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## **Adoption of the Disclosure-Based Regulation for Investor Protection in the Primary Share Market in Bangladesh: Putting the Cart Before the Horse?**

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# Adoption of the Disclosure-Based Regulation for Investor Protection in the Primary Share Market in Bangladesh: Putting the Cart Before the Horse?

## Abstract

The Bangladesh securities market, despite its operation of half of a century, remains in embryonic form. The market has been suffering from a chronic lack of investor confidence since 1997 following an unprecedented share scam. Ever since, the government has been striving in vain to promote investment by progressively offering incentives to investors and corporations. The government watchdog unexpectedly introduced the Disclosure-Based Regulation (DBR) in January 1999 to protect investors from the misfeasance of other players in the market for Initial Public Offerings. Recent studies have identified some problems in the market, which are unfavourable for the new regime. In such a situation, the governmental incentives to induce market participants and adopting the DBR to restore public confidence in the moribund securities market appear to be like using "ointment on an infection which urgently needs antibiotic injections". This article intends to argue upon critical analysis of the regime that importing the disclosure philosophy from the developed markets without attaining the pre-requisites for its usefulness is an arrangement like 'putting the cart before the horse'.

## Keywords

Adoption, Disclosure, Based, Regulation, for, Investor, Protection, Primary, Share, Market, Bangladesh, Putting, Cart, Before, Horse

## Disciplines

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# ADOPTION OF THE DISCLOSURE-BASED REGULATION FOR INVESTOR PROTECTION IN THE PRIMARY SHARE MARKET IN BANGLADESH: PUTTING THE CART BEFORE THE HORSE?

S M SOLAIMAN\*

*[The Bangladesh securities market, despite its operation of half of a century, remains in embryonic form. The market has been suffering from a chronic lack of investor confidence since 1997 following an unprecedented share scam. Ever since, the government has been striving in vain to promote investment by progressively offering incentives to investors and corporations. The government watchdog unexpectedly introduced the Disclosure-Based Regulation (DBR) in January 1999 to protect investors from the misfeasance of other players in the market for Initial Public Offerings. Recent studies have identified some problems in the market, which are unfavourable for the new regime. In such a situation, the governmental incentives to induce market participants and adopting the DBR to restore public confidence in the moribund securities market appear to be like using "ointment on an infection which urgently needs antibiotic injections". This article intends to argue upon critical analysis of the regime that importing the disclosure philosophy from the developed markets without attaining the pre-requisites for its usefulness is an arrangement like "putting the cart before the horse".]*

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## I INTRODUCTION

A vibrant capital market helps ensure the efficient and sustainable funding of government initiatives, corporations, large-scale or long-term development projects. Unlike the case in developed economies, investment games in stock markets in the third world involve two major unequal players – fund seeker corporate entities and fund provider unsophisticated small savers. A recognized informational asymmetry exists between them and hence the market is an uneven playing field. The disclosure of information affecting investment decisions in a prospectus aims to facilitate informed investment decisions by minimizing this information gap. The securities regulator in Bangladesh in January 1999 adopted the Disclosure-Based Regulation (DBR), a regulatory regime useful for the developed securities markets, for an embryonic capital market by discarding the previous merit regime without any study being conducted on the market readiness to utilize the new philosophy. Despite this significant reform in regulatory philosophy and offering of some incentives (eg, tax benefits) to both companies and investors, the market fails to restore public confidence which is evident from its continuous poor performance over the years. There have been widespread allegations of corporate misfeasance in raising funds from the primary market. Recently the Dhaka Stock Exchange, the prime bourse of the country, has discovered that a total of 19 companies out of 52 floated so far since the introduction of the DBR have ‘easily exploited general shareholders through IPOs and thus eroded the confidence of the investors significantly’.<sup>1</sup> The chairman of the Securities and Exchange Commission (SEC) took pride in introducing the DBR.<sup>2</sup> But the market, in the meantime, proved the decision to be wrong and premature. Of late, the stock exchanges have identified the DBR as one of the major impediments to the revitalisation of the securities market.<sup>3</sup> This paper intends to investigate the applicability of the DBR to the primary share market in Bangladesh by reference to some selected aspects. It also provides a brief account of origins of the DBR. The conclusions present that the DBR is inapplicable to this market mainly because of the paucity of sophisticated investors, almost non-existence of corporate governance and a profound lack of full and fair disclosure of material information in prospectuses. The discussions concentrate on some selected aspects of market readiness for the application of the DBR.

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<sup>1</sup> ADB's Capital Market Dev Project "Little Productive, THE NEW AGE, Dhaka (1 Jun 2004).

<sup>2</sup> SECURITIES AND EXCHANGE COMMISSION (SEC), DHAKA, ANNUAL REPORT 1998-1999, at 58.

<sup>3</sup> AIMS, *Waning Indices in the Bourses*, WEEKLY MARKET REVIEW (15 Mar 2003) at 1.

## II METHODS OF PROVIDING INVESTOR PROTECTION IN IPO MARKETS

The expression 'investor protection' in this paper refers to saving investors from being misled, defrauded or deceived by defective prospectuses which are prepared by promoters and directors in collaboration with their intermediaries and market professionals. This can be achieved by preventing the members of IPO coalitions (persons involved in an IPO ranging from promoters to professionals) from expropriating resources from investors. If any wrong occurs, investors should be adequately compensated and offenders should be brought to justice.

Effective regulation is considered to be the most useful mechanism of investor protection.<sup>4</sup> Since the inception of securities regulation, various philosophies, methods or systems of regulation have emerged to regulate IPO markets. A single system of regulation is not suitable for all. A country should choose a particular philosophy depending on the characteristics of its financial market.<sup>5</sup> The major systems of IPO regulation are the Merit-Based Regulation (MBR), the DBR and the Hybrid of the two (MBR and the DBR). The basic functions of regulation are two-fold. First, it prohibits frauds, and secondly, it requires companies to disclose information necessary to make informed investment decisions both at the time of the issuance of securities and periodically thereafter.<sup>6</sup>

<sup>4</sup> This view is commonly reflected in works in which investor protection has been emphasised for the development of securities markets: See R. La Porta, F. Lopez-De-Silanes & A. Shleifer, *What Works in Securities Law*, available at: <<http://post.economics.harvard.edu/faculty/shleifer/papers.html>> (2 Dec 2002); R. La Porta, F. Lopez-De-Silanes, A. Shleifer & R. Vishny, *Investor Protection and Corporate Valuation*, 57 JOURNAL OF FINANCE 1147 (2002); A. Shleifer & D. Wolfenzon, *Investor Protection and Equity Markets*, 66 JOURNAL OF FINANCIAL ECONOMICS 3 (2002); F. Lopez-De-Silanes, *The Politics of Legal Reforms*, 2 *Economia* 91 (2002); R. La Porta, F. Lopez-De-Silanes, A. Shleifer & R. Vishny, *Investor Protection and Corporate Governance*, 58 JOURNAL OF FINANCIAL ECONOMICS 3 (2000); R. La Porta, F. Lopez-De-Silanes, A. Shleifer & R. W. Vishny, *Agency Problems and Dividend Policies Around the World*, 55 JOURNAL OF FINANCE 1 (2000); R. La Porta, F. Lopez-De-Silanes, *Corporate Ownership Around the World*, 54 JOURNAL OF FINANCE 471 (1999); R. La Porta, F. Lopez-De-Silanes, A. Shleifer, *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY 1113 (1998); R. La Porta, F. Lopez-De-Silanes, A. Shleifer & R. W. Vishny, *Legal Determinants of External Finance*, 52 JOURNAL OF FINANCE 1131 (1997); A. Shleifer & R. W. Vishny, *A Survey of Corporate Governance*, 52 JOURNAL OF FINANCE 737 (1997).

However, there have been some academic scholars who oppose securities market regulation: see G. J. Stigler, *Public Regulation of the Securities Markets*, 37 JOURNAL OF BUSINESS 117 (1964). For reply to Stigler's observations, see I. Friend & E. S. Herman, *The S.E.C. Through a Glass Darkly*, 37 JOURNAL OF BUSINESS 382 (1964); S. Robbins & W. Werner, 'Professor Stigler Revisited', 37 JOURNAL OF BUSINESS 406 (1964). Stigler responded to his criticism, see G. J. Stigler, 'Comments', 7 JOURNAL OF BUSINESS 414 (1964). Nonetheless, the idea is still limited to mere academic debate. This is because, to the best of the present writer's knowledge, securities markets worldwide are regulated in one form or another with the primary objective of investor protection.

<sup>5</sup> T. H. McINISH, *CAPITAL MARKETS-A GLOBAL PERSPECTIVE* 155 (2000).

<sup>6</sup> F. H. Easterbrook & D. R. Fischel, *Mandatory Disclosure and the Protection of Investors*, in *FOUNDATIONS OF CORPORATE LAW* 303 (Roberta Romano, ed., 1993).

## A Merit-Based Regulation

The MBR originated in the US through the blue sky laws in the early 20<sup>th</sup> century.<sup>7</sup> The central concept of the MBR is that the regulator will consent to only those proposed public offers which are considered to be worthy of investment. The regulator assesses the merits of a proposed offer before consenting or refusing to consent to it. The MBR thus represents a paternalistic approach, because the regulator carries out the merit assessment on behalf of investors.

The theoretical basis of the merit regulation is that '[b]ecause of the nature of securities, a buyer cannot make an immediate value judgment, as he [or she] would with tangible items'.<sup>8</sup> The MBR is based on a philosophy which presupposes that ordinary investors are not able to make prudent investment decisions even though companies disclose all 'material information'<sup>9</sup> in relation to the issuers and their issues. It is also considered that issuers are in a better position than investors in respect of the knowledge of economic fundamentals and the potential of the business of the issuer and investment wisdom as a whole. Viewed from this perspective, the regulator assesses the merits of proposed offers and consents only to those offers which are considered to be 'fair, just, and equitable'.<sup>10</sup> In this way, the MBR protects potential investors from 'unfair' offers and maintains market integrity for 'fair' ones.<sup>11</sup> It is widely believed that the MBR is the best system for emerging markets where the market is dominated by unsophisticated retail investors.<sup>12</sup> As per the assessment of the International Organization of Securities Commissions (IOSCO), the MBR is a preferable system for developing markets especially those markets which lack professional analysts and advisers.<sup>13</sup> It is noteworthy that there have been significant volumes of literature concerning the debate on merits and demerits of both the MBR and the DBR.<sup>14</sup> The Bangladesh securities market is still

<sup>7</sup> L LOSS, TRENDS IN CORPORATE GOVERNANCE AND INVESTOR PROTECTION 36 (1981). Loss mentioned the MBR as 'homegrown regulatory or merit philosophy'.

<sup>8</sup> R L Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 610 (1964).

<sup>9</sup> The term "material information" will be discussed in section 3.4.

<sup>10</sup> LOSS, *supra* note 7.

<sup>11</sup> From the regulatory point of view, a public offer is considered to be "fair" if it is assessed by the regulator as beneficial for the investing public.

<sup>12</sup> C K Low, *Revisiting the Regulatory Framework of Capital Markets in Malaysia*, 14 COLUM. J. ASIAN L. 277, 287 fn 22 (2001). For details of the MBR at a suitable length, see P A Wellons, 'Prototypes of Securities Regulation for Africa: Key Issues', Harvard Law School, CAER II Discussion Paper No. 47 (CD-ROM) (2000) at 17-23.

<sup>13</sup> *Issuers, Market Intermediaries, and Secondary Markets* in INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS (IOSCO), OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION: A REPORT OF THE INTERNATIONAL ORGANISATION OF SECURITIES COMMISSION (Sep 1998) at 14. Available at:

<<http://www.iosco.org/doc-public/1998-objectives-document01.html>> (2 Jul 1999).

