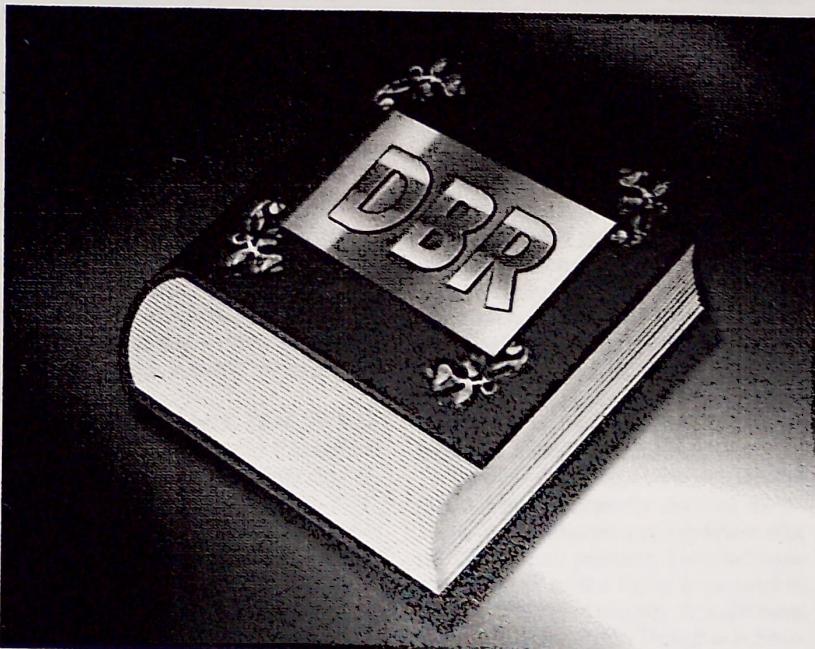


## Disclosure Based Regulation

## Sustainability Examined



**In order to enable investors and issuers to take informed decisions, full and accurate information about the issuers and intermediaries and their products and services should be made available.**

**M S Sahoo**

Chief General Manager, SEBI.

The availability of relevant information about products (goods and services) and their suppliers greatly enhances market efficiency, as it enables the users of the products to take informed decisions. The availability of information is generally ensured, as suppliers have to disclose information about themselves and their products. This also gives the users the right to demand and obtain information from the suppliers. For example, the election regulations require candidates to disclose their assets, so that the electorate can decide whom to elect. They also empower the electorate to demand the details of the assets of the candidates. These kinds of regulations which provide for the availability of information through disclosure by the suppliers on their own or on demand from the

users are called Disclosure-Based Regulations (DBR). This paper discusses the relevance of DBR, the requirements for its success and how it can be sustained in the securities market.

**Relevance in the securities market**

In the context of the securities market, DBR means disclosure of information about products like securities and services of intermediaries and their suppliers, namely the issuers of securities and the intermediaries. The issuers and investors are users of the services rendered by the intermediaries, while the investors are the users of the securities. In order to enable investors and issuers to take informed decisions, they must have full and accurate information about the issuers and intermediaries and their products and services. They need information even

about the regulator and its services to determine if it is safe to transact in the securities market, particularly if the regulator enforces the prescribed disclosure regime. Such information enables an investor to decide whether to undertake transactions in the securities market and if so, in which securities and at what prices and through which intermediary. It similarly enables an issuer to decide, if required, to raise resources through the securities market and if so, through what instruments and which intermediary.

This is in contrast to merit-based regulation, where the regulator takes decisions on behalf of the investors and issuers. It reviews each transaction according to its perceived merits. It assumes that the regulator is better equipped than the investors/issuers and can better decide the merits of a transaction on their behalf. However, this approach has severe limitations in the securities market, which suffers from moral hazards and adverse selection associated with information asymmetry. DBR, on the other hand, assumes that the market rather than the regulator is best equipped to determine the merits of a transaction. Under this approach, the regulator ensures the disclosure of full and accurate information, based on which investors/issuers can take informed decisions and also assume responsibility for their own decisions. If the regulator can ensure the disclosure of full and accurate information, it does not have to bother about protecting the investors/issuers.

