Suruhanjaya Sekuriti
Securities Commission

Disclosure-based Regulation - What Directors Need To Know

CONTENTS

This publication aims to provide a basic understanding of disclosure-based regulation (DBR) for directors of companies. It is not an exhaustive write-up on the subject and is not intended to be a substitute for legal advice or diminish any statutory duty that is imposed on persons by existing laws. The information contained is accurate as of November 1999.

Introduction

Financial markets exist to facilitate the raising and allocation of capital. To achieve this objective, markets depend greatly on their ability to win the trust and confidence of both users and providers of capital. Such confidence can only be built in an environment where prices are fair, material information is readily available, and abusers of public trust are brought to task.

The best form of market regulation is therefore one that nurtures growth and development while facilitating enforcement against those abusing public trust. Indeed, a system of self-regulation by market participants and self-regulatory organisations coupled with vigilant regulatory oversight has produced the most mature, stable and liquid markets throughout the world.

Upon its establishment in March 1993, the Securities Commission inherited the merit-based regulation (MBR) regime.

In 1996, the Securities Commission decided that a shift to disclosure-based regulation (DBR) is a necessary progression for the Malaysian capital market to become more efficient and to develop into a sound and credible market of international standing.

Under MBR, the Securities Commission regulates the offering of securities by assessing the investment merits and pricing of the offering. The regulator assumes a paternalistic role in assessing the merit of securities to be issued and interposes itself between those seeking to raise funds and those seeking to invest.

Under DBR, the onus of assessing the merit of any securities rests with the investors whose money is being put at risk. The investors assess and determine the investment merits of the offering while the Securities Commission regulates the disclosure of material information.

A clear illustration of the difference between MBR and DBR is in the issue and offering of securities in the primary market by public companies (see Table 1).

Table 1: Comparison of Securities Offerings in the Primary Market Under MBR and DBR

Under MBR	Under DBR
• Authorities regulate securities offerings - Onus on authorities	• Authorities regulate disclosure of information in securities offerings - Onus on issuers and advisers
• Issuers and advisers disclose to authorities	• Issuers and advisers disclose to investors
• Authorities review investment merits of offerings	• Investors determine investments merits of offerings

MARKET INTEGRITY
AND
INVESTOR PROTECTION

Rationale for Move to DBR

In moving 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.

Besides enhanced regulatory focus on investor protection, the shift to DBR would:

?? increase the efficiency of the market by removing the deficiencies which exist in an MBR environment;

?? inculcate higher standards of disclosure, due diligence and corporate governance as well as accountability among promoters and directors of public companies, their advisers to investors; and

?? facilitate market discipline on pricing and valuation of securities.

The aim of making the securities market more efficient and transparent is achieved through DBR by ensuring that:

?? access to the capital market for companies through primary offerings is conditional upon the full, timely and accurate disclosure of relevant information so that investors can make informed and reasoned investment decision; and

?? continuous flow of relevant information, about the affairs of companies whose securities are being publicly traded, is being provided in a timely manner so that the secondary securities market operates efficiently and investors are adequately informed.

In regulating disclosure, the Securities Commission will continue to strengthen surveillance and enforcement functions to ensure compliance for greater market integrity and investor protection.

Three Tenets of DBR

DBR consists of three tenets which, if well embedded in the corporate culture of every public company, will contribute significantly to the efficiency, maturity and stability of our capital market.

The three tenets of DBR are:

?? Disclosure
?? Due Diligence
?? Corporate Governance

Essentially, in moving from MBR to DBR, the capital market progresses to an environment largely governed by self-regulation, high standards of disclosure and due diligence as well as corporate governance practices.

Disclosure

It is the responsibility of directors of public companies 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 directors must ask themselves the following questions:-

?? 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.

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, provides answers to the following questions:-

- ?? Who will be held responsible for conducting the due diligence?
- ?? Who should be included in a Due Diligence Working Group(DDWG)?
- ?? What should the terms of reference and role of the DDWG be?
- ?? 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.

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

Phase	Expected Time-Frame	Focus
One	1996 - 1999	Flexible MBR with enhanced disclosure, due diligence and corporate governance
Two	1999 - 2000	Hybrid MBR and DBR further emphasis on disclosure enhancement, due diligence and corporate governance as well as promotion of accountability and self-regulation
Three	2001 onwards	Full DBR with high standards of disclosure, due diligence, corporate governance as well as exercise of self-regulation and display of responsible conduct

Measures Taken by The Securities Commission

The Securities Commission is currently in Phase 2 of the shift to DBR. During Phase 1, the most notable change was the flexibility allowed for securities under initial public offerings and rights issues to be priced on market-driven basis and fixed by companies together with their advisers and underwriters.

Under Phase 2, the Securities Commission continues to look at corporate proposals as practised under Phase 1 except that it does not intervene, as long as the principles and requirements stipulated under the "Policies and Guidelines on Issue / Offer of Securities" are complied with, in the following:-

- The pricing of securities under most types of corporate proposals;
- The valuation of assets, either for the purpose of incorporating revaluation surpluses into accounts or as the basis for purchase consideration in support of acquisitions; and
- The utilisation of proceeds raised from issuance of all types of securities for core activities of the companies.

In Phase 3, the Securities Commission will be evaluating corporate proposals wholly from the perspective of quality of information disclosed in public documents.

Investor protection will remain the Securities Commission's key responsibility, and in this regard, there will be greater emphasis on compliance and enforcement.

The following are the major measures taken by the Securities Commission to date in the shift to full DBR :-

- Amendments to the Securities Commission Act 1993
- Amendments to the Securities Industry Act 1983
- Amendments to the Securities Industry (Central Depositories) Act 1991
- Introduction of, and subsequent amendments to, the "Policies and Guidelines on Issue/Offer of Securities"(1995, 1997 and 1999)
- Publication of Guidelines on Due Diligence Practices (1996)
- Introduction of the new Malaysian Code on Take-Overs and Mergers (1998)
- Introduction of the Securities Commission (Unit Trust Scheme) Regulations 1996, and the Guidelines on Unit Trust Funds (1997, with Practice Notes in 1998 and 1999)
- Establishment of Malaysian Exchange of Securities Dealing & Automated Quotation (MESDAQ) which operates on full DBR principles (1997)
- Establishment of the Financial Reporting Surveillance and Compliance Department within the Commission with the responsibility of monitoring the financial reporting standards of public listed companies (1998); and
- Release of Corporate Governance Report by the Finance Committee that includes the Malaysian Code on Corporate Governance (1999).

Responsibilities of Directors Under DBR

The move to DBR means that there will be higher level of responsibilities from companies and their directors and promoters. They will be expected to provide full, accurate and timely disclosure of information to investors, to adhere to good practices of corporate governance and have a deeper understanding of the Securities Commission's policies, rules and regulations.

Directors of public companies are expected to discharge their duties with greater integrity and due care, bearing in mind the criminal liabilities imposed on persons convicted of violating the securities laws. Ultimately, they are liable for any breach of the securities laws and regulations.

Under Section 32B (4) of the SCA, a person who contravenes subsection (1) or sub-section (3) shall be guilty of an offence and shall on conviction be liable to a fine not exceeding three million ringgit or to imprisonment for a term not exceeding ten years or to both.

Sub-section (1) refers to submission of false or misleading information and omission of material information while sub-section (3) refers to the need to inform the Commission of misleading or incomplete material that has been submitted.