<sup>14</sup> The debate originated following the adoption of the DBR at the federal level in 1933 in the US, whilst state level securities regulation relied on the merit philosophy. For details of the debate, see Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, 'Report on State Merit Regulation of Securities Offerings', 41 BUS. LAW. 785 (1986); J S Mofsky,

pre-emerging and it is overwhelmingly dominated by retailers who seriously lack investment knowledge and who are unsophisticated in the true sense.<sup>15</sup> The market followed the MBR till the end of 1998, before the adoption of the DBR.

## B Disclosure-Based Regulation

In contrast to the MBR, the DBR relies on making 'full and fair disclosure' to the public. The DBR differs fundamentally from the MBR in that it requires that any company may be allowed to go public if it discloses all material information necessary to make informed investment decisions in its prospectus. This regime relies entirely on compliance with the disclosure requirements instead of fulfilling any threshold 'qualifications' as envisaged in the merit regime. The regulator does not assess the merit of the public offer; rather it leaves the onus of the assessment to potential investors themselves. In the DBR, the regulator is thus least concerned with the merit of public offers. The regulator, in fact, does not take any responsibility

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'State Securities Regulation and New Promotions: A Case History', 15 WAYNE L. REV. 1401 (1969); J S MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971); MATTHEW BENDER & H KRIPKE, DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979); H S Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969); E W Walker & B B Hadaway, *Merit Standard Revisited: An Empirical Analysis of the Efficiency of Texas Merit Standards*, 7 J. CORP. L. 651 (1982); M A Sargent, *Blue Sky Law: The Challenge to Merit Regulation-Part I*, 12 SECURITIES REGULATION L.J. 276 (1984); M A Sargent, *Blue Sky Law: The Challenge to Merit Regulation-Part II*, 12 SECURITIES REGULATION L. J. 367 (1985); C G Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, WIS. L. REV. 79, 81 (1976); H M Makens, *Who Speaks for the Investors? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435 (1984); M H Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1351-52 (1966); J T Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689 (1985); J T Brandi, *Merit Securities Regulation, Market Efficiency, and New Issue Stock Performance*, 12 J. CORP. L. 699 (1987), Knauss, *supra* note 8.

<sup>15</sup> Based on the state of development (in terms of per capita Gross National Income as well as the market performance) securities markets worldwide have been broadly divided into two categories, namely, developed and emerging markets. The markets in the countries which have achieved the high per capita Gross National Income fixed by the World Bank are designated as developed markets and the remaining markets are said to be emerging ones. For details of the market classification, see Standard & Poor's, *Emerging Stock Markets Factbook 2002* (2002) New York: Standard and Poor's at 30 & 352. The market in Bangladesh falls under the broad category of emerging markets. However, there have been significant differences amongst the emerging markets in terms of their achievements and performance. In view of these differences, a new division was introduced in September 1996 and currently, a total of 20 of the emerging markets as covered by the Standard and Poor's have been identified as "frontier markets". The frontier markets are those which are "relatively small and illiquid even by emerging market standards": Standard & Poor's, 'S & P Frontier Index Series', available at: <<http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/Page/IndicesIndexPg&r=1&b=4&s=6&ig=44&l=EN&i=64&xcd=FRONT>> (19 Jun 2003). The Bangladesh market has been placed in the frontier market category: Standard & Poor's, *Emerging Stock Markets Factbook 2002* (2002) New York: Standard and Poor's at 33 & Standard & Poor's (Apr 2002) *Emerging Stock Markets Review* at 218. Similarly, the United Nations Conference on Trade and Development (UNCTAD) designated the stock markets of least developed countries 'pre-emerging market': UNCTAD, *Investing in Pre-Emerging Markets: Opportunities for Investment of Risk Capital in the LDCs* (1998) New York: United Nations. Accordingly, the UNCTAD included the Bangladesh market as pre-emerging one.

ity with respect to the merits of an offer and such a disclaimer shall be published 'bold type face' (upper case) in the prospectus.<sup>16</sup>

As regards the theoretical basis for the DBR, the disclosure philosophy is that, once the facts about the issue and the issuer are made public properly, investors have no one but themselves to blame for their investment decisions. The sole responsibility of the regulator is 'to ensure the full and fair disclosure' in the prospectus in order to enable investors to make informed investment judgments.<sup>17</sup> This is consistent with the prime objective of corporate disclosures which allow investors to make 'informed, rational investment decisions as to the best estimate of the price of the securities'.<sup>18</sup>

The IOSCO considers that the DBR is beneficial for developed markets.<sup>19</sup> However, the securities regulator in Bangladesh adopted the DBR in January 1999 for a frontier or pre-emerging market.

### **C Hybrid of the MBR and DBR**

A hybrid system of regulation combines the characteristics of the above two systems, the MBR and the DBR. This system may be applied by allowing some relaxation in the merit requirements and exempting some selected public offers from the regulatory merit review. A securities regulator may adopt this hybrid approach as an interim arrangement during the shift from the MBR to the DBR. Malaysia, for example, adopted this system for the period of its transition from the MBR to the DBR during the period between 1996-2002.<sup>20</sup>

## **III THE DBR AND THE REALITY IN THE BANGLADESH IPO MARKET**

### **A Origins of the DBR**

The genesis of the DBR can be traced in the UK in the middle of the 19<sup>th</sup> century.<sup>21</sup> English law first recognised the need for regulating public issues of securities and its initial enactment for such regulation was the *Bubble Act* 1720.<sup>22</sup> Basically, the

<sup>16</sup> See Public Issue Rules 1998 r7(B)(1)(i)

<sup>17</sup> Public Issue Rule 1998 r7(B)(1)(i).

<sup>18</sup> L C KEONG, *SECURITIES REGULATION IN MALAYSIA* 110 (1997).

<sup>19</sup> See 'Issuers, Market Intermediaries, and Secondary Markets' in IOSCO (1998) at 14.

<sup>20</sup> Low, *supra* note 12 at 287 fn 22, Securities Commission, *Market Readiness for Disclosure-Based Regulation* (July 2002) available at <[http://www.sc.com.my/html/whatsnew/fr\\_whatsnew.html](http://www.sc.com.my/html/whatsnew/fr_whatsnew.html) (29 Nov 2002). In Malaysia, transition from the MBR to the DBR had been completed in March 2003: SECURITIES COMMISSION, PRESS RELEASE (31 Mar 2003)

<sup>21</sup> LOSS, *supra* note 7, at 36.

<sup>22</sup> Knauss, *supra* note 8. This source mentioned that the Bubble Act was of 1719. But many other sources show that it was an Act of 1720. For example, see J B BASKIN & P J MIRANTI JR, *A HISTORY*



Act was not concerned with the regulation of corporate disclosures. The Act which was repealed in 1825 imposed restrictions on the formation of joint-stock companies to combat corporate frauds, and eventually halted the growth of joint-stock companies.<sup>23</sup> Frauds in the securities market continued and a committee (Gladstone Committee) was appointed in 1841 to investigate the laws concerning joint-stock companies for the purpose of providing greater protection to the public.<sup>24</sup> The *Companies Act 1844* was enacted following the report of the Gladstone Committee, and became the 'real beginning of English corporations law'.<sup>25</sup> The genesis of the modern disclosure requirements in a prospectus can be found in this Act.<sup>26</sup> However, the contents of a prospectus were first detailed in the English *Companies Act 1867*.<sup>27</sup> To provide civil remedies against the violation of disclosure requirements, the British Parliament enacted the *Directors Liability Act 1890*. This legislation modified the common law tort of deceits as expounded by the House of Lords in *Derry v Peek* with regard to the requirements of scienter.<sup>28</sup> It made the directors and promoters of a company the subject of civil liabilities for untrue disclosures in a prospectus without the proof of scienter.<sup>29</sup> The English *Company Act 1900* further 'tightened' the civil liabilities of persons involved in a prospectus. The *Company Act 1948* 'established the hitherto most extensive legal disclosure requirements under English law'.<sup>30</sup> However, the success of the disclosure requirements greatly owed to the corresponding listing requirements of the London Stock Exchange during the first half of the 1900s.<sup>31</sup>

Although the US followed the UK in formulating its (US) securities regulation regime, the US did not adopt the disclosure philosophy until 1933. Securities regulation was the subject matter of state governments exclusively till 1933. Most of the state securities laws were enacted in order to follow the merit philosophy and still many states adhere to this philosophy in preference to the DBR.<sup>32</sup> Following the unprecedented securities market crash in 1929, the US introduced securities regula-

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OF CORPORATE FINANCE 111 (1997); L LOSS, FUNDAMENTALS OF SECURITIES REGULATION 2 (2<sup>nd</sup> ed. 1988)

<sup>23</sup> Knauss, *supra* note 8, at 611.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> LOSS, *supra* note 22. For some details of that disclosure requirements, see Knauss, *supra* note 8, at 611-12.

<sup>27</sup> Knauss *id.* at 612.

<sup>28</sup> (1889) 14 App Cas 337.

<sup>29</sup> LOSS, *supra* note 22, at 3.

<sup>30</sup> K Pistor & C Xu, *Incomplete Law: A Conceptual and Analytical Framework and Its Application to the Evolution of Financial Market Regulation* (2002). Available on Social Science Research Network at <<http://ssrn.com>>.

<sup>31</sup> See, for details, Knauss, *supra* note 8, at 612.

<sup>32</sup> L. Loss, *Disclosure as Preventive Enforcement*, in, CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES 327 (KLAUS J HOPT & GUNTHER TEUBNER, eds., 1985). As of 1978, approximately 46 states followed the MBR in varying degrees: Brandi (1985), *supra* note 14, at 696. As of 1995, there were a total of 22 US states which follow merit regulation: P D Lehmkuhl, *Securities Law in the United States of America: Blue Sky Laws*, in INTERNATIONAL SECURITIES LAW HANDBOOK 245, 249 (K V D HEYDT & S KELLER, eds., 1995)

tion at federal level for inter-state offerings and adopted the DBR by enacting the *Securities Act* 1933.<sup>33</sup>

Although the British *Company Act* 1844 incorporated the DBR for the first time in the modern history, the adoption of this philosophy by the US in 1933 significantly influenced the other nations to follow this suit. The US Supreme Court expounded the DBR as the substitution for the philosophy of *caveat emptor* for financial products.<sup>34</sup> Justice Brandeis<sup>35</sup> might be called the 'spiritual father' of the *Securities Act* 1933 as suggested by Loss.<sup>36</sup> In regard to corporate disclosures, Brandeis said in 1913 that '[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman'.<sup>37</sup> However, he recognised that 'excessive sunlight can cause skin cancer'.<sup>38</sup> A different view with respect to the justification of the adoption of the DBR was evident at its very beginning in the US. Commenting on the disclosure philosophy entrenched in the *Securities Act* 1933, Justice Douglas of the US Supreme Court in 1934, a few years before being the chairman of the US Securities and Exchange Commission, opined that:

[T]hose needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant.<sup>39</sup>

During the period of the 1990s, many countries have adopted this disclosure system. For example, Asian countries had been applying the MBR for a long time.

<sup>33</sup> Securities Act 1933 (is the first federal securities law enacted for the regulation of the primary market. Before this enactment, the regulation of securities market was a concern of the state governments. These states governments mainly pursued the philosophy of merit-regulation under the respective "blue-sky laws" (US state securities laws. See, for detail, Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, *Report on State Merit Regulation of Securities Offerings*, 41 BUS LAW 785 (1986); J F Hueni, *Application of Merit Requirements in State Securities Regulation*, 15 WAYNE L. REV. 1417-1445 (1969). Still many states have been following the merit-regulation in US. In 1995, 22 states followed the merit regulation: see Lehmkuhl *id* at 249. The US system thus has a disclosure-based foundation but substantial merit elements are built upon it: see J H Honea, *An Empirical Study of Usefulness and Communicative Ability of Segment Disclosures among Sophisticated Users of Corporate Financial Statements* (1982) an unpublished Ph D dissertation submitted to the Louisiana State University and Agricultural and Mechanical College, UMI Dissertation Service at 28.

<sup>34</sup> SEC v Capital Gains Research Bureau Inc 375 US 180 (1963) 186; *Affiliated Ute Citizens of Utah v United States* 406 US 128 (1972) 151.

