The Road Not Taken: Rethinking Approach to Disclosure Requirements for IPOs

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Introduction

Prior to 1992, India followed the merit based regulations for securities offerings. The companies intending to offer securities to the public were required to obtain the approval of the Controller of Capital Issues ("**CCI**"), a governmental authority, which would specifically approve each public offering and its terms, including the price at which shares were to be offered.[1] Thus, there was complete governmental oversight.

Major initiatives were taken in the early 1990s including the repeal of the Capital Issues (Control) Act, 1947 in May 1992, abolition of the office of the CCI and advent of the Securities and Exchange Board of India ("**SEBI**").[2] Since the empowerment of SEBI through the SEBI Act in 1992, SEBI undertook a number of initiatives and issued various circulars and notifications towards introducing a disclosure based regime in the Indian securities market. These circulars and notifications were subsequently consolidated and included in the SEBI (Disclosure and Investor Protection) Guidelines which was issued in 2000 (the "**DIP Guidelines**")[3]. The DIP Guidelines prescribed detailed and comprehensive disclosure requirements for the offer documents. With the DIP Guidelines, the Indian securities made a systematic and a complete shift from the merit regulations to the disclosure regulations.[4] This shift was consistent with the practice followed by certain developed securities market jurisdictions after these jurisdictions had realised the difficulties of the merit regulations. In 2009, the DIP Guidelines was replaced with the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (the "**SEBI Regulations**") which continued the extensive disclosure requirements.

However, in 2012, SEBI issued the SEBI (Framework for Rejection of Draft Offer Documents) Order (the "**Rejection Order**") which provided certain indicative grounds for rejection of offer documents. These grounds are not limited to inadequate disclosure in the offer documents and extends to grounds which are subjective and would depend on the regulator's judgment. Arguably, the Rejection Order partially takes the Indian securities market back to a merit based regime.

We believe that at this stage of growth of the Indian securities market, the objective of SEBI should be to bolster the existing disclosure requirements prescribed under the SEBI Regulations by way of guiding the issuers to meet the disclosure requirements in the most effective and efficient manner. The disclosure of material and relevant information in the offer documents should be to enable the investors to make accurate investment decision. The existing disclosure requirements have unintentionally contributed to inundation of information and average quality of disclosure.

The first section of this essay briefly discusses the experience of Indian securities market with the merit regulations and the Rejection Order. In the second section, we have highlighted some concerns with the current disclosure model prescribed under the SEBI Regulations. We have suggested various ways in the third section in which SEBI may consider providing guidance to the issuers to limit the disclosure to the material and relevant information consistent with approach followed in certain developed securities market jurisdictions.

Are merit regulations being enforced through the General Order for rejection of offer documents?

As the term "merit regulation" suggests, this approach entails "review by a securities regulator to determine whether the quality of a given issue of securities is adequate for sale in the relevant jurisdiction"[5]. The difference between the disclosure based norm and the merit based norm is that the disclosure approach allows investors and the market to determine whether a given offering is fair or excessively risky, whereas it is a government official who makes that determination in case of the merit regulations.

Most of the developed securities market jurisdictions have, partially or completely, phased out the merit based approach. The regulators realised that the screening of the securities offerings by the government officials clearly

imposed burdens on capital formation. Under this approach, not only must securities issuers convince the capital markets of their offering's worthiness, but they had the added hurdle (and costs) of having to convince a regulator as well. With that hurdle came the regulatory risk that a quality offering could be wrongfully rejected. The specter of corruption and bias in the process also became relevant[6].

In India, before the advent of SEBI, the CCI controlled mobilization and issuance of capital through the securities market. The CCI regime was an extreme instance of the "merit regulations". The result of the CCI regime was that it (i) impeded resource mobilisation; (ii) led to unhealthy administrative practices; (iii) resulted in inability of the system to cope with increasing resource mobilisation load; and (iv) led to development of grey market and paid little or no attention to development of market institutions.[7]

Since its inception, SEBI has done a splendid job in providing a robust disclosure regime which has facilitated stupendous and organised growth of the securities market in India. However, after almost two decades of providing guidance on disclosure regime, SEBI has issued the Rejection Order which provides for certain grounds for rejection of offer documents:

"if SEBI has reasonable grounds to believe, for the protection of interest of investors, that the adequacy and quality of disclosures in such offer documents are not satisfactory, or where an investor may not be able to assess the risks associated with the issue (emphasis supplied)".[8]

