Indian Securities Market – Challenges in Corporate Disclosures

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Intuitively people think that regulation of the securities market is a given good and a *laissez faire* policy leaves the system open to unnecessary fraud and market risks. What is less apparent is that regulations always impose a cost on all regulated entities (including the investor) not merely on the fraudulent entities alone. Even though these costs are paid by the companies, they are ultimately borne by the investors themselves. A large part of regulation is pivoted around disclosure by listed companies in the capital markets. Along with the anti-fraud rule, this forms the basis of modern securities regulation. This is in contrast to the previous regime where a bureaucrat or the ministry decided what was good for issuers and companies.

Disclosure

Disclosure is, and mandatory disclosure arguably is, the fundamental principle on which today's capital markets rest. In a market where ownership grows more distant from the management, the owners need to know increasing amounts of information so that self dealing and violation of fiduciary duties are minimized.

Mandatory disclosure

With the exception of the Chicago school of thought, mandatory disclosure today is seen by most people as a necessary rule in the field of securities regulation. Some of the reasons why disclosure is not allowed to be voluntarily made are as follows. A voluntary scheme of disclosures coupled with the anti-fraud rule would permit silence when from a policy perspective specific disclosure is considered 'good'. A mandatory standard allows easy comparisons as 'income' or other terms would mean similar things across companies and industries allowing investors to compare comparables in terms of time, place and manner of disclosure. Mandatory disclosure also permits a more efficient means of dissemination of company information and reduces the costs to investors to gather and process the data. A voluntary standard may also discourage a company from disclosing information if its competitors decide not to disclose and thus putting the disclosing company at a competitive disadvantage.

Cost v. Benefit

Even though disclosure is mandated, it is important to question every disclosure made as every disclosure has a cost attached and unless a cost benefit analysis is made, we could easily move into the territory where costs of disclosure are higher than the benefits. The first problem about weighing the costs and benefits of regulations is the difficulty of quantification. The *Securities Exchange Commission* often does a quantification of the costs involved to the society by the introduction of a new regulation. For example, before the introduction of filings under *Regulation Fair Disclosure*, the SEC carried out an analysis of how many listed companies would be affected by the introduction of the regulation. The cost to each firm was estimated by looking at the proposed form, number of filings a year, and estimating the number of hours filling up and filing of the documents in terms of attorney time, internal counsel time and other specialist times required for complying multiplied by the average rate of fees for each. After taking the cost to all the firms and other costs to the society including time of the regulator and stock exchanges an inaccurate but probative cost of between $35 to 50 million to the society was arrived at. The benefits were of course not quantifiable but were enumerated before coming to the conclusion that the benefits exceeded the costs.

DISCLOSURES – THE WAY FORWARD

Though disclosure standards have markedly improved over the past few years, a lot of work needs to be done before we can feel even slightly complacent with the state of current affairs. The prime areas which need work are integration, simplification and accessibility of information.

Treating unequals as equals

Disclosure standards are expensive. And much of the cost of disclosures is the same whether the issuer is large or small, thus making the cost of capital much less for larger entities. This higher burden needs to be lightened for small business issuers. As William Blake put it several centuries back – treating the lamb and the lion as equals is a travesty of justice. Companies like Infosys were small companies just a decade ago when they first raised capital. It's necessary to encourage small honest companies; we need to get over our presumption that larger companies are more honest and small companies quickly vanish away with investor money. Smaller companies can be encouraged to enter the capital markets if the regulatory and disclosure burdens they face are lighter than those faced by companies several hundred times their size. Thus there needs to be a two tier system which encourages

smaller companies to enter a separate platform for trading and in turn face fewer disclosure norms. For instance quarterly filings by a small company are burdensome and can easily be done away with. The challenge in India would be to allow a small companies to raise capital and list while at the same time improve enforcement so that past instances of vanishing companies is not repeated.