<sup>35</sup> Justice Louis D Brandeis became a Justice of the US Supreme Court in 1916 and retired in 1939: T K MCCRAW, *PROPHETS OF REGULATION* 135 (1984).

<sup>36</sup> LOSS *supra* note 22, at 32.

<sup>37</sup> L D BRANDEIS, *OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT* 62 (1933) It was first published in *Harper's Weekly*, 1913-1914.

<sup>38</sup> Loss, *supra* note 32, at 331.

<sup>39</sup> *Id.*

Since the middle of the 1990s, some of these countries started adopting the DBR system as espoused in Western developed markets.<sup>40</sup>

## **B Information to be Disclosed in a Prospectus**

There have been two standards for the determination of the contents of a prospectus under the DBR. One is 'non-prescriptive' or 'general disclosure standard' and the other is 'prescriptive' or 'minimum disclosure standard'. The former standard does not have any strictly prescribed list of issues concerning disclosures and it requires the issuer to disclose all material information necessary to make informed investment decisions. Hence, it is the issuer, not the regulator, who is responsible for the contents of its prospectus. Usually, developed markets follow this standard. On the other hand, the latter, the minimum disclosure standard, provides for a specific list of information which must be embodied in a prospectus. Under such a standard, the securities regulator may ask for further information, if it deems necessary. This standard is well favoured in emerging markets, and is followed in Bangladesh.

## **C Legal Requirements for Disclosures under the Bangladesh Law**

Disclosures with respect to IPOs are regulated under the *Companies Act 1994* (CA'94) and the *Securities and Exchange Commission Public Issue Rules 1998* (PIR'98). Section 135 of the CA'94 prescribes the contents of the prospectus. These contents were formulated for the purposes of the previous merit regulation regime. The DBR requires greater disclosures which have been articulated in r7B of the PIR'98. Under r7B, the prescribed information to be embodied in the prospectus makes a long list. In brief, the prospectus shall contain: the basic particulars of the IPO such as the amount and type of securities being issued, offering price, commis-

<sup>40</sup> The securities markets in Japan, Singapore Hong Kong are developed markets. None of them adopted the DBR until recently. Japan adopted the DBR in 1997, Singapore adopted a predominantly disclosure-based regulation in 1998 and Hong Kong undertook a four-year plan (1998-2001) to shift from the MBR to the DBR. See, for details, Corporate Research Centre, *Disclosure-Based Regulation*, REGIONAL MONITOR available at:

<<http://www.hkex.com.hk/library/reports/issue31.htm>> (26 Nov 2001).

As emerging markets, India adopted the DBR in 1992 and Malaysia started moving towards the DBR in 1996 and could not complete the total shift from the MBR to the BDR Until March 2003. For details of Malaysian position, see Securities Commission, Malaysia (SC), *Malaysian Capital Market Completes Transition to DBR with Release of Revised Fund-Raising Guidelines* PRESS RELEASE (31 Mar 2003); SC, *SC Studies Market Readiness for Full Disclosure-Based Regulation*, PRESS RELEASE (2 Apr 2001); SC, *SC Amends Issued Guidelines to Support Second Phase of DBR*, PRESS RELEASE (30 Dec 1999); SC, *SC Encouraged by Positive Market Response to Plans for New Disclosure-Based Regulatory Framework*, PRESS RELEASE (8 Jul 1999); SC, *Disclosure-Based Regulation- What Directors Need to Know* (SC In-House Publication issued in Nov 1999); and SC, *Market Readiness for Disclosure-Based Regulation* available at:

<[http://www.sc.com.my/html/whatsnew/fr\\_whatsnew.html](http://www.sc.com.my/html/whatsnew/fr_whatsnew.html)> (29 Nov 2002).

sions to be given to intermediaries etc; risk factors; the use of proceeds; the description of business; the description of property held by the issuer; the plan of operation and the description of financial condition; the description of directors and officers; the involvement of officers and directors in certain legal proceedings; certain relationships and related transactions between the company and the directors and officers; executive compensation, options granted to the officers, directors and employees of the company; transactions with promoters; the ownership of the company's securities, the determination of offering prices, the plan of distribution of securities and their market; the description of securities outstanding or being offered; and financial statements.

The PIR'98 thus provides for the details of all material information in order to enable investors and their investment advisers to make informed investment decisions. Apart from these, the SEC may require the disclosure of additional information in a particular prospectus.<sup>41</sup> In brief, it can be said that the PIR'98 covers the aspects of investors' considerations which a knowledgeable investor may wish to know before arriving at an investment decision. The PIR'98 actually complemented the CA'94 in order to meet the requirements of the new regime of disclosure regulation.

## **D      *Material information***

There are no hard and fast rules as to which information is material with respect to investment in securities. In *Cackett v Keswick* the Court of Appeal in the UK held that, a statement will be material if it would have an impact on a reasonable investor, or such an investor is influenced or induced in making an investment decision on the basis of the prospectus.<sup>42</sup> Lord Halsbury LC in *Arnison v Smith* made a classic formulation of inducement by saying that:

A person reading the prospectus looks at it as a whole.... You cannot weigh the elements by ounces...if a court sees on the face of the statement that it is of such a nature as would induce a person to enter into the contact, or would tend to induce him to do so, or that it would be part of the inducement to enter into the contact, the inference is, if he [or she] entered into the contact, that he [or she] acted on the inducement.<sup>43</sup>

In relation to the materiality of an omitted fact, the US Supreme Court held in *TSC Industries Inc v Northway Inc* that:

It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is the showing of a substantial likelihood that, under all the circumstances, the omitted fact would have as-

<sup>41</sup> See for the contents and format of a prospectus under the DBR, Public Issue Rules 1998 r7A(2).

<sup>42</sup> [1902] 2 Ch 456 para 2 (per Farwell J).

<sup>43</sup> (1889) 41 Ch D 348, 369.

sumed actual significance in the deliberations of the reasonable shareholders. Put another way, there must be a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.<sup>44</sup>

The above judicial observations suggest that a disclosed fact should be considered material if a reasonable investor considers the fact in question important in making an investment decision based on the prospectus. In the case of an omitted fact, the materiality would be determined on a substantial likelihood that a reasonable investor would consider the matter important in deciding on the offer if it were disclosed. Thus the materiality of information is consistent with the reasonability test.<sup>45</sup>

In Bangladesh, both the unfair disclosure as well as non-disclosure of material information are prohibited. However, there has been no statutory definition of the term 'materiality' in any of the relevant laws. In addition to the specifically required and additional information as alluded to earlier, the rule 7(A)(1) of the PIR'98 with regard to material information provides that:

[T]he prospectus shall contain all *material information* necessary to enable investors and their investment advisers to make an informed assessment of the business engaged in, or to be engaged in, by the company, its assets and liabilities, its financial position, its profits and losses and its future prospectus and the rights attaching to the securities being offered and, in case of more than one project being included in the proposed initial public offering, separate full disclosure for each project [emphasis added].

It is thus clear from the above discussion that a prospectus shall contain all information in relation to both the issuer and the issue that may be of the interest of investors in making investment decisions.

## **E Full and Fair Disclosure**

The primary function of disclosure is to eliminate the informational asymmetry between issuers and potential investors. With this end in view, President Roosevelt proposed to introduce the DBR in the United States.<sup>46</sup> He pointed out that:

<sup>44</sup> (1976) 426 US 438,448.

<sup>45</sup> For the statutory meanings of the "concept of materiality" as adopted in Australia, Belgium, Canada, France, Germany, Italy, Hong Kong, Japan, Luxembourg, The Netherlands, Spain, Switzerland, United Kingdom and United States, see IOSCO, COMPARATIVE ANALYSIS OF DISCLOSURE REGIME (1991) Appendix A. It is the report of the Technical Committee of the IOSCO submitted in September 1991.

<sup>46</sup> Until the enactment of the Securities Act 1933, there was no central regulatory body for the securities market in the US. It was the states responsibility to regulate the market in pursuance of the respective securities laws - the so-called blue-sky laws, of the state concerned (the first law of this kind was enacted in Kansas in 1911, which sought to protect investors). All the state laws fol-

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 present 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.

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.<sup>47</sup>

Full and fair disclosure typically refers to complete, accurate and timely disclosure of the affairs of issuers as well as the underlying issues. An issuer of securities shall ensure that the prospectus contains all material information necessary to make informed investment decisions by the potential investors. This information has to be free from any material omission or misleading elements.

The primary thrust of the DBR was to ensure truth in securities issuance. To achieve this goal, the new system imposes the burden of telling the whole truth upon the seller of securities. However, ensuring honest and diligent performance of the issuers and intermediaries in this respect is complex particularly in a country like Bangladesh. One of the most crucial objections against the disclosure regime is the difficulty of ensuring full and fair disclosure. Generally, an issuer is much more powerful than most investors. The issuer's strength is measured in terms of professional knowledge, business techniques, and political support.<sup>48</sup>

Generally, the promoters and directors of companies have both institutional education and practicing experience in relation to business. In addition, each company is supposed to hire qualified people having expertise in law, finance, accounting and economics.<sup>49</sup> In Bangladesh, the vast majority of investors have hardly any knowl-

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lowed the MBR. The above Act of 1933 introduced the current central regulation and, at the same time, adopted the philosophy of the DBR for the first time: Corporate Research Centre, *Disclosure-Based Regulation*, *supra* note 40.

<sup>47</sup> H R Rep No 85 73<sup>rd</sup> Congress, First Session 2 (1933) quoted in CORPORATE RESEARCH CENTRE *ibid*.

<sup>48</sup> For example, the former two presidents of the Federation of Bangladesh Chamber of Commerce and Industries (FBCCI), Mr Salman F Rahman and Mr Abdul Awal Mintu, contested the National Election 2001 with the tickets from two major political parties (Bangladesh Awami League and Bangladesh Nationalist Party) respectively. It is widely believed that the businessmen are used to paying considerable amounts of money to the fund of the political parties. Their financial superiority over the individual investors is needless to explain.

<sup>49</sup> Knowledge on these subjects is most relevant for a public issue, and for defending the company for any pertinent fault.

edge of investment.<sup>50</sup> More importantly, they do not even have adequate financial solvency to get their portfolios managed by professionals, even if such a service becomes available. Moreover, investors are not able to bring issuers to the court to redress the violation of law mainly because of financial deficiency. Therefore, from a practical point of view, the issuers are superior to the general investors in terms of investment knowledge as well as financial ability. Perhaps the lack of financial sophistication of investors has contributed to the non-availability of professional advisory services in the Bangladesh market.<sup>51</sup> Thus it is easy to understand why, although the market is half a century old, it has been seen as an 'infant' market.<sup>52</sup>

Generally speaking, most businesspersons in Bangladesh are involved in party politics directly or indirectly.<sup>53</sup> By virtue of their political affiliation and financial strength, they might feel some sort of 'implied immunity' against any legal course of action (judicial or regulatory), and thereby become less honest in their preparation of the prospectus. The influence of their money and political alliance (or contribution to parties' funds) is best evident in the unusual delays of 15 criminal cases instituted by the SEC in 1997 pursuant to the inquiry report on the share scam 1996. In three out of 15 of these cases, the deputy chairman of the Beximco Group of Companies (Beximco), country's largest industrial conglomerate,<sup>54</sup> amongst others, was implicated. None of the above cases has yet been finally disposed of.<sup>55</sup> The Appellate Division of the Supreme Court in *Shainpukur Holding Ltd v Securities and Exchange Commission*<sup>56</sup> (one of the above 15 cases) observed that:

It is true that in criminal matters the accused should get all protection under the law but it is also important that the law should not be stretched too far so that big companies against whom serious allegation of foul play concerning national economy is being made before the Court by a statutory authority [SEC] can themselves overtake the law by raising ingenious contentions in order to frustrate the prosecution on the threshold.<sup>57</sup>

<sup>50</sup> ENQUIRY COMMITTEE, ENQUIRY REPORT ON SHARE MARKET 12 (1997)

<sup>51</sup> INVESTOR INFORMATION CELL, CSE, Mr K U Jalal <iic@csebd.com> email (10 Apr 2003)

<sup>52</sup> M O Imam, *Capital Market Development in Bangladesh: Problems and Prospects*, PORTFOLIO 43, 46 (Oct-Dec 2000).