The securities regulators are increasingly resorting to DBR and mandating issuers/intermediaries to disseminate standardized information about themselves at regular intervals. This fits well with today's antiregulatory climate, which is characterized by an increasing deference to private decision making. It believes that the regulator cannot take decisions for investors/issuers, but it can protect them by arming them with the information they need to take decisions. The investors/issuers prefer it because of their diminishing faith in the honesty and competence of the regulators, even as it gives them the freedom to take their own decisions. The regulators prefer it because they are reluctant to be accountable for the decisions they take for or on behalf of the issuers/investors. The issuers/intermediaries like it because it is not as ideologically threatening or as costly to comply with, particularly with the availability of technology, as substantive mandates.

The securities market is hardly a perfect market. It suffers from information asymmetry between the issuers, the intermediaries and the regulator on the one hand and the investors and issuers on the other. DBR removes this information asymmetry and, thereby, (a) improves allocative efficiency, as the investors and issuers get information about the market and can make more informed and socially optimal decisions; (b) promotes equity, as all the investors and issuers have equal access to the information necessary for making decisions and no one benefits exclusively or at the cost of others from the information; (c) promotes democratic governance and prevents fraud and corruption, and (d) improves the performance of the disclosing parties as they know that their performance is being watched and evaluated.

DBR changes the behavior of the issuers/intermediaries/regulators (henceforth called 'disclosers'), and the issuers/investors (henceforth called 'users'), or both. First, the disclosers provide, either on their own volition or in compliance to some regulatory mandate, certain information about them, their activities and their products. The users gather the information, and if warranted, change their conduct/behavior with respect to discloser or his product. As a result of the change in the behavior of the users, the behavior of the discloser also changes. The discloser also reveals his changed behavior, which in turn, induces further changes in the behavior of the user. The process continues ad infinitum and the market benefits from the combined changes in the behavior of the users and the disclosers in the desired policy direction.

For example, the issuer discloses his activities, track record and performance through financial statements in the prospectus or through continuous disclosures to the stock exchanges. These disclosures enable an investor to assess the risk-return profile of the issuer and make informed investment decisions. As the issuer knows, the investor would invest or continue to remain invested in his business only if it performs well or tries to improve its performance. As the discloser improves the performance and discloses the same, the investors assess the changed risk-return profile of the issuer and compare it with those of other competing issuers and decide where to make the investment and at what price. This leads to efficient allocation of resources, which is the desired policy objective.

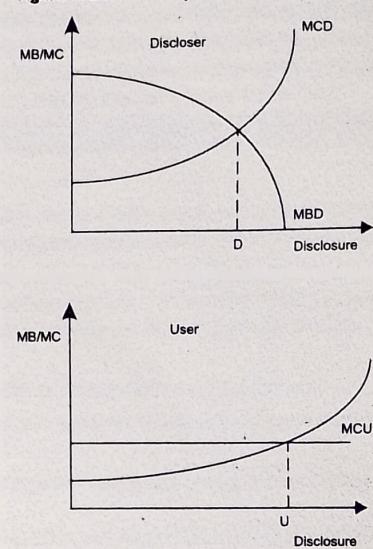
### Requirements of a successful DBR

What should be disclosed? Any thing material to decision-making by investors and issuers needs to be disclosed. The regulator should identify the relevant information and mandate its disclosure. The regulator also should specify the information to be disclosed, how it should be disclosed and when it should be disclosed. The information should be disclosed in a public media easily accessible to users. It should be disclosed in a language easily intelligible. It should be unambiguous, reliable, comprehensive, and consistent with generally accepted accounting principles, so that comparison becomes easy. It should not be pages of disclaimers and 'risk factors' used in such a way as to limit their responsibilities. In short, it should be such that users understand enough about the disclosers and their products, so that they can make their own informed decisions.

