Towards Better Disclosures in Indian IPOs

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Introduction

The proposition that the efficiency of the price information process in a securities market depends in large part upon the mechanisms whereby information is produced verified and analysed to or in that markets is widely accepted[1]. Whilst, securities regulators in almost every international venue for raising capital have prescribed detailed disclosure requirements for prospectuses which are distributed to investors, debates and discussions with respect to the efficacy of these disclosure requirements is a continuing one both in academia and the professional circuit. Securities regulators in overseas jurisdictions have provide regulatory guidance with respect to disclosure requirements that assist the issuer and other market participants to draft disclosures in accordance with the expectation of the regulator. Such guidance is essentially a process of non-legislative rule making. SEBI presently does not provide such guidance on a voluntary basis. This note comments that regulatory interpretive guidance from SEBI for disclosure requirements in certain areas will assist issuers and merchant bankers to prepare offer documents which enhance the quality of information which is being provided to the investor. Such guidance will also be helpful in indicating the manner in which a regulator interprets and intends to apply the law relating to their obligations.

Interpretive guidance

The theoretical difference between legislative and non-legislative rules is quite distinct. A legislative rule is essentially an administrative statute – an exercise of previously delegated power, new law that completes an incomplete legislative design.[2] Non-legislative rules are not administrative statutes; instead they provide guidance to the public, regulatory staff and decision makers. These rules are not legally binding on the members of the public. Interpretation is an indispensable part of administration and enables regulators to fill gaps and reduce ambiguities to a practical and concrete level.[3] Whilst, a regulator might choose to decide not to deal with an interpretive problem and allowing its staff to work things out on a case-by-case basis, it appears worthwhile for regulators in certain circumstances to arrive at an agreed-upon approach and publish a non-legislative interpretive rule of general applicability. Interpretive material helps assure consistent day-to-day administration by the regulator's staff and provides an invaluable resource for members of the public. Whilst, such interpretive guidance is not legally binding, in practice a regulator's view is taken as the final answer.[4] Interpretive rules of general application provide guidance to both the regulator's staff and the public and their issuance should be encouraged in contrast to inaction or private advice.[5]

Securities regulators in some overseas jurisdictions such as SEC in the United States provide interpretive guidance with respect to regulations that it administers. Whilst, the SEC provides these interpretations on a voluntary basis, the SEC indicates that such interpretations are the views of the staff and are not rules, regulations or statements of the SEC and are intended only as general guidance. Similarly, other regulators including the FSA in the United Kingdom, ASIC in Australia and the FMA in New Zealand also provide regulatory guidance with respect to some of the legislation that they administer.

The disclosure-based regime for public offers

The Capital Issues (Control) Act, 1947 administered by the Controller of Capital Issues governed capital raising activities in India. The Capital Issues Control Act was repealed in 1992 when SEBI was established as a statutory authority. SEBI has regulated the primary market through (i) the regulation of issuer's eligibility to offer securities to the public (access restrictions); (ii) regulation of information production at the time of issuance; and (iii) regulation of processes and procedures relating to issuance of securities.[6] These aspects are largely governed by the SEBI (Issue of Capital and Disclosure Requirements Regulations), 2009 ("ICDR Regulations")[7]. These disclosure requirements are in addition to requirements specified under the Companies Act, 1956.

Whilst, the SEBI Regulations are fairly prescriptive with respect to information which is required to be disclosed in an offer document for a public offer, there are areas where guidance from the regulator would be welcome. For example, whilst, ICDR Regulations require that risk factors should be determined on the basis of their *materiality*, the regulations do not provide guidance as such with respect to factors which issuers can consider for this purpose. This essentially leads issuers to disclose a significant number of risk factors which may not be material for an investor to consider and often leads to "distracted information." Another example that can be considered here is litigation disclosures made by issuers. The ICDR Regulations do not prescribe any materiality standard for disclosure of this information for companies making an IPO. This also leads issuers to disclose information which is not always material for an investor to consider in making his investment decision. The case for SEBI to clarify or introduce the concept of materiality with respect to certain categories of disclosures for public offers through the introduction of guidance notes is a strong one. This route will enable SEBI to make changes or fine tune any guidance with more flexibility as compared to a formal regulation amendment process.

The case for materiality

The concept of materiality is crucial to the efficacy of securities laws[8]. In this role, materiality analysis serves a dual process in the disclosure process. First, materiality analysis shapes the content of mandatory disclosure required under securities laws[9]. Second materiality analysis shapes the content of clarifying disclosure; information not expressly mandated by disclosure requirements needs to be disclosed if it is material and necessary to make mandated statements not misleading[10]. Therefore materiality analysis pervades a number of aspects of a securities regulation regime[11].