<sup>53</sup> A recent research shows that a total of 78 per cent of companies "give donations to political parties or candidates": *Corporate Funds Flow into Political Pockets: 78% Firms Pay Political Parties*, CDP Research Reveals, THE DAILY STAR, Dhaka (5 Aug 2002).

<sup>54</sup> Mr Salman F Rahman is the Deputy Chairman of Beximco Group of Companies, the largest private sector industrial conglomerate in Bangladesh having a total of 28 companies. This group had 11 companies listed with the DSE out of a total of 224 listed companies as at 30 June 2001. He was the president of the Federation of Bangladesh Chamber of Commerce and Industry (FBCCI), the apex body of the businessmen of the country, and the Chamber of South Asian Association of Regional Cooperation (CSAARC).

<sup>55</sup> SECURITIES AND EXCHANGE COMMISSION, SEC Quarterly Review (Jul – Sep 2004), Dhaka at 19.

<sup>56</sup> 18 BLD (1998) 61.

<sup>57</sup> *Shinepukur Holding Ltd v Securities and Exchange Commission* 18 BLD (AD) (1998).

One of the main reasons for the delay is believed to be the financial strength and political connections of the accused.<sup>58</sup> More surprisingly, there are no reported cases in the last 20 years concerning the misstatement or concealment of material facts in prospectuses, although such statutory requirements<sup>59</sup> have reportedly been violated on several occasions.<sup>60</sup> In this way, the issuers and investors cannot be seen as parties of equal status in respect of IPOs.

It should be pointed out that to take advantage of such weakness of investors, many issuers adopt unfair means in preparing prospectuses by concealing material facts and/or embodying false and misleading information. In support of this allegation, some eminent auditors of the country observed that 'though financial reports is [sic] prepared by the management, very often auditors do not discharge their duties from the point of professional ethics'.<sup>61</sup> The relationship between the companies and their auditors is so unethical that the SEC had to promulgate a new rule to combat professional unfairness and unethical conduct.<sup>62</sup> In accordance with this new rule issued by the SEC on 26 November 2001, companies were barred from appointing the same audit firms consecutively for more than three years. The High Court Division of the Supreme Court on 20 May 2002 stayed the operation of this rule upon the petition from the Beximco.<sup>63</sup> There are reports to show that such unfair practices are rife. In so doing, either material information has been concealed, and/or false and misleading information has been furnished.<sup>64</sup> Hence, the situation

<sup>58</sup> For the reasons for such delay and influential role of the accused, see M S Rahman, "Justice Should Not be Done, but Must be Seen to be Done": Prosecution Lawyer Opposes Transfer of Beximco Share Scam Cases, THE DAILY STAR, Dhaka (5 Apr 1999); M S Rahman, Hearing of '96 Share Scam Cases: Defence Charged with Delaying Tactic, THE DAILY STAR, Dhaka (15 Mar 1999); M S Rahman, Cases on Share Scam Move at Snail's Pace: Hearing on Charge Framing Begins September 24, THE DAILY STAR, Dhaka (1 Sep 2000); M S Rahman, Share Market Case: Lengthy Hearing on Charge Framing Goes on Innocent Acts Can be Illegal if Taken Together-Prosecution, THE DAILY STAR, Dhaka (7 Jan 1999); M S Rahman, Share Scam Case: Proceedings Against 2 Directors of 2 Firms Quashed, THE DAILY STAR, Dhaka (24 Jun 1999); M S Rahman, Share Scam: A Stormy Session at High Court, THE DAILY STAR, Dhaka (8 Jun 1999); HC Judge, Defence Lock in Debate over "Fair Hearing", THE DAILY STAR, Dhaka (4 Mar 1999); Beximco Case Embarrassed HC Judge, THE DAILY STAR, Dhaka (5 Mar 1999); 1996 Share Scam: Supreme Court Judgment on Merit of the Cases, THE DAILY STAR, Dhaka (31 Dec 1998); M S Rahman, Judges, When Transferred, Do Not Carry Their Jurisdiction Along, THE DAILY STAR, Dhaka (19 May 1999); M S Rahman, SEC, State Lawyers Tell Court: Transfer of Share Scam Case to Raise Questions, THE DAILY STAR, Dhaka (20 May 1999); Plea to Transfer 3 Share Scam Cases Rejected, THE DAILY STAR, Dhaka (8 Apr 1999); M S Rahman, 1996 Share Market Scam: Charges Framed against Former DSE Chief, THE DAILY STAR, Dhaka (5 Apr 1999); 3 Share Market Cases Referred to MSJ Court, THE INDEPENDENT, Dhaka (15 Mar 1999); Hearing in 3 Share Scam Cases Resumes, THE DAILY STAR, Dhaka (9 May 2001); Share Scam: 2 Beximco Companies Move Petition for HC Stay, THE DAILY STAR, Dhaka (4 Jun 2001); Share Scam Case: HC Turns Down Petition by Beximco Cos, THE DAILY STAR, Dhaka (5 Jun 2001).

<sup>59</sup> See Companies Act 1994 s135.

<sup>60</sup> See for example, *infra* note 64

<sup>61</sup> D N Saha, New SEC Law Removes Monopoly of Audit Firms, THE INDEPENDENT, Dhaka (14 Nov 2001).

<sup>62</sup> *Id*

<sup>63</sup> HC Stays Two Notifications of SEC, THE FINANCIAL EXPRESS, Dhaka (21 May 2002).

<sup>64</sup> AIMS of Bangladesh Limited cancelled their commitment for underwriting the floatation of Modern Food Products Limited after the publication of the prospectus. AIMS decided on this can-



demonstrates that many issuers are issuing defective prospectuses in collaboration with the other members of IPO coalitions.<sup>65</sup> In a report by Khan, an experienced accountant, it was observed that, 'most of the CA [Chartered Accountants] firms

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cellation after detecting that the audited account of the company provided to them by the Merchant Bankers and Issue Manager of the issue differed from the one published on the prospectus and concealed material facts. The audit report on the prospectus had been qualified by the auditors for not complying with Bangladesh Standard of Accounting (BSA) 4 and 16 on fixed asset schedule. It was also exposed that the sponsors of the issuer are bank loan defaulters. The bad loan liability and litigation against them have been understated and concealed at Taka 5.205m against actual Tk 13.465m: see AIMS, *AIMS Ditches Modern Food*, WEEKLY MARKET REVIEW (10 Jul 2000) at 1; M S Rahman, *AIMS Backs Down on Pledge to Underwrite Modern Food: Audited Accounts Differ from Prospectus Statement*, THE DAILY STAR, Dhaka (3 Jul 2000).

The SEC has sued the directors of Wonderland Toys Ltd and its Issue manager (National Securities and Consultant Ltd) for allegedly "inducing the investors into purchasing its shares by artificially showing a rosy picture of the company". The company went for an IPO of Tk 50 million. In its prospectus, the company showed that Wonderland's counterpart in Hong Kong had provided them with the plant and machinery as per a joint venture agreement and all the machinery had been installed. The SEC filed the case based on its inquiry reports. The SEC complaint stated that "[a]ll these claims are outright false, deceptive and an illegal bid to gain by providing false information with a view to luring investors into buying its shares". It may be mentioned here that Wonderland failed to make any profit and pay dividends for two consecutive years. For detail, see M S Rahman, *Court Summons Wonderland Toys Directors for Alleged Deception: Fake IPO Info Make Investors Buy Scrips*, THE DAILY STAR, Dhaka (19 Jan 2001).

Audit firm M/S Ata Khan & Co had been accused of certifying false statements by two companies on their balance sheets. The SEC inquiry as well as the investigation of the disciplinary committee of the Institute of Chartered Accountants of Bangladesh (ICAB), the professional statutory body of accountants, found the firm guilty for certifying balance sheets of two companies showing inflated amounts of bank liability. These two green field companies' sponsors sought to raise Tk 360 million from the IPOs. For details, see M S Rahman, *Auditing Firm under SEC-ICAB Fire*, THE DAILY STAR, Dhaka (21 Apr 1998).

FU-Wang Ceramic Industry Limited, a Taiwanese-owned company, concealed tax evasive information in its prospectus for an IPO to raise Tk 50 million which was revealed during the subscription period. Such information is required to be published under the prevailing law and international accounting practices, which have been adopted by Bangladesh: see T I Khalidi, *IPO to Raise Tk 5 cr by Taiwanese Tiles Producers: Fu-Wang Conceals Information*, THE DAILY STAR, Dhaka (11 Feb 1998).

Madina Shoe Industries Ltd submitted a petition for IPO for the SEC's approval. The petition enclosed a due diligence certificate with the forged signature of a director. Later, the SEC turned down the application. The SEC detected the forgery when directly contacting the director: see M S Rahman, *SEC Turns Down Madina Shoe's IPO Petition: Allegation of Submitting False Documents*, THE DAILY STAR, Dhaka (12 Jun 2000).

The SEC suspended the IPO of Raspi Data Management and Telecommunications Ltd by accusing the company of inflating its assets. An investigation conducted upon a complaint by some internet services providers led to this accusation: see M S Rahman, *SEC Suspends Raspi IPO, Orders Special Audits: Auditor to be Selected by the Company*, THE DAILY STAR, Dhaka (15 Sep 2000).

Keya Cosmetic Ltd, a reputed company, allegedly concealed the evasion of a huge amount of Value Added Tax (VAT) in its prospectus. The company offered IPO for Tk 25 million whereas the alleged amount of evaded tax was Tk 390 million: see M S Rahman, *Alleged Tax Evasion by Keya: SEC May Ask Co to Issue Public Notice*, THE DAILY STAR, Dhaka (15 Jun 2001).

There are more cases supporting the adoption of unfair means by the issuers, intermediaries and/or auditors to raise fund for the firms from the public, but could not be mentioned due to space constraints.

<sup>65</sup> For raising money from the public through unfair disclosures, see for example, K A Mansoor, *Share Scandal: Some Companies Looted 500 Crore Taka*, THE DAILY JANAKANTHA, Dhaka (15 Jun 2002) (translated from Bengali).

don't bother to verify the books of records adequate enough to make their audit reports true and fair'.<sup>66</sup> This report also claims that the 'irresponsible signing of audit reports by most of the audit firms are discouraging the few firms that are still struggling to maintain auditing standard'.<sup>67</sup> By reiterating the lack of confidence, recently, the Finance Minister has advised the DSE officials to stop indulging in market manipulation. In response to this request, the officials highlighted the fact that the financial reports of companies lack transparency.<sup>68</sup> Thus the submission of false or misleading reports by auditors is one of the reasons for the prevalence of the lack of proper and adequate disclosure in Bangladesh.<sup>69</sup>

In such a situation, it would be really difficult to ensure full and fair disclosure in prospectuses. If the information is not disclosed properly, the investors cannot make informed decisions even if they are able to utilise the disclosure in a prospectus. When the assurance of full and fair disclosure is frustrated, the whole objective of the disclosure regime becomes futile, because, incomplete and inaccurate information cannot help investors make informed investment judgments. Instead, such disclosure can lead to deception. Since the vast majority of investors in Bangladesh are unsophisticated, they are unable to invest further, once they lose their life savings. Thus they stay away from the market. In such circumstances, the new investors cannot put their trust in the market, and as a result, the market suffers from lack of investor confidence. All of these observations ensure that it would be unrealistic to expect full and fair disclosure in prospectuses in the prevailing circumstances.