Who should disclose information? The disclosures are generally made by the issuers, intermediaries and regulators who are selling their products. The most complex product in the world is securities. Though it is called security, it is the most unsecured instrument. Though it is invisible because of dematerialization, it embodies a bundle of rights and obligations. Its price depends on the market perception about the credibility of the issuer, his business and the associated risks. The issuer needs to disclose full information about the security, so that the investors can make an investment decision or price it appropriately.

The intermediaries undertake, design and market transactions on behalf of the issuers and investors, who bear the ultimate risk of the transaction. In order to enable the issuers and investors to choose the intermediary suitable for their transactions, the intermediaries must make continuous disclosures about their performance, competence, financial positions, track record, penal actions, etc. Further, the issuers are the interested parties. They would like the transactions to go through at any cost. They will seek the assistance of the intermediaries to do so. In such cases, the intermediaries have the added responsibility of disclosing the product they are selling and ensuring the adequacy of the disclosure made by the issuers. Since they work as agents, they must also disclose the interest they have in the transaction and also what they did to earn the fee.

Figure 1: Sustainability of DBR



It is not enough if the issuers and intermediaries disclose information. Even the regulators must disclose. The regulators / Self Regulatory Organizations must be transparent in the way they work. They must disclose the practices and rationale for their decisions to avoid market confusion and accusations of bias. They must disclose the penal actions taken against the issuers and intermediaries, so that investors can be careful. In order to reduce the scope for manipulation by large investors, they must disclose their holding in a security beyond a level.

All participants in the market are interested parties and, hence, may not always make disinterested disclosures. Further, since disclosure is a public good, it may be under produced. In order to ensure adequate disinterested disclosure, it is desirable to encourage third parties to undertake the business of disclosure.

The success of DBR hinges on the presence of a very congenial market environment. First, is the faith in DBR. The disclosers must believe that the disclosure is in the interest of the market and, hence, in their own interest. Otherwise, DBR will be a mechanical exercise. The disclosure document would then deal with all the items on the relevant checklists. It would include a number of warning statements and a lengthy and largely meaningless section on risk factors. This would frustrate DBR and encourage misleading disclosure. The second is financial literacy. A disclosure-based regulatory regime presumes that users will make sen-

## The Transformation of the Indian Securities Market\*

In order to improve the quality of the market, that is, to improve market efficiency, enhance transparency, prevent unfair trade practices and bring the Indian market to international standards, a package of reforms consisting of measures to liberalize, regulate and develop the securities market is being implemented since the early 1990s. The reforms got boost with the establishment of a statutory autonomous agency, the Securities and Exchange Board of India (SEBI) in 1992. The reforms in the Indian securities market have been so fast paced that the market changes beyond recognition every couple of years. Table 1 presents a brief summary of the reforms undertaken since the 1990s.

Table 1: Elements of Market Design in the Indian Securities Market, 1992 and 2004