The reasons for issue of the Rejection Order is difficult to understand considering that SEBI already had prescribed extensive disclosure requirements with the scope for requiring additional disclosure or detailing on the existing disclosure requirements. Further, the Rejection Order does not restrict the grounds for rejection of offer documents to inadequate disclosure only and extends to non-disclosure subjective test of SEBI such as vague objects of the issue, unidentifiable promoters, circular transactions for building up the capital/net worth of the issuer, exaggerated, complex or misleading business model or existence of litigation so major that the issuer's survival is dependent on the outcome of the pending litigation. Such non-disclosure based grounds mark a major shift in the approach of SEBI from disclosure regulations to a hybrid approach of disclosure and merit regulations. This approach poses a significant risk of lapsing of a developed securities market back into the subjective regime of the regulator.

We suggest that SEBI should reconsider the non-disclosure based grounds for rejection of offer documents and should limit the Rejection Orders only to the disclosure based grounds. The reforms are required to ensure that the existing disclosure requirements are strengthened to ensure that an investor can make an accurate decision on investment in the issue entirely based on disclosure made in the offer documents.

Prescriptive Disclosure based SEBI regime - Treasure hunt for investors?

The disclosure based approach was a delicate balancing act which devised a regulatory regime that would simultaneously protect investors without impeding corporate access to the capital markets[9]. The shift from the merit regulations also helped the Government or a securities market regulator in avoiding the implicit approval on the merits of any securities offered for sale to the public[10].

With disclosure as its primary regulatory tool, SEBI has steadily expanded the scope and detail of disclosure requirements that are expected in the offer documents. However, this has unintentionally contributed to inundation of information and has resulted in average quality of disclosure in the offer documents. The disclosure in the offer documents have continued to lengthen (offer documents sometimes exceed 600 pages), resulting in ample data, but, perhaps less useful information. It is questionable whether investors are able to absorb fully the vast amounts of information that is available in the offer documents today. The prospective investors would invariably face real cognitive limits regarding how much new and complex information they can absorb and use in arriving at a decision for investment. Given this, more information may not improve investment decisions and could prove harmful if investors, especially retail investors, end up being unable to identify the most pertinent facts.

Another pitfall of strict disclosure based norm is that it encourages the issuers to provide excessive disclosure in the offer document to ensure that they are protected from any potential liability in the future. This has resulted in a plethora of disclosure in an offer document which could conveniently have been summarised in a succinct manner. Further, this approach also does not provide an incentive to the issuers to highlight or draw attention of the prospective investors to certain crucial business and risks disclosure in the offer document which may materially affect the decisions of the investors in a particular offering.

Whilst institutional and high net-worth individuals may have the benefit of road-shows and other issue related presentations where specific issues may be highlighted and the participants may have the opportunity to seek responses on specific issue related queries, the retail investors are supposed to review the entire offer document and form an opinion based on their assessment of the voluminous disclosure included in the offer document.

The disclosure based approach is surely the way forward for the Indian securities market and SEBI, however, it may be worth delving into certain best practices adopted by some of the developed securities market jurisdictions which have supplemented the disclosure regulations in various ways to achieve optimal disclosure in their offer documents.

Towards "Guided" and "Material" Disclosure Based Regime in India

Issue of Guidance Notes for Style and Method of Meeting Disclosure Requirements

Some of the developed securities market jurisdictions such as the United Kingdom and Australia have been issuing guidance notes on various disclosure requirements prescribed under their respective legislations.[11]

For example, the UKLA Technical Note[12] on Risk Factors does not provide any indicative risks or customised risks for various class of issuers. The Technical Note succinctly sets out the expectations of the regulator in relation to disclosure of risk factors such as avoidance of boiler plate risks or requirement of explanation for a particular risk in the context of the issuer's business or the issue of the securities in question. The Technical Note provides certain disclosure issues in relation to risk factors which, if identified in an offer document, will be questioned by the regulator. Similarly, FSA has also issued guidance notes on various other disclosure issues such as financial information and directors' and management disclosures.

SEBI may also consider issuing guidance on various disclosure sections prescribed under the SEBI Regulations based on past experience with the issuers, standard observations issued by SEBI on the offer documents and international best practices. We believe that issuing separate guidance will provide SEBI with necessary flexibility to elaborately address specific disclosure requirements and would facilitate effective disclosure in the offer documents. SEBI can consider issuing the guidance notes under its own authority with necessary disclaimers or through any other organisation adequately authorised by SEBI.