## F Due Diligence of the Persons Involved in an IPO Coalition

The term 'due diligence' implies '[a] close examination, particularly in a legal sense, of a transaction and its related documentation'.<sup>70</sup> In respect of disclosure, due diligence is a process by which inquiries are conducted to ensure that information to be disclosed is true, sufficient and timely. Persons involved in the preparation of a prospectus must undertake a due diligence exercise to verify and ensure the accuracy, completeness and timeliness of information to be disclosed to the public. They should demonstrate a minimum standard of conduct which provides safeguards against the contravention of relevant regulatory provisions and adequate

<sup>66</sup> K A Khan, *Auditors' Responsibility*, THE DAILY STAR, Dhaka (5 Jan 2002). The report further mentions that the auditors do not have propensity to maintain the auditing standard due to lack of accountability and supervision. Most of the firms are engaged in unjustifiable competition to increase the number of their clients. The writer is a well-known accountant and auditor of the country.

<sup>67</sup> *Id.*

<sup>68</sup> THE PROTHOM ALO, Dhaka (13 Feb 2002) (translated from Bengali).

<sup>69</sup> Imam (2000) *supra* note 52, at 56. Even Mr Amir Khosru Mahmood Chowdhury, the founder president of the Chittagong Stock Exchange and currently Minister for Commerce has described the condition of disclosure standard as "deplorable". See A K M Chowdhury, *The Capital Market of Bangladesh: Present & Future*, PORTFOLIO 13, 13 (Oct-Dec 2000).

<sup>70</sup> P E NYGH & P BUTT (EDS), BUTTERWORTHS AUSTRALIAN LEGAL DICTIONARY 393 (1997).

supervision ensuring that the system is properly carried out.<sup>71</sup> The central point of due diligence is that the persons involved in a transaction or a documentation must exercise their powers and carry out their duties with care and diligence. Their role must satisfy a standard that a reasonable person would exercise his or her powers and perform duties in the same manner under the same circumstances.

Various persons adopt unfair means in various forms. The examples of unfair practices as noted earlier show that directors' signatures are forged; intermediaries and auditors provide due diligence certificates by concealing material information or embodying untrue and false information. At times, the issuers are getting auditors' reports prepared without exercising due diligence. Subsequently, such issuers are submitting these imperfect reports to underwriters to convince them that they should enter into an underwriting agreement. After obtaining underwriting agreements, the issuers publish in their prospectuses different financial statements which are at odds with the previous audit reports. For example, as discussed earlier, this happened in July 2000, when Asset & Investment Management Services (AIMS) withdrew its underwriting pledge with Modern Food Products Limited. Despite the existence of such prohibited practices, remedial action against the auditors is seldom heard of in Bangladesh.<sup>72</sup> Until December 2000, the SEC has filed at least 12 complaints against different audit firms with the Institute Chartered Accountants of Bangladesh (ICAB),<sup>73</sup> but the ICAB suspended in a single instance one of its members for one year only.<sup>74</sup> Recently, speakers in a seminar on the Capital Market Development in Bangladesh have identified unfair disclosure as one of the fundamental problems that the market is currently encountering.<sup>75</sup> Disclosing the hidden reality of the audit reports, a SEC official commented that:

Audit reports and balance sheets of many listed companies, approved at their annual general meetings, were found to have been tailored to suit the needs of the sponsors and deprive shareholders of dividends.<sup>76</sup>

A similar comment is found in a study on investor protection. It says that '...audits of some companies are cooked up in a tailor-made way'.<sup>77</sup> Thus the fabrication of audit reports is a well established practice in this market.

In light of the above-mentioned malpractice, this analysis suggests that neither companies nor auditors are following legal and ethical standards in auditing com-

<sup>71</sup> Universal Telecasters (Qld) Ltd v Guthrie (1978) 18 ALR 531; 32 FLR 360. See also SPCC v Kelly (1991) 5 ACSR 607.

<sup>72</sup> The SEC filed at least 12 complaints against auditors to their professional statutory body (ICAB) for punishment. The ICAB in one instance suspended one of its members for one year: see M S Rahman, *SEC Draws the Line for Auditors: Firms Violating International Standard to be Black Listed*, THE DAILY STAR, Dhaka (24 Dec 2000).

<sup>73</sup> The ICAB is the statutory self-regulatory body for accounting professionals.

<sup>74</sup> M S Rahman *SEC Draws the Line for Auditors: Firms Violating International Standard to be Black Listed*, THE DAILY STAR, Dhaka (24 Dec 2000).

<sup>75</sup> See *Stability in Capital Market Sought*, THE INDEPENDENT, Dhaka (6 Oct 2000).

<sup>76</sup> Rahman, *supra* note 74.

<sup>77</sup> M Hossain, *Protecting Investors in Capital Market*, PORTFOLIO 11,13 (Oct 1999).

panies' accounts to a reliable extent. This is happening although the SEC has made it compulsory that audited balance sheets of listed companies must be prepared in compliance with the International Accounting Standards (IAS) and International Standards on Auditing (ISA).<sup>78</sup> The extent of unfairness concerns both the ICAB and the SEC. As an acknowledgment of the prevalence of the malpractice of auditors, two respective regulatory agencies (the ICAB and the SEC) in a meeting emphasised the importance of credibility of the auditors' reports and audited financial statements for promoting capital market development in the country.<sup>79</sup> This observation is complemented by an important study on investor protection across 31 countries (70,000 firms between 1990-1999 examined). This study revealed that the quality of financial reports has a positive impact on the level of investor protection.<sup>80</sup> The full exercise of due diligence is essential for quality financial reports; but in view of the reality in Bangladesh as noted above, providing a due diligence certificate seems to be merely window-dressing on many occasions. Thus, from the investors' point of view, it would be another way of being deceived by being made to believe in such certificates. Therefore, ordinary investors are more willing to buy shares of reputed companies to avoid the risk of losing their savings. At the same time, they demonstrate their lack of confidence in the companies that are not well known to the public regardless of the real value of their offers.

## G Improved Corporate Governance

Corporate governance denotes a system whereby a company is governed. It is concerned with establishing a system in which the directors of the company are entrusted with responsibilities and duties to run the entity.<sup>81</sup> According to Sheikh, an effective corporate governance system attempts to devise some mechanisms to regulate company directors 'to ensure that they act in the best interests of the company in its broad sense' and that they refrain from 'abusing their powers'.<sup>82</sup> The systems of this kind of governance 'have evolved over centuries' in the wake of corporate failures.<sup>83</sup> Investors, both individuals and institutions, make their investment decisions depending on the issuer's outlook, its reputation as well as its governance.<sup>84</sup> The issue of corporate governance is regarded as a means of promoting enterprise and ensuring accountability.<sup>85</sup> A recent empirical study conducted by the World Bank researchers strongly supports this view and shows that corporate gov-

<sup>78</sup> See Securities and Exchange Rules 1987 (amendments).

<sup>79</sup> ICAB, SEC Joint Meet Held, THE INDEPENDENT, Dhaka (13 Jul 2001). See also, *Scenario of Capital Market Discussed*, THE INDEPENDENT, Dhaka (25 Feb 2001).

<sup>80</sup> C Leuz, D Nanda & P D Wysocki, *Investor Protection and Earnings Management: An International Comparison*, MIT Sloan School of Management Working Paper No. 4225-01 at 1 available at: <<http://papers.ssrn.com>> (20 Dec 2001).

<sup>81</sup> S Saleem *Perspective on Corporate Governance*, in CORPORATE GOVERNANCE & CORPORATE CONTROL 5 (Sheikh Saleem & William Rees, eds., 1995)

<sup>82</sup> *Ibid.*

<sup>83</sup> M R ISKANDER & N CHAMLOU, CORPORATE GOVERNANCE: A FRAMEWORK FOR IMPLEMENTATION I (2000).

<sup>84</sup> *Id.* at 2.

<sup>85</sup> *Id.*

ernance and corporate performance are highly correlated.<sup>86</sup> The study also maintains that companies practicing good corporate governance can provide investors with better protection.<sup>87</sup> Improved corporate governance is thus an important consideration for the development of the securities market.

The concept of good corporate governance relates to the relationship between the board of directors of the company and its stakeholders.<sup>88</sup> Although management is responsible for carrying out the regular/day-to-day business of the company, the board is entrusted with the tasks of formulating the corporate policy, recruiting the staff of the management, overseeing and evaluating the activity of the management and disciplining the staff. Thus the primary authority of the administration of the company lies with the board. Basically the board exists to serve and protect the stakeholders. There are 'three groups of players' in corporations. They are: 'shareholders (and employees, if they have a governance role), boards of directors, and managers'. Good governance warrants balancing the roles of these groups.<sup>89</sup> However the way of accomplishing this objective is not uniform. 'There is no single model of corporate governance'<sup>90</sup> and there is an ongoing debate about what makes up good corporate governance.<sup>91</sup> In May 1999, the Organisation for Economic Co-operation and Development (OECD) formulated a set of principles for good governance known as the *OECD Principles of Corporate Governance* (these principles were subsequently revised in 2004). These principles have gained international recognition as the minimum acceptable standards for companies and investors around the world.<sup>92</sup> Having regard to the recent development in corporate governance worldwide as well as corporate collapse in some countries such as the USA and Australia, the OECD Principles 1999 have been reviewed in 2004. The revision

<sup>86</sup> L F Klapper & I Love, *Corporate Governance, Investor Protection, and Performance in Emerging Markets*, World Bank working paper number 2818 at 21 (Apr 2002).

<sup>87</sup> *Id* at 21-22.

<sup>88</sup> Stakeholders typically include: shareholders, creditors, employees, suppliers, customers, and communities

<sup>89</sup> ISKANDER & CHAMLOU, *supra* note 83, at 20.

<sup>90</sup> *Id* at 6.

<sup>91</sup> *Id* at 3.

<sup>92</sup> In April 1998, the OECD council meeting called upon the organisation to develop a set of corporate governance standards and guidelines. Following this resolution, the OECD formed the Ad-Hoc Task Force on Corporate Governance to develop a set of non-binding principles. In addition to its members states' experience, the Task Force benefited from broad exposure to input from non-OECD countries, the World Bank, the International Monetary Fund, the business sectors, investors, trade unions, and other interested parties (see forewords of the Principles). The Task Force concluded its work in April 1999 and its submission was subsequently approved by the OECD and endorsed by the member nations at their annual general meeting on 26 and 27 May 1999 respectively. The OECD Principles are the first multilateral set of principles on corporate governance. These principles were welcomed by the G7 leaders in June 1999 and are likely to work as "signposts" for corporate governance by the United Nations, the World Bank, the International Monetary Fund, and other international organisations: see, for details, *Statement on the OECD Principles*, in INTERNATIONAL CORPORATE GOVERNANCE NETWORK (ICGN), ICGN STATEMENT ON GLOBAL CORPORATE GOVERNANCE PRINCIPLES available at:

<<http://www.icgn.org/documents/globalcorpgov.htm>> (2 Apr 2002); ISKANDER & CHAMLOU, *supra* note 83, fn 9 at 28; Industry Canada, *Questionnaire on the OECD Principles of Corporate Governance*, available at: <[http://strategis.ic.gc.ca/sc\\_mrksv/corplaw/oecd](http://strategis.ic.gc.ca/sc_mrksv/corplaw/oecd)> (2 Apr 2002).

aims at strengthening the corporate governance regime further.<sup>93</sup> Bangladesh is far behind the original principles formulated by the OECD in 1999, and could not yet adopt a minimum standard for corporate behaviour.<sup>94</sup> The situation is so critical that the World Bank (WB) has recently imposed conditions on the Government of Bangladesh regarding corporate governance for receiving financial support. According to the WB conditions, the government will have to, inter alia, make law to ensure corporate accountability to the national legislature.<sup>95</sup> In such a reality, Bangladesh should first look at the fundamentals of corporate governance. The fundamental tenets of the OECD principles are: fairness, transparency, accountability, and responsibility.<sup>96</sup> On the basis of these pillars, the OECD's four basic principles can be identified as follows:

- i. protection of shareholder rights;
- ii. equitable treatment of shareholders;
- iii. timely and accurate disclosure and transparency; and
- iv. diligent exercise of the board of directors' responsibilities.<sup>97</sup>

To implement the OECD principles, the above mentioned pillars are to be established first. In fact, none of the above pillars exists in Bangladesh. Commentators describe poor corporate governance as one of the fundamental problems in the market.<sup>98</sup> In this regard, the situation prevailing in Bangladesh is discussed below.

