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It's About Time to Adopt Disclosure-Based Regulation for the Korean Capital Market

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While serving as Resident Scholar of the Asian Development Bank (ADB) (June 1997-June 1999), the author spearheaded an ambitious ADB research project which focused on fundamental weaknesses in macroeconomic policies, banking sectors, and capital markets of nine countries in the Asia-Pacific region. The nine countries encompass: (i) five crisis-affected economies including Indonesia, Korea, Malaysia, Philippines, and Thailand; and (ii) four vulnerable economies including China, India, Pakistan, and Viet Nam.

In the capital market segment, the Asian financial crisis cast doubt on the readiness and effectiveness of regulatory and supervisory arrangements. Beset by enforcement problems and rising monitoring costs, the regulatory frameworks in the region revealed the following three key weaknesses: (i) fragmented structure and coverage; (ii) overemphasis on merit-based regulation; and (iii) under-utilization of self-regulated organizations. When Asian senior capital market regulators held a regional level policy dialogue in Tokyo, April 25-26, 1999, to address these issues, the ADB reports were utilized for background discussion documents.¹ At this policy dialogue, serious concerns were expressed regarding the exceedingly prescriptive approach of capital market regulation in the region. Rather than establishing general principles and monitoring adherence to those principles, the capital market regulators focused in

the merit evaluation of individual cases, which, in turn, caused delays, inefficiencies, misfeasance, even corruptions in the regulatory processes. Hence, one of the major policy recommendations endorsed at the Tokyo policy dialogue was the adoption of disclosure-based regulation, a significant shift from merit-based regulation.

In the merit-based regulatory approach, market regulators review each transaction according to its perceived merits. The evaluation is completed in two stages: first, adequacy of disclosure is assessed; then, 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. However, the capital market is notorious for the problems of moral hazard and adverse selection caused by information asymmetry, which are far worse than what borrowers and lenders experience in the banking sector. The regulator and the regulated often engage in regulatory games. Market participants, always reluctant partners in this regulatory game, disclose as little as possible. Market regulators are responsible for collecting as much information as possible and seeking assurance of the information quality from the regulated, thus increasing the cost of monitoring and compliance. Market regulators are inclined to delay deciding the merits of transactions in the effort to gather more quality information, which result in undue delays, operating inefficiency, corruption, and missed opportunities. Moreover,

¹ A total of 37 reports will be released by the ADB in the early part of this year. This column is drawn from the author's capital market overview report, entitled *Rising to Asia's Challenge: Enhanced Role of Capital Markets* (Manila, Philippines: Asian Development Bank, 2000).

merit review adversely affects the attitude of market participants. Believing that government requirements are achieved, the market participants lose the incentive to comply. They also become too dependent on the market regulators for disclosure standards and quality of information, which should be determined by the market participants themselves. The cost of enforcement thus escalates to exacerbate the degree of the moral hazard problem.

An alternative to the merit-based approach, disclosure-based regulation, was first introduced in the United States in 1933. Disclosure-based regulation was derived from the principle that the market rather than the regulators is best equipped to determine the merits of a transaction. Under this principle, investors are required to assume responsibility for their own investment decisions and should not be protected from poor judgments. Responsibility for compliance is upheld by market participants, especially securities market institutions. Market regulators are not trapped in a never-ending “cat-and-mouse game” in their search for additional information on which to base their merit assessment. Market discipline determines the merits of transactions as better-informed investors exercise greater vigilance. The US Securities and Exchange Commission, for example, does not rule on the quality of a share issue, but reviews prospectuses and proxy statements for initial public offerings (IPOs) unlike Asian market regulators and stock exchanges charged with IPO evaluation.

It is about time that Korean capital market regulators shifted away from the costly merit-based regulatory approach that is typical of traditional, top-down

regulatory regimes. It is about time that Korean market regulators embraced the disclosure-based regulatory approach which is consistent with market-based regulation widely adopted by advanced capital markets. In well-developed disclosure-based environments, institutional investors and self-regulatory organizations help raise the standard of corporate disclosure and market discipline. In a merit-based environment, however, market regulators must set up necessary standards and impose market discipline on the participants. As a result, enforcement and compliance become very costly in merit-based regulation. Furthermore, innovations by participants and efficiency in the market as a whole are not encouraged. Disclosure-based regulation, on the other hand, can achieve the opposite. Thus, it is about time that Korean market regulators changed their philosophy of capital market regulation.