We have set out below certain indicative subject matters on which SEBI may consider issuing guidance notes.

Guidance note for certain disclosure sections which have detailed requirements

SEBI may consider issuing a set of guidance notes on various disclosure requirements clearly setting out its expectations from the issuers from such requirements. For instance, SEBI may consider issuing guidance on disclosure of the risk factors including instructions that the boiler plate risks should be avoided and specific factual instances should be included for each risk factor, to the extent possible.

Similarly, SEBI may also consider issuing guidance note on disclosure of outstanding litigation as currently, the outstanding litigation section forms the most voluminous disclosure section of the offer documents. SEBI may consider allowing clubbing of other litigation which over time can be removed (as this is usually not material). SEBI may also consider limiting the disclosure of litigation to top five group companies consistent with the requirement of disclosure of financial items limited to top five group companies. However, these relaxations can continue to remain subject to disclosure of any litigation which may have a material adverse effect on the issuer[13].

Guidance note on certain terms which have an impact on disclosure requirements

The SEBI Regulations have extensive disclosure requirements in relation to the group companies including disclosure of corporate and financial information and outstanding litigation involving such group companies. The SEBI Regulations define "group companies" to mean certain entities which are promoted by the promoters of the issuer, irrespective of whether such entities are covered under Section 370(1)(B) of the Companies Act, 1956 or not. The SEBI Regulations currently does not provide the manner in which "promoted by the promoters" is to be determined. Whilst the SEBI Regulations provide the definition of a "promoter", it would be helpful if SEBI clarifies that "promoted by the promoters" is restricted to those entities where the promoter of the issuer would also be considered as a promoter (as defined in the SEBI Regulations) of such entity. This becomes especially important as certain other laws such as Press Note No. 2 of 2013 issued by DIPP and the Competition Act, 2002 provide specific definitions of "group" and "group companies".[14]

Guidance note customised for certain specific sectors

The disclosure requirements currently prescribed under the SEBI Regulations do not specifically address a particular sector and understandably, provides generic disclosure requirements applicable for all sectors. However, given the rich experience of SEBI in dealing with issuers from diverse sectors and specific issues that they have faced in disclosure of their business and risks, SEBI may consider issuing guidance note for customised disclosure requirements specifically for business and risk disclosure for prospective issuers from certain sectors which regularly access capital markets such as real estate and various infrastructure sectors.

Guidance note for materiality threshold for certain disclosure requirements

The concept of materiality is crucial to the efficacy of securities laws. However, defining materiality is a perpetual challenge and an elusive accomplishment for most of the jurisdictions. Whilst developed jurisdictions such as United States have provided subjective threshold[15], the regulators in the United States have also provided that no information need be given in respect of proceedings that involves exceeding 10 per cent of the current assets of the issuer and its subsidiaries on a consolidated basis. Similarly, in Australia, ASX Rule 3.1 indicates that changes in previously reported financial information above 10%-15% are normally material.

In case of certain disclosure requirements such as disclosure of outstanding litigation for a rights issue[16], the SEBI Regulations already recognises and provides materiality thresholds. SEBI may consider issuing a guidance prescribing a materiality threshold of 5% or above of the assets or turnover or profits (whichever is lower) of the issuer on a consolidated basis for disclosure of litigation. However, the issuers should continue to disclose any other litigation which, individually or cumulatively (in case of similar matters), may have adverse effect on the issuer on a consolidated basis.

Guidance Note on disclosure requirements under other laws in the offer document

In addition to the SEBI Regulations, an issuer may also be required to comply with the disclosure requirements under various other laws. For instance, certain new disclosure requirements prescribed under the new Companies Act, 2013 and the Companies (Prospectus and Allotment of Securities) Rules, 2014 (the "**Prospectus Rules**") may require further clarity from the perspective of the SEBI Regulations. The Prospectus Rules require disclosure of source of funds contributed towards promoters' contribution along with complete details of external and own sources for such contribution. The Prospectus Rules do not provide clarity on whether this promoters' contribution is linked to the promoters' contribution that is locked-in for a period of three years in terms of the SEBI Regulations or it extends to any and all contribution, in any form, made by the promoter of the issuer. This would be challenging for issuers who have been in existence for many years. SEBI may consider issuing guidance notes in consultation with the Ministry of Corporate Affairs clarifying on such disclosure requirements to guide the issuers to include suitable disclosure in the offer documents.