## H Fairness

There have been widespread allegations of unfairness in corporate activities. Annual General Meetings (AGMs) are the ultimate controller of the affairs of companies, because, an AGM can elect as well as remove the management of a company. There are some reasons which inhibit shareholders' participation in the activities of companies through the AGMs. First, shareholders are deprived of their right to voice their opinions in respect of the irregularities of the company management since many companies do not hold their AGMs for several years. Secondly, the companies holding AGMs are not fair-minded enough to allow their members to elect the directors and claim their dividends. This passivity of these shareholders is partly attributable to their own unwillingness to take part in the AGMs, and partly to the offering of gifts to them by the management. An example of the lack of

<sup>93</sup> For details, see OECD PRINCIPLES OF CORPORATE GOVERNANCE 2004.

<sup>94</sup> See, *Corporate Governance Code Vital to Cutting Corruption- Speakers Observe at BEI-Junior Chamber Seminar*, THE DAILY STAR, Dhaka (20 Aug 2004).

<sup>95</sup> R K Byron, *Corporate Sector to be Accountable to JS*, THE DAILY STAR, Dhaka (9 Mar 2005).

<sup>96</sup> ISKANDER & CHAMLOU *supra* note 83 at 21.

<sup>97</sup> *Id.* The wording of the principles has been borrowed from the source.

<sup>98</sup> M A Chowdhury, *Corporate Governance: Transparent Disclosure to Strengthen Investor Confidence*, THE FINANCIAL EXPRESS, Dhaka (26 Nov 2002); *Order to Recast Z Group Firms in Interest of Small Investors: SEC Chairman Says at a Press Conference*, THE DAILY STAR, Dhaka (2 Sep 2002).

fairness in corporate governance can be seen in the AGMs of four companies of the 'Apex Group' (an influential group of industries in Bangladesh) where there is usually a noticeable absence of shareholders.<sup>99</sup> The members who were present were reportedly offered gifts either in cash or in kind from the respective management. The gifts might be seen as a bribe to stop them from voicing their criticisms (opinions).<sup>100</sup> In an interview with the Bangladesh Sangbad Sangstha (BSS) in October 2000 the SEC chairman identified 'gifts in AGMs' as one of the major problems.<sup>101</sup> The SEC had to formally resolve that no benefit in cash or kind, other than in the form of cash dividend or stock dividend, shall be paid to the shareholders of a company.<sup>102</sup> For the enforcement of this directive, the SEC on 3 January 2002 issued a rule directing the listed companies to deposit the video films of their AGMs to its (SEC) office. But the High Court Division suspended the operation of this rule on 20 May 2002 following a writ petition of the Beximco Group referred to earlier.<sup>103</sup> Hence, the true participation of the shareholders in the election of the company's board of directors and the discussion of other aspects of the company were hindered either by the lack of interest or knowledge of the shareholders themselves or malpractice pursued by the management.

The example of unfairness is also evident in the floatation of companies. It is observed that 'the newly floated primary shares in the secondary market squeezed to less than half [of the issue price]'.<sup>104</sup> More alarmingly, the market prices of shares of a significant number of companies had 'fallen even to the extent of 10 per cent of their face value'.<sup>105</sup> Furthermore, Ahmed, an eminent market analyst, observed that shareholdings of sponsors and directors as shown in balance sheets are false in many cases.<sup>106</sup> Potential investors are induced by such false information. Ahmed in another study finds that only 8-10 company shares (out of nearly 240 companies) are good and 'many shares do not have any economic value'.<sup>107</sup> This implies that issuers were not fair in raising funds from the public in many cases.

<sup>99</sup> F Bari, *Culture of Managing AGMs Getting Intensified: 72 Out of 101 Companies Did Not Pay Dividends*, THE DAILY INQILAB, Dhaka (14 Dec 1999) (translated from Bengali).

<sup>100</sup> *Ibid.*

<sup>101</sup> SEC Chief Sees Market Turnaround by January: Arrival of Good New Issues Likely, THE DAILY STAR, Dhaka (7 Oct 2000).

<sup>102</sup> SECURITIES AND EXCHANGE COMMISSION (SEC), DHAKA, ANNUAL REPORT 2000-2001, at 40 (translated from Bengali) [hereinafter SEC (2001)].

<sup>103</sup> HC Stays Two Notifications of SEC, THE FINANCIAL EXPRESS, Dhaka (21 May 2002).

<sup>104</sup> Share Prices Rise, THE NEW NATION, Dhaka (24 Aug 2002). There were at least five companies the shares prices of which went below 20 per cent of the issue price: F Bari, *Market Price of 200-Taka Primary Shares Only 11 Taka*, THE DAILY INQILAB, Dhaka (22 Aug 2002) (translated from Bengali).

<sup>105</sup> *Investment in Shares*, THE FINANCIAL EXPRESS, Dhaka (1 Jul 2002).

<sup>106</sup> A Ahmed, *Volatility in Share Bazar*, THE PROTHOM ALO, Dhaka (12 Nov 2001) (translated from Bengali).

<sup>107</sup> See A Ahmed, *What Thai Prime Minister Told*, THE DAILY JUGANTOR, Dhaka (17 Jul 2002) (translated from Bengali).

## I Transparency

As argued by Mobius, transparency provides the best protection to investors against the malpractice of the company management especially in a situation where the management tries to act dishonestly.<sup>108</sup> Transparency is a common problem in Bangladesh<sup>109</sup> and the lack of transparency is a chronic problem in corporate culture. One of the causes of regulatory failure in securities regulation is argued as the lack of transparency in the market.<sup>110</sup> This problem is evident in many situations. For example, directors of some companies are allegedly involved in dishonest activities: such as misappropriation of subscription money; overpricing of company assets; forging company shares; and procuring many false audited reports and so on.<sup>111</sup> There are also allegations that company profits are not shown in the balance sheet so as to deprive the shareholders.<sup>112</sup>

In the wake of such malpractice, the Chief Metropolitan Magistrate Court (CMMC) in Dhaka issued warrants of arrest against three directors of Mark Bangladesh Shilpa and Engineering Ltd, a listed company, for their alleged involvement in misusing investors' fund.<sup>113</sup> The SEC made allegations concerning the overvaluation of company's assets, and misappropriation or improper use of IPO funds. The SEC's allegations were based on several investigations.<sup>114</sup> Clearly, the lack of

<sup>108</sup> J M Mobius, *Issues in Global Corporate Governance*, in CORPORATE GOVERNANCE: AN ASIA-PACIFIC CRITIQUE 43-44 (L C Keong, ed., 2002).

<sup>109</sup> The Berlin based Transparency International has placed Bangladesh at the top of the Corruption Perception Index as the most corrupt country in the world in the last consecutive four years: *Most Corrupt for Fourth Time- Govt Rejects TI Report*, THE DAILY STAR, Dhaka (21 Oct 2004). Recently, the joint report of the World Bank and UNDP released on 3 June 2002 reveals that the accounting process in Bangladesh is not transparent and corruption eats away 40 per cent of public funds. See *WB, UNDP Report on Bangladesh: Corruption Eats 40 pc Public Funds*, THE NEW NATION, Dhaka (4 Jun 2002).

<sup>110</sup> M Hossain, *Getting Back Investors' Confidence*, THE FINANCIAL EXPRESS (27 May 2002).

<sup>111</sup> The SEC lodged a First Information Report (FIR) with a police station against three directors, auditors and issue managers of the IPO after necessary investigation. The investigation reveals that "...directors injected forged allotment letters into the stock market and siphoned huge amounts of money by deceiving the general investors". See for detail, M S Rahman, *Complaints Lodged with Motijheel Thana [Police Station]: SEC Finds JH Directors, 3 Firms Involved in Share Forgery*, THE DAILY STAR, Dhaka (22 Dec 1999); *SEC Files FIR against 5 JH directors in Share Forgery*, THE FINANCIAL EXPRESS, Dhaka (22 Dec 1999).

<sup>112</sup> A Ahmed, *Volatility in Share Bazar*, THE PROTHOM ALO, Dhaka (12 Nov 2001) (translated from Bengali).

<sup>113</sup> For detail, see *Warrants of Arrest Issued against Three Mark Bangladesh Directors*, THE FINANCIAL EXPRESS (3 Jun 2000).

<sup>114</sup> The accused persons were the directors of Mark Bangladesh Shilpa and Engineering Ltd. The SEC investigation reveals, amongst other things, that the "realistic value of the plant and machinery of the company was 53.51 million taka while the figure was shown as Tk 504.73 million in the audited balance sheets... and 523.61 million taka in another report submitted to the SEC...". In addition to these, another enquiry discloses that the company has procured machinery in violation of conditions imposed by the SEC. And the activities of the company were also a deviation from the statements made in the prospectus about utilisation of IPO funds as evident from the inquiry: see for detail, *ibid*. Another listed company, Mark Bangladesh Shilpa & Engineering, one of the top 30 companies based on value of share capital, has had transacted its own shares with its own funds (of more than Tk 20 million) as disclosed in an inquiry conducted by the Bangladesh Bank, central bank of the country. Such transactions are unlawful: see A Kibria, *Information of the In-*



transparency in corporate activities is evident and the transparency of transactions in the market is almost non-existent in the absence of effective legal, regulatory and supervisory functions.<sup>115</sup>

## J Accountability

The management of a company is accountable to its shareholders in respect of using corporate 'resources in the most efficient and desirable manner'.<sup>116</sup> The best way of exercising corporate accountability to its shareholders is holding AGMs regularly. In a *Press Release* on 21 November 2001, the SEC said that shareholders of a significant number of listed companies are not in a position to know the true state of affairs of their companies, because AGMs were not held. Legal provision in this regard is clear. The statutory law<sup>117</sup> as well as the SEC directives<sup>118</sup> require the companies to hold AGMs in each year, but in practice, the extent of not convening AGMs is adversely affecting the market as observed by the securities regulator.<sup>119</sup> The SEC also added that under the present state of affairs, very often investors failed to make considered judgment about investment.<sup>120</sup> In the same release, the SEC acknowledged that despite repeated efforts, the commission has not received any tangible results in this regard.

Many listed companies have been failing to hold their AGMs for several consecutive years.<sup>121</sup> Even if some companies hold their meeting in time, there is evidence that the directors will be able to gain the favour of the participating shareholders by adopting unfair means (gifts in cash or in kind) as alluded to earlier.

Getting dividends, if declared, is an important right of shareholders. Non-holding of AGMs normally affects the declaration of dividends. Many companies do not declare dividends for several years and if declared, do not deliver on time.<sup>122</sup> So

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*quiry Report of Bangladesh Bank: Mark Bangladesh Has Got Its Shares Transacted with the Company's Funds*, THE PROTHOM ALO, Dhaka (22 May 2000). See also for the company's position in the DHAKA STOCK EXCHANGE (DSE), DHAKA, ANNUAL REPORT 1998-1999 at 79.

<sup>115</sup> Hossain, *supra* note 110.

<sup>116</sup> Mobius, *supra* note 108, at 41.

<sup>117</sup> *Companies Act* 1994 s 81.

<sup>118</sup> SEC *supra* note 102.

<sup>119</sup> SEC, *Press Release* (21 Nov 2001).

<sup>120</sup> *Id.*

<sup>121</sup> The SEC decided to carry out audits of 25 listed companies which failed to hold AGMs for two or three years consecutively: see *Failure to Hold AGMs for Two to Three Years: SEC to Audit Financial Conditions of 25 Companies*, THE DAILY STAR, Dhaka (12 Dec 1999).

