the investors themselves to evaluate the investment merit of a security will be available. Investors must also take a more active interest in the companies they invest in emphasis should always be placed on fundamentals and long-term performance rather than short-term profit. Investors should be concerned about ensuring that their rights and interests as shareholders are protected, and that greater transparency and accountability are shown by the directors or principal officers of the companies concerned. Ultimately the effectiveness of the disclosure regime to be adopted in Malaysia will depend on investors themselves. They must also rise to the occasion by paying closer attention to the affairs of the corporations in which they invest.

Under a disclosure-based regulation, investment analysts and financial journalists would have access to more relevant information to enable them to make more detailed analysis, research and assessment of each security issue or offering and can conclude at a better finding and recommendation. This is of particular importance in Malaysia in view of the large proportion of retail investors, some of whom lack the technical expertise and or the time needed to evaluate the web of information disclosed by issuers of securities. These investors may need to rely on the analysis disseminated by the

investment analysts and financial journalists to make better informed investment decisions.[9]

Advantages of DBR

There are several advantages of the DBR regulatory model system. Basically, this would result in a more transparent and informed market whereby companies have to improve their quality of disclosure to facilitate potential decision making by potential investors. By upgrading the quality, the investors have more choice and more information pertaining the business and the finances of the companies before making any investment in the companies.

Investor must know and get the information given by the issuer of securities to because the investor will hold the burden of all the responsibility towards their investment decision.

One of the major advantages of DBR, the companies can raise more funds at a lower or cheaper cost. This is because it is based on the assumption that the higher level of transparency will lead to a greater evaluation risk by underwriters which would then contribute to a lesser cost in raising the fund which give the issuers companies the power to price it assets at a higher premium rates.[10]

Another advantage under the DBR is where the role of the regulator is to ensure that the structure of the market is consistent and efficient for the market In order for the investor to make a decision. The regulators will ensure that the information given by the companies are disclosed so that the investor will become the judge in making judgment of the merits of <https://assignbuster.com/comparing-disclosure-based-regulation-and-merit-based-regulation-finance-essay/>

alternative investment, so that the regulator would only emphasis on disclosure and eradication of fraud.[11]

According to analysis, by shifting towards the disclosure based regulation, the benefit that the securities market will enjoy is that the increased of efficiency of the Malaysian capital market by removing the barriers to competitiveness which is present in the old merit regulatory system.[12]

A higher standard of disclosure by the companies is ensuring by the regulatory bodies. This is because the companies are expected to follow the guidelines of disclosure of the information according to the SC. This would give more chance to the investor in making their own research of the accountability of the companies before making any investment.

The Ground for the shift of regulatory model from MBR to DBR

The Securities Commission continues to play an important role in providing direction on broad policy matters and in enforcing the securities laws and regulations. Its role is to ensure that the incentives and structure of the market are consistent with efficiency, fairness and stability. The table below shows the ground for the shift to DBR regulatory system.

Three Tenets of DBR

Disclosure

The responsibility of directors of public companies is to ensure that all material information required by the public to make investment decisions is provided accurately, in full and on a timely basis.

In disclosing such information, the question that is need to be asked is whether

Has any important piece of information been omitted?

Is any part of the information misleading?

Is the information complete and accurate?

Investors rely on available information when deciding where and when they should invest their money. There is a need for information when new securities are offered in the primary market.

There is also a need for information when dealing in securities already traded in the secondary market.

Disclosure of information therefore benefits investors by facilitating them to make investment decisions.

Companies intending to offer securities to the public are required to fully disclose information about the affairs of the companies and the securities which are being offered, in the offering documents or prospectuses. For a public listed company, disclosure obligations are stipulated in the Listing Rules of the stock exchanges.

Due Diligence

In preparing the information to be disclosed to the public, directors of public companies must undertake a due diligence exercise to verify and ensure that the information to be released is accurate and timely.

<https://assignbuster.com/comparing-disclosure-based-regulation-and-merit-based-regulation-finance-essay/>

Due diligence is a process by which inquiries are conducted to ensure that information to be disclosed is true, sufficient and timely. Due care must also be given to ensure that there is no omission of material information. Material information is information which would reasonably be expected by rational investors to facilitate their investment decisions.

Information that can affect the trading activities and prices of the company's securities must be released immediately. The onus then lies with the investor to consider and weigh the information provided before making decisions.

Following amendments to the Securities Commission Act 1993 (SCA) in 1995, which placed a higher standard of responsibility on promoters, directors, and advisers in respect of disclosures, the Securities Commission released a publication on Due Diligence Practices in August 1996.

The publication is intended to explain the importance of due diligence, especially given the criminal liabilities imposed on persons responsible for submission of proposals to the Securities Commission under section 32 of the SCA.

In March 1999, another publication on "Due Diligence Guidelines on Submission of Proposals to the Securities Commission" was published. It was jointly issued by the Association of Merchant Banks in Malaysia, Federation of Public Listed Companies, MIA, MACPA and MAICSA. The publication, in detailing the due diligence process, the question whether

1) Who will be held responsible for conducting the due diligence?

<https://assignbuster.com/comparing-disclosure-based-regulation-and-merit-based-regulation-finance-essay/>

2) Who should be included in a Due Diligence Working Group(DDWG)?

3) What should the terms of reference and role of the DDWG be?

4) What is the methodology used in conducting the due diligence exercise?

The publication also includes a due diligence checklist for an initial public offering and sets out clearly the roles and responsibilities of the various parties involved in the exercise.

Corporate Governance

The timely, accurate and transparent disclosure of material information is an integral component of ensuring good corporate governance. Boards of directors of companies need to be open about the businesses they direct and this includes transparency in corporate activities and transactions. This is essential so that shareholders can exercise their rights constructively.

However, they can only do so if they are provided the relevant information.

Apart from compliance with laws and regulations that constitutes one aspect of ensuring that directors perform their fiduciary duties properly, there are also codes of best practices which the directors are expected to observe.

Among the codes to be observed are The Malaysian Code on Corporate Governance, issued by the Finance Committee on Corporate Governance and The Company Director's Code of Ethics issued by the Registry of Companies.

[13]

Time Frame for Shift to DBR

The shift to DBR takes effect over a period of five years under three phases, beginning in 1996,

with full DBR expected to be achieved by the year 2001. An outline of the time frame and focus

of the shift is set out below:

Table 2: Time Frame for Shift from MBR to DBR