Features	1992	2004
Regulator	No Specific Regulator, but Central Government oversight	A specialized regulator for securities market (SEBI) vested with powers to protect investors' interest and to develop and regulate securities market. SROs strengthened.
Intermediaries	Some of the intermediaries (stock brokers, authorized regulated by the SROs clerks and remisiers)	A variety of specialized intermediaries emerged. They are registered and regulated by SEBI (also by the SROs). They and their employees are required to follow a code of conduct and are subject to a number of compliances. All participants are identified by a unique identification number.
Access to Market	Granted by the Central Government	Eligible issuers access the market after complying with the issue requirements.
Disclosure	Voluntary, vague, scanty, non-standardized	Systematic and on par with international standards. A dedicated website for corporate disclosures.
Pricing of Securities	Determined by the Central Government	Determined by the market, either by the issuer through fixed price or by investors through book building.
Access to International Market	No access	Corporates allowed to issue ADRs/ GDRs and raise ECBs. ADRs/GDRs have two way fungibility. FIIs allowed trading in Indian market. MFs also allowed to invest overseas.
Corporate Compliance	Very little emphasis	Emphasis on disclosures, accounting standards and corporate governance.
Mutual Funds	Restricted to public sector	Open to private sector and emergence of a variety of funds and schemes.
Trading Mechanism	Open outcry, available at the trading rings of the exchanges, opaque, Auction/negotiated deals	Screen-based trading system, orders are matched on price-time priority, transparent, trading platform accessible from all over country.
Aggregation Order Flow	Fragmented market through geographical distance. Order flow unobserved	Order flow observed. The exchanges have Open Electronic Consolidated Limit Order Book (OECLOB).
Anonymity in Trading	Absent	Complete.
Settlement System	Bilateral	Clearing House of the Exchange or the Clearing Corporation is the central counterparty.
Settlement Cycle	14-day account period settlement, but not adhered to always	Rolling settlement on T+2 basis.
Counterparty Risk	Present	Absent.
Form of Settlement	Physical	Mostly Electronic.
Basis of Settlement	Bilateral Netting	Multilateral Netting.
Transfer of Securities	Cumbersome. Transfer by endorsement on security and registration by issuer	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories.
Risk Management	No focus on risk management	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, VaR-based margining, client level gross margining, online position monitoring etc.
Derivatives Trading	Absent	Exchange traded futures and options available on two indices and select securities.

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sible choices or, at least, that they have no one to blame for their foolishness but themselves. For example, the securities laws in theory permit issuers with no reasonable prospects of profitability to sell securities to the public, as long as their poor quality is fully disclosed. Further, the marketplace often offers products with diverse features to meet the specific preferences of investors. In such cases, if investors are not discerning, DBR will not achieve much. Third, the disclosures

should be such that everyone across the globe derives the same meaning. This means that the discloser must use standard conventions of accounting and practices to produce the information for disclosure. Fourth, the cost of disclosure on the part of the discloser and the cost of using the disclosed information should be a minimum and be less than the benefits that accrue to the system. In case, the benefits from DBR accrue to a set of entities different from that which bears the cost, or

if the benefits are not commensurate to the costs incurred by the discloser / user, but the benefits outweigh the costs for the market as a whole, there has to be a mechanism to share the costs. These aspects need to be borne in mind while designing the disclosure architecture. Fifth, a strong enforcement mechanism. DBR is only as effective as the liability that the disclosers have to bear for breaching the requirements. Moreover, the liability has to outweigh the potential gain from

non-disclosure. This requires the regulator to have the ability to detect and establish non-disclosure and the powers to impose deterrent sanctions. What this means is that those who make disclosures—the issuer, and the intermediaries involved in bringing an issue to the market or carrying out securities transactions—have both responsibility and liability in ensuring that the quality and quantity of disclosure meets the objectives and criteria set for the disclosure. And if they fail in such duties or make deceitful disclosures, there should be a credible set of sanctions that adequately punishes them.

### Sustainability of DBR

The disclosers have reasons to voluntarily disclose information about them and their products that the users want. Those who do not disclose will find it difficult to raise resources or get clients, as users may take silence for bad news and refuse to invest or transact. They do not, however, have an incentive to disclose everything, because disclosure is costly. Hence, the voluntary disclosure may fall short of the level required by the users. There can be a gap between what the disclosers are willing to disclose on their own volition and what the users need to take informed decisions. Similarly, there can be a gap in the quality (form, time, frequency, medium, standard, etc.) of the disclosure. This happens because of uneven power of the interest groups—disclosers and users. The disclosers are small in number and are better organized. They have an interest to reduce the cost of the disclosure. The users are large in number and are not generally organized. This inevitably reduces the quality and quantity of the disclosure. This calls for intervention from the regulator to bridge the gap. The regulator promotes an appropriate DBR regime which meets the needs of the users fully, puts in a credible enforcement mechanism and discloses information about itself.