<sup>122</sup> Despite several steps taken by the SEC and the tax incentives to regularise dividends, the situation did not improve. During the FY1999-2000, 79 companies out of 192 listed companies of the DSE which held AGMs did not declare any dividends. The remaining 27 companies did not hold AGMs. So, a total of 106 out of 219 listed companies of the DSE did not declare dividend: see SEC, DHAKA, ANNUAL REPORT 1999-2000 at 18-25 [hereinafter SEC (2000)]. During this year, the SEC received eight complaints from the investors against the companies for delayed or non-receipt of declared dividend: see above SEC (2000) at 29. A total of 44 listed companies have not declared any dividend in the last five years: *44 Companies Declared No Dividend in Five Years*, THE NEW AGE, Dhaka (18 Jul 2004). There are some companies which do not hold AGMs

accountability to investors is still long way off.<sup>123</sup> According to the chairman of the SEC, not more than 20 to 25 per cent of listed companies grant a dividend on a regular basis.<sup>124</sup>

The above discussion demonstrates clearly that corporate accountability has not yet been established in Bangladesh.

## K Responsibility

The Board of Directors has the responsibility for properly monitoring the affairs of the company. The above discussions on fairness, transparency and accountability also refer to the lack of responsibility of corporate management towards shareholders. From the viewpoint of investor protection, corporate management is charged with the responsibility to maximise the benefits of the company rather than to increase the benefits of the persons involved in the management. The lack of responsibility of the corporate directors towards general investors is perhaps best evident in two recent co-related decisions of the Beximco Pharma, a listed company belonging to Beximco. The Board of Directors of the company declared 10 per cent dividends in April 2002 along with 10 other listed companies of the group. In declaring the dividends, the company allegedly violated securities law for which the SEC suspended the trading of shares of these 11 companies.<sup>125</sup> After the resumption of trading, many ordinary investors offloaded their shares in a bearish market following the declaration of lower dividends as compared to those of the previous year. The company held its AGM in July 2002 and all of a sudden suspended its running AGM for 15 minutes and held an emergency meeting of the Board of Directors. The board decided to enhance the rate of dividends from 10 per cent to 15 per cent and the decision was immediately approved in the AGM which resumed after the above-mentioned suspension. Commentators observed that the enhancement of dividends in such a manner deprived the general investors of their due benefits since many of them already sold their shares.<sup>126</sup> The company management harmed the market in general by its former declaration of dividends (April 2002),

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even for more than five years: *Failure to Hold AGMs: SEC Asks 13 Cos to Submit Accounts for Defaulting Years*, THE DAILY STAR, Dhaka (24 Aug 2004).

<sup>123</sup> For details in respect of companies failure in holding AGMs and paying dividends, see *41 Listed Companies Did Not Pay Any Dividends in Last Five Years: DSE Decided to Take Action*, THE PROTHOM ALO, Dhaka (21 Nov 1999) (translated from Bengali); *60 Companies Did Not Pay Dividends for Four Years*, THE DAILY ITTEFAQ, Dhaka (20 Feb 2000) (translated from Bengali); F Bari, *Shares of 35 Companies Defaulting Dividends for Five Years are Instruments of Casino Board: Strength of Evil Powers*, THE DAILY INQILAB, Dhaka (8 May 2000) (translated from Bengali); Bari, *supra* note 99.

<sup>124</sup> See *SEC Chief Sees Market Turnaround by January* *supra* note 101.

<sup>125</sup> *SEC Suspends Trading of Shares of 11 Beximco Group*, THE INDEPENDENT, Dhaka (1 May 2002); *Share Trading of 11 Beximco Companies Suspended*, THE NEW NATION, Dhaka (1 May 2002).

<sup>126</sup> *SEC Serves Show Cause Notice on Beximco*, THE FINANCIAL EXPRESS, Dhaka (9 Jul 2002).

and its latter decision benefited the members of the board as large shareholders at the expense of small investors.<sup>127</sup>

The foregoing discussion shows that the basic pillars of good corporate governance are not present in the corporate life in Bangladesh. The country does not even have any code for corporate governance to date.<sup>128</sup> The SEC in 2000 emphasised the need for formulating the principles of corporate governance, and the necessity for amending the *Companies Act* 1994 to improve this governance.<sup>129</sup> Nonetheless, no real progress has taken place so far in this regard.

The lack of good corporate governance is recognised by all. The SEC acknowledges that investors lack proper knowledge of investment, and the auditing practices are not conducive to maintain investor confidence in audit reports.<sup>130</sup> The problem of accountability is so acute that 10 listed companies have not been publishing their annual reports for three consecutive years, but have nevertheless quoted their shares on the exchanges.<sup>131</sup> Clearly, such a serious lack of corporate governance does not support following the BDR for the IPO market as a method for providing investor protection.

## L Adequacy of Investor Knowledge of Investment

Investors' ability to make an intelligent investment judgment 'is a major assumption and is the cornerstone of the capitalistic economy'.<sup>132</sup> Maintaining a similar view, the Technical Committee of the IOSCO has emphasised the need for investor education for their protection and an effective regulation of the securities market.<sup>133</sup> In Bangladesh, the investment decisions of overwhelming majority investors are based on rumours instead of economic fundamentals of the issuers as revealed in a recent survey.<sup>134</sup> This finding is supplementary to that of an important enquiry committee.<sup>135</sup> Further, the SEC itself admitted on several occasions the fact that

<sup>127</sup> The declaration of lower dividends was allegedly intended to unfairly increase the holdings of the controlling shareholders: see *Trading of 11 Companies of Beximco Group in Share Market Suspended*, THE PROTHOM ALO, Dhaka (1 May 2002) & *Legal Steps Initiated: SEC Action Illegal-Says Beximco*, THE NEW NATION, Dhaka (3 May 2002).

<sup>128</sup> *Corporate Governance Code Vital to Cutting Corruption - Speakers Observe at BEI-Junior Chamber Seminar*, THE DAILY STAR, Dhaka (20 Aug 2004).

<sup>129</sup> *Share Bazar in the Eye of the SEC*, THE DAILY ITTEFAQ, Dhaka (20 Feb 2000) (translated from Bengali).

<sup>130</sup> *Id.*

<sup>131</sup> Bari, *supra* note 99.

<sup>132</sup> Testimony of Denise Voigt Crawford, Texas Securities Commissioner, before the U S Senate Banking, Housing and Urban Affairs Committee, on *The Importance of Financial Literacy and Education in America*, at 15, available at:

<[http://www.nasaa.org/nasaa/abtnasaa/view\\_top\\_stories.asp?start=0&partition=1](http://www.nasaa.org/nasaa/abtnasaa/view_top_stories.asp?start=0&partition=1)> (12 Feb 2002).

<sup>133</sup> See IOSCO TECHNICAL COMMITTEE BULLETIN, INVESTOR PROTECTION IN THE NEW ECONOMY at 11; *The Role of Investor Education in the Effective Regulation of CIS and CIS Operators*, REPORT OF THE TECHNICAL COMMITTEE OF THE IOSCO (March 2001) at 2-8.

<sup>134</sup> M Rahman, "Devil" and Future of Share Market, THE PROTHOM ALO, Dhaka (18 Dec 1999) (translated from Bengali).

<sup>135</sup> ENQUIRY COMMITTEE, *supra* note 50, at 17.

investors lack investment knowledge. Furthermore, international market analysts complement this admission of the SEC by characterising the investors as 'innocents'.<sup>136</sup> Hence, the DBR has imposed an exclusive responsibility on these unsophisticated investors for assessing the merits of IPOs based on disclosures made by the companies in unfavourable circumstances.<sup>137</sup> Accepting the inability of investors to make a so-called informed investment decision, the SEC as well as stock exchanges have undertaken some programs to educate investors. However, these programs had no significant effect on imparting investment knowledge to the investors.<sup>138</sup> In brief, the programs of stock exchanges are limited to holding seminars and discussions. Only 257 people attended the SEC Weekly Investors' Education Program introduced in June 1999 until June 2000.<sup>139</sup> The participants in this program were 48, 111 and 105 in 2001, 2002 and 2003 respectively.<sup>140</sup> It can be easily understood that the total number of participants is insignificant as compared to the actual number of ordinary investors in the market.

The information disclosed in a prospectus is related especially to the disciplines of finance, accounting, law and economics. In addition, the investors must have knowledge of English because the prospectuses are published in English, the second language in the country. Thus, there is no plausible ground to believe that these ordinary investors are able to understand and properly analyse the information embodied in the prospectus.<sup>141</sup> It is argued that if the 'investors are given access to all material information, it is up to them to decide how to use the information and to accept the consequences of their investment choices'.<sup>142</sup> This argument ignores the fact that investment knowledge is not something to be achieved with 'divine inspiration' and without sincere efforts.<sup>143</sup> Moreover, securities literature is complex and technical and therefore not readily understood.<sup>144</sup> In view of the above reality, it can

<sup>136</sup> *The Bangladesh Stockmarket: Slaughter of the Innocents*, THE ECONOMIST (7-13 Dec 1996) 90 at 90-91; EMERGING STOCKMARKET: REVENGE OF THE INNOCENTS, THE ECONOMIST (12-18 April 1997) 74 at 74.

<sup>137</sup> This is so because, all concerned including the SEC recognise that companies do not practice good governance, and auditors reports are not trustworthy: *Share Bazar in the Eye of the SEC*, *supra* note 129.

<sup>138</sup> Despite numerous rigorous education programs over the last few years in the United States, Texas Securities Commissioner acknowledged on 6 February 1999 that "on average, the general public is financially illiterate": *Testimony of Denise Voigt Crawford*, *supra* note 132 at 1. If this is the situation in US, then the situation of Bangladesh can be easily understood.

<sup>139</sup> SEC, *supra* note 122, at 49.

<sup>140</sup> SEC, *supra* note 102, at 38, and SEC, DHAKA, ANNUAL REPORT 2001-2002, at 40 (translated from Bengali) [hereinafter SEC (2002)], SEC, DHAKA, ANNUAL REPORT 2002-2003, at 51.

<sup>141</sup> Investors in the United States are not yet able to rely on themselves. "Investor Ignorance" *Investment News* (6 Aug 2001) at 4. If this is the situation in United States, then how could one believe that investors in Bangladesh are quite able to make their investment decisions prudently without any pertinent knowledge.

<sup>142</sup> H A J FORD, R P AUSTIN & I M RAMSAY, *FORD'S PRINCIPLES OF CORPORATIONS LAW* 877 (9<sup>th</sup> ed. 1999).

<sup>143</sup> Securities analysis requires prophetic knowledge without divine blessings. "Basically, the security analyst must be a prophet without the benefit of divine inspiration"- B G MALKIEL, *A RANDOM WALK DOWN WALL STREET* 121 (1990).

<sup>144</sup> J H LORIE, P DODD & M H KIMPTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* viii (2<sup>nd</sup> ed 1985) "[T]he law governing [securities] manipulations has become an embarrassment- confusing,

be said that investors in Bangladesh cannot have meaningful access to information furnished in the prospectus. The DBR offers no assistance to the investors. In fact it may, despite its good intentions, deprive the investors of benefiting from the assessment of the regulator (under a merit regime), resulting in further undermining the protection of investors in the IPO market.

### **M Competent Market Professionals and Intermediaries**

Apart from auditors and lawyers, professionals and intermediaries in the IPO market include issue managers, underwriters, financial advisers and portfolio managers. So far, no registered financial advisers are engaged in the securities market and there is no practice of seeking investment advice in fact.<sup>145</sup> Actually, the SEC has not promulgated any regulations for them to date. The reason may be the lack of interest from both service providers and service users.<sup>146</sup> However, the SEC has granted licences to 23 companies as full-fledged merchant banks until June 2003.<sup>147</sup> Blaming the merchant bankers for their inactivity, the SEC chairman observed that, not more than four or five of them operate at a reasonable level.<sup>148</sup> In another report on the continued poor performance of listed companies on the bourses [could this concept be clarified], merchant banks have been termed as 'mere spectators' in the capital market just a month before the adoption of the DBR.<sup>149</sup> Moreover, these banks are not experienced and financially strong enough to function on a large scale. In addition, some of them meanwhile have allegedly been involved in market manipulation resulting in the SEC suspending brokerage licences of Equity Partners Securities Limited, a merchant bank.<sup>150</sup> Therefore, the extent of merchant banking services is not in favour of the DBR.