Concluding Thoughts

Given the past experience of Indian securities market with the merit regulations and the globally accepted merits of the disclosure regulations, it would be desirable that SEBI reconsiders the elements of subjectivity and value judgment in the review and rejection of offer documents introduced by way of non-disclosure based grounds in the Rejection Order. SEBI may consider strengthening the existing disclosure requirements to ensure that the issuers issue such offer documents which provide complete and material information to the investors to enable them to make suitable investment decisions. SEBI may also consider taking a new course of advisory on disclosures in the offer documents to guide the issuers to make effective and relevant disclosures in the offer documents to facilitate easier and convenient review of the offer documents by the investors.

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1 G.Sabarinathan, Securities and Exchange Board of India and the Indian Capital Markets – A Survey of the Regulatory Provisions, IIM Bangalore Research Paper No. 228 at 10-11, available at http://ssrn.com/abstract=2152909

2 Arvind Panagariya, India: The Emerging Giant 242 (2008).

3 SEBI issued a set of Disclosure and Investor Protection Guidelines in 1992, which was followed through with a number of clarifications issued over the years. In 2000, these were consolidated in the SEBI (Disclosure and Investor Protection) Guidelines, 2000.

4 A Historical Perspective of the Securities Market Reforms in India; http://www.sebi.gov.in/cms/sebi_data/docfiles/2975_t.html

5 Richard A. Booth, Financing The Corporation §9.13 (2012)

6 Gregory A. Mark, The Court And The Corporation:Jurisprudence, Localism, And Federalism, 1997 SUP. CT. REV. 403, 414 (1997); Jay T. Brandi, The Silver Lining in Blue Sky Laws: The Effect of Merit Regulation on Common Stock Returns and Market Efficiency, 12 J. CORP. L. 713, 734 (1987)

7 G.Sabarinathan, Securities and Exchange Board of India and the Indian Capital Markets – A Survey of the Regulatory Provisions. Working Paper 228 (July 2004)

8 Recital to the SEBI (Framework for Rejection of Draft Offer Documents) Order, 2012.

9 Charles H.B. Braisted, State Registration of Securities: An Anachronism No Longer Viable, 78 WASH. U. L. Q. 401, 405 (2000)

10 Ronald J. Colombo, Merit Regulation via the Suitability Rules, World Economic Review, http://wer.worldeconomicsassociation.org/files/WEA-WER2-Colombo.pdf.

11 For instance, the Financial Services Authority in the United Kingdom maintains the knowledge base and introduces the purpose of the guidance notes in the following manner: *"The information is designed to assist both issuers and practitioners advising issuers in interpreting the Listing Rules, the Prospectus Rules, and the Disclosure and Transparency Rules. The guidance notes provide answers to the most common queries we receive. The notes, which are presented in a series of Technical notes and Procedural notes, set out how we would expect certain issues to be addressed.",* http://www.fca.org.uk/firms/markets/ukla/guidance.

12 Ref: UKLA/TN/621.2 – Consultation - http://www.fsa.gov.uk/static/pubs/ukla/ukla_risk_factors.pdf

13 For example, if one of the group companies has provided a guarantee to the issuer, a winding up suit against such group company may impact the issuer. Another example, if one of the group companies is a major supplier of raw material or purchaser of products, any adverse litigation affecting such group company should be disclosed in the offer document. Companies which do not have inter-dependence are arguably not necessary for inclusion in the offer document.

14 Press Note No. 2 of 2013 issued by DIPP defines a group company to mean two or more enterprises which, directly or indirectly, are in position to: (i) Exercise twenty six per cent, or more of voting rights in other enterprise; or (ii) appoint more than fifty per cent, of members of board of directors in the other enterprise. Further, Explanation (b) to Section 5 to Competition Act, 2002 defines "group" to mean two or more enterprises which, directly or indirectly, are in a position to (i) exercise twenty-six per cent or more of the voting rights in the other enterprise; or (ii) appoint more than fifty per cent of the members of the board of directors in the other enterprise; or (iii) control the management or affairs of the other enterprise.

15 TSC Industries v Northway Inc. (426 U.S. 438 (1976) indicates that a fact will be material if there is 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.

16 For instance, the SEBI Regulations requires that the letter of offer for rights issues to disclose pending litigation matters (cumulatively in case of similar matter) exceed one per cent of the total revenue of the issuer as per the last completed financial year.