Integration and accessibility

Today information is so fragmented that obtaining much of the public information about a company is quite difficult. Even if information is public, it needs to be searched from several sources e.g. company website, SEBI's Edifar website, Registrar of Companies, stock exchange archives etc. For instance to get the Articles of Association of a listed company – the most fundamental charter of a company is a Herculean task. One must queue up outside the *relevant* (perhaps in another state) Registrar of Companies to obtain a copy. A review of listed companies revealed that few companies put up their Articles of Association on their website.

To take another example: to gather information of 5% change in shareholding of a company under the takeover code – an information which is to become public is a difficult task as is obtaining the 2% report under the insider trading regulations. This is so even though a static 1% shareholding pattern is available on a quarterly basis from several sources including Sebi's Edifar website and the stock exchanges' websites.

Further company information is not integrated between the primary and secondary markets and between regulations leading to disclosures ending up as theoretical frameworks and not actual means of communicating to the investors. Information about a listed company should be comprehensively available from a single source.

Readability and plain English

Current disclosure documents are practically unreadable and are more attempts by lawyers to defend their client, attempts by the regulator to disown their liability, attempts by the accountants to make convenient assumptions hidden in small footnotes. Starting from the font size to the type of jargon used and the incomprehensible English used, there is nothing in an annual report or a quarterly report (or several other disclosure documents) which is understandable to an ordinary educated investor.

Arthur Levitt the former chairman of SEC had famously stated that he rarely understood these disclosure documents even though he was the President of the American Exchange for several years and had been a part of the securities industry for decades. He introduced a drive to use plain English and the SEC brought out a very useful guide to using plain English – an effort which can be used in India with equal benefit.

A good example of plain and readable English is Warren Buffet's letter to the shareholders of Berkshire Hathaway. In one paragraph this year, he narrates the improved sales in the company's investment in the lingerie maker Fruit of the Loom in the following words:

"In apparel, Fruit of the Loom increased unit sales by 10 million dozen, or 14%, with shipments of intimate apparel for women and girls growing by 31%. Charlie, who is far more knowledgeable than I am on this subject, assures me that women are *not* wearing more underwear. With this expert input, I can only conclude that our market share in the women's category must be growing rapidly."

Multiple registrations and regulations

Several aspects of primary market disclosures are contained both in the Companies Act and in the Sebi regulations causing enormous amounts of duplications and unnecessary paperwork besides making compliance more difficult and making companies more prone to technical violations. Similarly, when Sebi is fully seized of a matter, registering a prospectus with the Registrar of Companies adds no value while adding an additional layer of cost. Primary market regulations and disclosures needs to be deleted from the Companies Act altogether. Given the setting up of a Committee to look into drafting of a new Companies Act, this would be an appropriate time to modify the provisions in the Companies Act.

Disclosures to stock exchanges

Our exchanges use a Byzantine form of communication when corporate information is released by a Board. For instance when the Board of Directors releases quarterly numbers, they are asked to be faxed by the company to the Stock Exchanges. The exchanges then manually feed the information faxed into their systems. If the documents are voluminous, the task could take days leaving price sensitive information with several people, besides the manual process could introduce several errors. On enquiry, why the process is used, the apparent reason is that the exchanges think that it is not legally possible to send information electronically. This is of course incorrect since the passing of the Information Technology Act 2000 when not only was electronic information recognized, but presumptions of authenticity were created for electronically signed documents sent by electronic means. It is important to note that the Act overrides all other statutes and even specifically amends such statutory provisions as the Contract Act. Some change is occurring in this area and some filings are taking place electronically, but the pace is so slow and the majority of filings are faxed which is a shame, given India much touted technology advantage.

Conclusion

Till now too many people have thought of corporate disclosures by listed companies as documents which no one reads and therefore issuers and intermediaries make them even more unreadable. We need to make disclosures more readable and accessible and that will happen when we treat disclosure documents as documents which communicate and which add value to a company's value not merely as formal boilerplate obligations. With our technological edge in these matters many of these can be achieved fairly effortlessly but the big question is – do we have the vision to do so?