The position of portfolio managers is not good either. Apart from the above merchant bankers, there has been only one merchant banker which is authorised to act only as a portfolio manager in the market as at June 2003.<sup>151</sup> The SEC issued licences to merchant bankers who are entitled to act as portfolio managers in a down-trend market after the market debacle 1996 with an expectation that they would play a significant role in salvaging the market by generating fresh funds. But in practice, none of these banks lived up to the expectation.<sup>152</sup> Acknowledging the

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contradictory, complex, and unsophisticated": E T McDermott, *Defining Manipulations in Commodities Futures Trading: The Futures "Squeeze"*, 74 NW. U. L. REV. 202, 205 (1979).

<sup>145</sup> INVESTOR INFORMATION CELL, *supra* note 51.

<sup>146</sup> The SEC started formulating regulations for the merchant bankers after receiving applications from the potential merchant bankers.

<sup>147</sup> SEC, DHAKA, ANNUAL REPORT 2002 – 2003, at 7.

<sup>148</sup> At the time of this comment, the total number of such banks was 25 or 26 as the SEC chairman mentioned. See SEC Chief Sees Market Turnaround by January, *supra* note 101.

<sup>149</sup> M S Rahman, *Depression in Bourses Blamed for Inertia: Merchant Banks Still Mere Spectators in capital Market*, THE DAILY STAR, Dhaka (26 Dec 1998).

<sup>150</sup> See D N Saha, *SEC's Surprise Over Canard: Trading in Bourses Not Suspended*, THE INDEPENDENT, Dhaka (27 Aug 2001).

<sup>151</sup> Business and management Company Ltd is the sole portfolio manager in addition to the fully-fledged merchant bankers: SEC, DHAKA, ANNUAL REPORT 2002 – 2003, at 7.

<sup>152</sup> Rahman, *supra* note 149.

difficulties of managing portfolios, the Managing Director of Industrial Development Leasing Company of Bangladesh (IDLC), a portfolio manager, said that '[w]e have to ensure profits before asking anyone to come and invest. And we are finding it a bit hard to ensure that'.<sup>153</sup> Expressing their pessimism about the market performance, market analysts maintained that the beginning of portfolio management by merchant banks was uncertain.<sup>154</sup>

The development of any professional service depends on its demand and continued honest and efficient practice. The demand for these professionals in the Bangladesh share market is very negligible, because of the absolute dominance of small individual retail investors. Hence, one of the major impediments to the development of investment advisory services in Bangladesh is the non-availability of sophisticated investors who usually look for such professional advice.

### **N      *Availability of Retail Research on Potential Issuers***

Another important consideration in relation to the introduction of the DBR is the availability of retail research. Retail research on potential issuers may help investors make informed investment judgment. They can compare the information disclosed in a prospectus with that which is found in private research on an issuer at the time of flotation. Institutional investors usually carry out this research. Because of the lack of institutional investors, there has been no retail research on the fundamentals and business prospects of potential issuers. As a result, investors have to rely exclusively on the information disclosed by the issuer concerned. The paucity of retail research thus leads the investing public to believe in the disclosures made in a prospectus regardless of their accuracy. In such a situation, issuers usually take advantage of the ignorance of investors by choosing their convenient time to float in a 'share hungry' market.

A study of Loughran and Ritter is regarded as 'the most useful work' on investment in IPOs.<sup>155</sup> Their study concludes that IPOs are poor investments in the long run for investors, relative to stock in general.<sup>156</sup> Shayne and Soderquist have identified two reasons for the conclusion arrived at by Loughran and Ritter. The reasons are: '(i) IPOs are made in high markets; and beyond that (ii) IPOs underperform the seasoned stocks available in such markets'.<sup>157</sup> In a bullish market, IPOs are very demanding, and thus investors buy primary shares in higher prices. The finding is fully consistent with the reality in Bangladesh. It becomes clear from the following table.

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

<sup>155</sup> J A Shayne & L D Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 Vand L Revi 965,967 (1995).

<sup>156</sup> See T Loughran & J R Ritter, *The New Issues Puzzle*, 50 *Journal of Finance* 23, 46 (1995).

<sup>157</sup> Shayne & Soderquist, *supra* note 155 .

Table 5.1: Correlation between Market-Trend and the Issues of Securities<sup>158</sup>

Year (Year ended in June)	Dhaka Stock Exchange All Share Price In- dex/Weighted Average Price Index*	Number of New Issues
1991	296.2	9
1992	369.5	11
1993	418.8	4
1994	659.8	17
1995	776.9	27
1996	959.1	21
1997	1111.6	18
1998	676.47	8
1999	546.79	4
2000	561.00	10
2001	716.06	11
2002	819.74	8
2003	823.14	13

\* Weighted Average Price Index was introduced in November 2001 in place of the previous All Share Price Index.

It can be seen from the table that the noticeable inconsistency with the above proposition can be found only in 1997 and 2002, because the number of new issues decreased despite the apparent increase in the Index. There are plausible explana-

<sup>158</sup> The number of new issues for 1991-93 has been taken from: DSE, FACT BOOK 1994 44 (1994). The remaining has been taken from: SEC, DHAKA, ANNUAL REPORT 1993-1994 at 31; SEC, DHAKA, ANNUAL REPORT 1994-1995, at 42; SEC, DHAKA, ANNUAL REPORT 1995-1996, at 57; SEC, DHAKA, ANNUAL REPORT 1996-1997 at 52, 31 [hereinafter SEC (1997)]; SEC, DHAKA, ANNUAL REPORT 1997-1998, at 54, 19; SEC, DHAKA, ANNUAL REPORT 1998-1999, at 78, 64; SEC (2000), *supra* note 122, at 16-17, 13; SEC, *supra* note 102, at 19, 15 (translated from Bengali); SEC (2002), *supra* note 140, at 15, 21 (translated from Bengali); SEC, DHAKA, ANNUAL REPORT 2002-2003, at 9, 17

tions of such exceptions. As regards the case of 1997, the reason is very clear. During the market crash in 1996, the Index jumped from 776.9 in 1995 to 3648.75 in the first week of November 1996. Thereafter the Index started falling drastically and became 2514.15 at the end of December 1996.<sup>159</sup> Since then the Index maintained a declining trend for a long time. Therefore, although the table shows that the Index increased in 1997, it actually decreased. Thus the number of new issues was also lower.

The reason for the exception in 2002 is different. As noted above, Weighted Average Price Index replaced the previous Index. The introduction of this new Index system artificially increased the Index points, because it does not take into account the performance of poorly performing companies. Market participants strongly criticised the new Index. The stock exchanges and investors alike protested it with an allegation that 'SEC is damaging share markets'.<sup>160</sup> There has been more criticism of this system. For example, pointing at the artificial improvement of the Index in June 2002, one commentator contended that with the introduction of the new Index, 'the small investors' dark days started, as the real movement of the capital market is not truly represented by the new system'.<sup>161</sup> There are a number of reports that the market was performing poorly even in June 2002.<sup>162</sup> Thus, in such a situation, the above-mentioned increase in the Index does not provide any acceptable evidence for an upward trend in the market in 2002 in the true sense. Amid severe criticism by various market players and commentators, the SEC eventually withdrew that Index in December 2003.<sup>163</sup> This time, two separate indexes were introduced - one for the blue chips and the other for the remaining securities, but again excluding those having weak fundamentals. As a result, the indexes failed to portray the true picture of the market. Finally in October 2004, the SEC allowed the bourses to reintroduce their general indexes covering all listed securities.<sup>164</sup>

It is therefore a fact in Bangladesh that issuers prefer to go public in a bullish market. In other words, issuers usually float in a market where the investors, especially the individual small investors, are hungry for shares and invest in IPOs regardless of their merits.<sup>165</sup> In such a situation, investors are not able to make intelligent

<sup>159</sup> For detail, see SEC (1997) *id.* at 21.

<sup>160</sup> D N Shah, *Stock Exchanges Lodge Protest against Weighted Index: SEC Damaging Share Market, Allege Small Investors*, THE INDEPENDENT, Dhaka (10 Dec 2001).

<sup>161</sup> M R Bari, *Beximco Vs SEC: The Case for SEC Reform*, THE BANGLADESH OBSERVER, Dhaka (25 Jun 2002) (editorial).

<sup>162</sup> The Index points mentioned in the above table represents the Index of June 2002. For the reports of the poor performance of the market, see for example, K Rahman, *Capital Market Collapse: Massive Decline in Share Price-Transactions and Index Decreased*, THE DAILY JANAKANTHA, Dhaka (1 Jun 2002) (translated from Bengali); *Doubts Dominate Share Market*, THE NEW NATION, Dhaka (29 Jun 2002).

<sup>163</sup> A Kibria, *Weighted Index Goes - SEC Sets up Consultative Committee to Recommend Measures*, THE NEW AGE, Dhaka (10 Dec 2003).

<sup>164</sup> I Ahmed, *DSE to Re-introduce All Share Price Index*, THE NEW AGE, Dhaka (22 Oct 2004).

<sup>165</sup> Sophisticated and institutional investors usually invest in IPOs depending upon the merit of the offers, but the small individual investors are not able to do that.



investment decisions. Thus the DBR is not regarded as an effective philosophy for the protection of such investors.

#### IV CONCLUSION

The assumption of market readiness for the utilization of the DBR in Bangladesh, in the absence of a significant number of sophisticated investors, active market professionals, good corporate governance and fair corporate disclosure, appears to be unrealistic. It is clearly evident from the poor performance of the Bangladesh securities market which unsuccessfully attempted to restore investor confidence by adopting the disclosure philosophy in the aftermath of an unprecedented share scam in 1996. Switching from the merit regulation to the disclosure philosophy should, it is submitted, rely on the market demand rather than on a regulatory dictum.

The development of a healthy market requires complex supportive institutions which cannot be achieved overnight. Some of these can exist in the early stage, whilst '[o]thers will grow only as the market itself grows'.<sup>166</sup> This assertion came true to the securities market in Bangladesh where all reforms aiming at bringing the investors back to the market went in vain. Investors are still market shy despite the change in regulatory philosophy and numerous government initiatives to offer various incentives to major market participants over the years.

The analysis in this paper adheres to the proposition that the securities laws of those jurisdictions which are striving to develop their markets should be more supportive of investor protection than those in the developed markets.<sup>167</sup> Many issuers, in collaboration with their selected market professionals and intermediaries, are taking advantage of the innocence of investors who are basically investment illiterate. No substantial efforts have been made thus far to educate investors. The profession of investment advisers could not grow simply because the investors are generally small savers who are not able to afford to pay for professional services and thus make their investment decisions by themselves. Institutional investors are very negligible and foreign portfolio investment is almost 'nil'. The lack of corporate governance has but added to the inapplicability of the DBR to the Bangladesh market.

Since the market is still in a stage of its infancy, the preferred policy would be to return to Merit-Based Regulation (MBR). Shifting from the merit regulation to the disclosure philosophy should be made gradually in response to, and depending on,

<sup>166</sup> B Black, *The Legal and Institutional Preconditions for Strong Stock Markets: The Nontriviality of Securities Law*, in ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE 82 (2001)

<sup>167</sup> B Black & R Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1921 (1996)

market readiness. Initially, a 10-Year Master Plan may be made mapping out the way of such shifting.<sup>168</sup> Over this period, all necessary reforms addressing weaknesses persisting in the IPO market should be accomplished as early as possible and it should not take more than five years. The remaining five years should be spent in carrying out studies on the market development towards market readiness before making a complete departure from the paternalistic regulation to the disclosure philosophy. A wholesale importation of the disclosure philosophy from the developed markets without attaining the pre-requisites for its usefulness by an underdeveloped market is an arrangement like 'putting the cart before the horse'.

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<sup>168</sup> In this respect, the *Capital Market Master Plan* 2001 of Malaysia may be taken into account. The text of this plan is available at: <<http://www.sc.com.my/html/cmp/CHAPTER1.PDF>> (10 May 2003).