As stated earlier, the disclosure is costly. The costs include the direct costs incurred on the provision of information and its dissemination, and on changing the disclosers' behavior necessitated by the disclosure. It also includes indirect costs arising from the use of the disclosed information by the competitors to their advantage and the discloser's disadvantage. The cost of the disclosure increases with the amount of disclosure to users. The extent of the rise depends on the change in the behavior of the discloser and

the disadvantage his competitors can cause him. In all probability, the marginal cost function will slope upwards as indicated by MCD in Figure 1. There are certain benefits to the discloser from the disclosure. It could be improved performance or avoidance of signaling effect or penalties associated with non-disclosure. The benefits from disclosure are, however, most likely to decline with an increase in the amount of disclosures. MBD could be the most likely marginal benefit function associated with the disclosure. Given the marginal cost and benefit functions for disclosers, 'D' is the maximum amount of disclosure that the discloser will willingly make. Disclosure beyond 'D' adds more to cost than to the benefit of the discloser.

The users, similarly, have cost and benefit functions associated with the use of the disclosure. The disclosure less than a threshold may not be of any use to the user. A minimum amount of disclosure is required before the user starts benefiting from it. The benefit may rise with increase in the amount of disclosure beyond the minimum. After a while, additional disclosures may not add much value to the user. The marginal benefit function could take the inverted U-shape. For the sake of simplicity, the figure presents an upward sloping marginal benefit function (MBU) for the user. The marginal cost function could take different shapes. However, it is reasonable to assume that a certain minimum investment is required to set up systems to gather and process information. Once that is done, additional cost for additional disclosure could be zero or negligible. This logic holds good in the current environment, which uses information technology for this purpose. The marginal cost function could be a horizontal line, as depicted by MCU in the Figure 2. Given the benefit and cost functions for the user, 'U' represents the minimum amount of disclosure that the user would need. He will welcome any amount of disclosure beyond 'U'.

If the minimum desired by the user is more than the maximum provided by the discloser, DBR is unsustainable. In such a case, if the discloser is mandated to disclose more than the maximum, he would do so to comply with the requirement in letter. He may compromise on the quality. This would increase the cost of monitoring and enforcement. Instead, it is better to create an environment where the cost and benefit functions of the user and of the discloser shift or change shapes in such a manner that the minimum wanted

### Securities and Exchange Board of India (SEBI)

SEBI has statutory responsibility to:

- Protect investors interest in the securities market;
- Promote the development of the securities market; and
- Regulate the securities market.

### Major Achievements of SEBI

- Screen-based trading
- Dematerialization of securities
- Online IPOs
- T+2 rolling settlement
- Central counterparty guarantee
- Derivative trading

### Securities and Exchange Board of India (SEBI)

SEBI is working continuously to make the Indian securities market a benchmark for the world in terms of efficiency, product innovations, and safety.

by the user exceeds the maximum willingly provided by the discloser.

The figure depicts a situation where the maximum provided by the discloser 'D' falls short of the minimum needed by the user 'U'. There could be situations where the reverse can happen depending on the shape and position of the cost and benefit functions. The gap, as shown in the figure, needs to be addressed by the regulator. The regulator should aim at increasing the level of disclosure from the discloser or decreasing the minimum level of disclosure needed by the user. This means that the regulator can play around various variables which can change the shape and position of the marginal cost and benefit functions of the discloser and of the user to reach a situation where the minimum wanted by the user is less than or equal to the maximum provided by the discloser. For example, technology can bring down the cost of the user and the MCU could shift downwards. Or, improved financial literacy could enhance the benefits from the disclosure to the user and the MBU could shift upwards. A combination of these would reduce the minimum disclosure wanted by the user. Similarly, the improved performance by the discloser resulting from the disclosure could shift MBD rightwards. Or, technology could bring down the cost of the disclosure, which could shift the MCD rightwards. A combination of these would increase the maximum disclosure provided by the discloser. A variety of tools could be used by the regulator to make DBR sustainable in the securities market. □