Disclosures in Offer Documents- Quality v/s Quantity

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Introduction

Globally, securities markets that are premised on sound legal and regulatory framework have played an integral role in the development of a balanced financial sector and have enabled corporates to access the public markets as a source of fund-raising. This has facilitated in paving the way for the long term economic growth for a country's economy.

Be it in India or outside, disclosure standards in an offering document vary and depend upon the type of offering and in many cases, are also driven by the choice of jurisdiction where the relevant securities are intended to be offered. Additionally, the extent of sophistication of the market where the offering is made also determines the quality and quantity of disclosures in offering documents. Offering documents in respect of debt offerings and equity offerings are the most common illustrations. Typically, a debt offering document has less disclosure standards as compared to the higher level of disclosure standards and requirements in the case of equity offerings system. While both these types of offering documents follow varied disclosures norms, these norms may further vary and depend on the fact whether the proposed offering is a private placement with a handful of investors or whether the same is being offered to the public at large.

Internationally, there are two main approaches regulating securities offering. The first is disclosure based and the other is merit based. While the disclosure based regime does not prohibit or directly intervene, it requires providing adequate disclosures as per the prescribed standards and in the event of failure to do so the system/regulator levies fines, sanctions and penalties. Further, in such approach, the regulator assumes no responsibilities for the quality of offerings made to the public. In the merit based regime on the other hand, the regulators themselves decide on the viability of a public offering on the basis of the disclosures made in the offer documents.

In the Indian context, disclosures in offer documents assumes significant importance as the Securities and Exchange Board of India (the "**SEBI**"), the Indian securities market regulator, *inter-alia* strives to achieve investor protection by ensuring material information is being disclosed in offering documents thereby safeguarding investors from being misled or deceived. Thanks to the performance by SEBI's of its regulatory functions, India in the recent past has witnessed an increased concentration on public disclosures by companies opting to access the Indian securities markets. Whilst this increased focus in relation to public disclosures has certainly resulted in enhancing the quantum of disclosures in offering documents, the quality of these quantitative inclusions have been questioned from time to time.

The Indian scenario

Like many other regulatory regimes, the regime in India requires that an investor is provided with all information which is necessary for such an investor to take an informed investment decision. Till 2009, the SEBI (Disclosure and Investor Protection) Guidelines, 2000 (the "**DIP**") read with Companies Act, 1956 (the "**Act**") primarily laid down the disclosure norms for Indian companies seeking to offer their securities to the public. In 1995, SEBI set up the Malegam Committee to review the disclosures requirements in offering documents post which SEBI issued certain guidelines, recommendations. Thereafter in 1999, a fresh committee was again set up under the chairmanship of Mr. Y.H. Malegam along with the representations of stakeholders, industry, investors, merchant bankers etc. The findings in Malegam Committee Report were lauded by many and some of the said recommendations found their way in to the DIP in the form of amendments. In 2009, DIP was replaced by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (the "**ICDR Regulations**"). It was anticipated that the ICDR Regulations would plug the gaps which existed in DIP and thereby make the disclosures more investor friendly, however that was not the case.

The ICDR Regulations, which are part of a disclosure based regime, *inter-alia* sets out the expected level of disclosures from a company approaching the general public for funds. The ICDR Regulations require extensive disclosures in respect of an issuer company, its promoter, its group companies (which are companies/entities promoted by the promoters of the issuer company) as well as the promoter group (which includes the promoter, their relatives and in cases where the promoter is a body corporate, a company where the said promoter holds 10 per cent or more of the equity share capital or any body corporate which holds 10 per cent or more in the promoter). Post this, practically speaking, it has become a difficult task for an issuer company to collect and updated information in respect of the promoter group and group companies in cases of large conglomerates where the promoters of the issuer company have incorporated numerous companies. Whilst usually financial and corporate details of the largest five group companies are given (and in case where there are listed group companies, the top five listed group companies), there is no such threshold for disclosures of litigations of the group companies, thereby resulting in a situation where litigations for all and not the largest five or listed group companies are required to be disclosed.

However, understandably, the rationale for concentrating on such extensive promoter, promoter group and group companies disclosures stems primarily from the fact that issuer companies in India accessing securities market are thinly diluted in the course of fundraising and remain substantially controlled by the promoters as opposed to companies accessing capital in developed securities markets like the United States, where companies are highly diluted. Therefore, a widely dispersed shareholding gives way to material and qualitative disclosures and closely held companies are expected to disseminate greater information. However, as a result, at times the qualitatively important information tends to get obscured in view of the bulk of information disclosures in the offering documents. Another rationale for a thrust on disclosures of these nature is that the goodwill of an issuer company would be directly or indirectly linked with the goodwill of it promoters, or group companies promoted by the promoters of the issuer company or the members of the promoter group. The alleged involvement of promoters in recent scams lends credence to the inclusion of information regarding the promoters, companies incorporated by them or companies where they have invested. Having said that, the question which still needs to be answered is how much information is sufficient so as to ensure material information is not overshadowed by the quantum of information expected to be disclosed in offering documents.