The securities law approach to materiality follows closely the common law concept of materiality that developed in actions for fraud and misrepresentation. For example, *Halsbury's Laws of England* defines a representation to be material when its tendency, or its natural and probable result, is to induce the representee to act on the faith of it in the kind of way in which he is proved to have in fact acted. Commentators have suggested that the common law approach to materiality enhances commercial stability because parties cannot avoid completing a transaction on the basis of a minor or irrelevant misrepresentation. Whilst, the ICDR Regulations carry references to materiality for certain disclosures, the SEBI ICDR Regulations itself do not provide guidance as to factors that could be considered for determining materiality. On the other hand, the Listing Agreement and AS 1 indicate qualitative standards that are helpful to understand materiality. This section attempts to set forth the need to determine standards for assessing materiality is useful for disclosures in the Prospectus and uses the sections on "Risk Factors" and "Outstanding Litigation" to illustrate this point.

Whilst, the SEBI ICDR Regulations essentially requires an Issuer to take into account quantitative and qualitative factors to determine materiality for disclosure of risk factors, the Regulations do not progress to illustrate standards that could enable issuers to determine materiality. The identification of risk factors that are considered to be material for disclosure purposes is a burden that rests primarily on the Issuer. However, the regulator could provide an indication of factors that could assist an issuer to identify material risks which the regulator would expect the issuer to disclose in the offer document. For example, in the United States, the SEC through its *Updated Staff Legal Bulletin No. 7* provides guidance in relation to disclosure of risk factors. The Bulletin indicates that risk factors typically fall in three broad categories and provides guidance to the nature of risks that can be considered under these categories.

The risk disclosure guidelines prescribed by the North American Securities Administrators Association indicate that "*risk factors alert the potential investor to all of the <u>material risks</u> (emphasis supplied) involved in the offering that bear on the likelihood of business success and financial return to the investor*" Regulation S-K under the U.S. Securities Act, 1933 specifies that issuers should not present risks that could apply to any issuer or offering. These guidelines and regulations indicate that issuers are required to present risks that are considered specific and material to the issuer and its business. Accordingly, the regulator could consider indicating certain standards that would assist an Indian issuer to determine and disclose material risks to its business in the Prospectus. The regulations should require that all issuers should disclose only material risks in relation to its business, the industry in which it operates and the offering of securities.

Whilst, the ICDR Regulations provides guidance with respect to litigation matters which should be considered material for disclosure in rights offerings, similar guidance is not available for public offers. In the United States, Item 103 of Regulation S-K under the U.S. Securities Act, 1933 requires an issuer to briefly disclose material pending legal proceedings, other than routine litigation incidental to the business, to which the issuer or any of its subsidiaries is a party or of which any of their property is the subject. This regulation also provides guidance in relation to litigation disclosures. The SEBI ICDR Regulations have indicated a quantitative criterion for litigation disclosures in a Letter of Offer (1% of the revenue of the issuer). However, this does not often prove to be a reasonable threshold. The Regulations should prescribe a threshold for litigation disclosures in the Prospectus which should be 5% or 10% of profit after tax or turnover of the issuer. In addition, the issuer should be required to disclose criminal proceedings any regulatory proceedings pending against the issuer or its promoters or directors of the issuer, pending litigations against the promoter which could have a material adverse effect on the issuer, pending litigations against those group companies which have significant related party transactions with the issuer or which could have a material adverse effect on the issuer and any other litigation which could have a material adverse effect on the issuer.

Guidance notes

Guidance notes enable the regulator to provide an advance notice to the regulated community and regulatory beneficiaries about the expectation of the regulator. In addition, such guidance enables the regulator to inform interested parties by means which are significantly quicker and less expensive than the formal rule making process. The case for clarifying that certain disclosures in a prospectus should be considered from a materiality stand-point cannot be over-emphasized. Disclosure of "risk factors" or "outstanding litigation" from a materiality stand-point will enable issuers to focus on disclosures that are absolutely essential for an investment decision and prevent "distracted information." Interpretive guidance is prone to change and best dealt with a non-legislative process which can enable the regulator to respond to changing situations in "real-time." Guidance notes from the regulator in providing such interpretive guidance on materiality will be a route that is dynamic as it will enable the regulator to change or fine tune its expectations within a relatively short period of time.

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1 Ronald J Gilson and Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindsight Bias* (2003) 28 *Journal of Corporation Law* 715 reprinted in John Armour and Joseph A McCahery (eds), *After Enron* (Oxford: Hart Publishing, 2006).

2 Michael Asimow, *Non-Legislative Rulemaking and Regulatory Reform*, 1985 Duke L.J. pp. 381

3 *Ibid*

4 *Ibid*

5 *Ibid*

6 G. Sabarinathan, *SEBI's Regulation of the Indian Securities Market: A Critical Review of Major Developments*, VIKALPA, Vol. 35(4), October – December, 2010

7 The ICDR Regulations replaced the *SEBI (Disclosure and Investor Protection) Guidelines, 1999*, popularly known as the "DIP Guidelines"

8 Glen F. Miller, Note, *Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality*, 95 Nw. U.L. Rev. 361, 362-63 (2000)

9 *Ibid.*

10 *Ibid.*

11 Dan L. Goldwasser, *Disclosure Under the Federal Securities Laws*, 623 P.L.I. Comm. 279,284 (1992)