A possible way out to achieve the best of both the worlds may be through the introduction of certain threshold requirements within the ICDR Regulations which could weed out quantitative information about group companies or promoter group which is not material from the issuer company's perspective.

Be it the DIP or the ICDR Regulations, a strong emphasis, and rightly so, was laid down on the litigations of the issuer company, its promoters, directors, subsidiaries, material associates etc. Presently, in view of the extant requirements of the ICDR Regulations, over and above the litigation details of the abovementioned entities, the litigations details of the group companies are also required to be given. From a practical standpoint, issuer companies in the past have found it difficult to certify the litigations relating to group companies. In such a case, the likelihood of incorrect disclosures in the offer documents increases which thereby increases the chances of inadvertent contraventions of the provisions of Companies Act pertaining to the civil and criminal liability of the directors due to misstatements in the offering documents.

As the law and regulations evolve with time, it may not be wrong to say that inclusion of only "*material*" information in respect of business operations, penalties (regulatory or otherwise), litigations etc. of only the "*material*" group companies or disclosures regarding the "*material*" promoter group may required to be disclosed. This may be a welcome change in the extant disclosure based regime. Though it may be difficult to define what would constitute "*material*" the final decision in this regard could be left to the issuer/ merchant bankers along with potential penalties for non disclosure of material information.

Another area which may require some deeper introspection by the SEBI relates to the details of financial information provided in the offering documents. World over, established market regulators have laid down guidelines for the disclosures of financial information of the issuer companies and the management discussions and analysis, commonly known as "**MD&A**". The Securities Exchange Commission (the "**SEC**"), the market regulator in the United States provides for a handbook highlighting the concept and nature of financial and other business information expected to be disclosed by a company seeking to raise funds from the United States. Perhaps, financial information is one of the areas where the "quantity of information" is not debated as long as the same is also qualitative. Typically speaking, an MDA intends to *firstly*, provide a narrative explanation of company's financial statements which thereby enables investors to view the issuer company through the eyes of the management, *secondly*, enhances the overall financial disclosures and provide the context within which the financial information should be analyzed and *thirdly*, provides information about the quality of, and potential variability of, a company's earnings and cash flow, so that the investors can ascertain the likelihood that past performance is indicative of future performance. While the current standard of disclosure for the MD&A under the ICDR is robust, SEBI along with regulators like Institute of Charted Accountants of India, may consider making the expected financial information more qualitative for a proposed investor and also bring the same in line with the best global practices.

Global precedents

As discussed above, globally the quality *vis-à-vis* the quantity of the disclosures in an offering document depends on the nature of the offering and also the jurisdiction where the offering is made.

The SEC in the United States appears to have achieved a level playground in the quantity v/s. quality tussle. By way of illustration the SEC requires a company listed in U.S. to undertake quarterly filings of the MD&A and other relevant information. The ongoing and continuous filing of information certainly impacts the quantitative threshold but owing to the nature/quality of the information being imparted to the investors, quality seems to give way to quantity.

The UK has adopted disclosure based regulation regime, where the Financial Services and Markets Act, 2000 requires an issuer company to be self compliant with the disclosure requirements, failing which the regulator may levy penalties on the defaulting companies.

China currently follows a merit based regulation for its securities market wherein the China Securities Regulatory Commission (the "**CSRC**") carries out substantive examination of the efficacy of the proposed offering and decides to approve of it. The CSRC also provides guidance by way of regulations in respect of the content and form of information disclosures. The quality v/s. quantity discussion, at least with respect to China, seems to get sidelined, as despite regulations for disclosure standards, it is CSRC which plays a pivotal role in approving the security offerings.

Conclusion

An active and healthy securities market requires an environment of high investor confidence and satisfaction. Thanks to SEBI and its foresightedness, the Indian securities market has weathered the recent global financial crisis. Having said that, the challenge, as always, is for SEBI to ensure continuous investor protection and at the same time enhancement of investor confidence, which is essential for the developing and evolving Indian securities market.

Quantitative disclosures in offering documents may find acceptance with industry players as long as the same also enhances the quality of information. Then, be it a sophisticated investor like a foreign institutional investor or a retail individual investor, as the long the disclosure facilitates the investors making a sound investment decision, disclosure, whether quantitative or qualitative, may be welcomed.

The recent global financial crisis in developed economies has proven that blinkered compliance with disclosure based regime may not be in the best interest of the securities market. In such a situation, it seems plausible that a cautious approach is followed where there is healthy mix of the disclosure and merit based regime.

Lastly, with the ever increasing complexities of the global as well as the domestic securities market, the regulators may require a greater and better mix of disclosure from the quality and quantity standpoint in the offering documents so as to ensure that potential investors are not only provided with the right amount of information, but that such information is also of the appropriate quality. This would further the objective of ensuring that the investors are at all times, in a position to make a reasoned and informed investment decision.