Integrated Disclosures
A New Paradigm

Sandeep Parekh
Founder
Finsec Law Advisors
Former ED, SEBI

Background

In 1988, a shift from a controller regulated model for governing issue of securities to a disclosure based regulatory philosophy can be noted. Since then, the Securities and Exchange Board of India (SEBI), the securities market regulator in India, has prioritised public disclosure. To give some examples, apart from the disclosure standards prescribed during an IPO, SEBI also requires various disclosures under the listing agreement on an annual and quarterly basis, the takeover regulations and the insider trading regulations. The philosophy behind requiring disclosures is premised on the simple idea that securities represent a bundle of rights which are not visible to an investor of securities and such investors must be made aware of the underlying company and the nature of the bundle of rights before they take an investment decision.

However, while the quality of the disclosures contained during an IPO is of a very high standard and is comparable or even better than international standards set in Europe and the United States, the same cannot be said about continuing disclosures. With requirements arising from a variety of laws and regulations, there is not only excessive duplication, but the disclosures are fragmented, inadequate, vague and not disclosed with the consistency seen in public offer documents. To address these issues, there is a need to shift to the Integrated Disclosures model.

Integrated Disclosures

This model of integrated disclosure is premised on the efficient capital market hypothesis ("ECMH"). According to the ECMH, information put out in the public domain is promptly impounded in the price of a security. Thus, once information is already out in the public domain, no value addition will arise out of repeating the same information when capital is raised.

By adopting the Integrated Disclosures model, there is a shift from the current practice of registering each issue of securities to a model where the company itself is registered. Under the proposed structure, once the company has provided all information necessary as part of one comprehensive document, either during the first public issue of capital or at the advent of these new requirements, strengthened continuous disclosure norms will ensure that information which is currently sought only at the time of issue of capital becomes generally available at all times. As a result, full disclosures would be enjoyed by a larger class of investors and potential investors at the same time. As a result, by avoiding duplication, costs of issue of further capital would come down. Seasoned companies with a reliable track record would be able to raise capital easily and at a lower cost.

It is important to distinguish between company information and transaction information. The former is already in the public domain and includes the issuer's business, management compensation, capital structure, recent financial results, etc. The latter relates to the particular issue of capital and needs to be published in a prospectus. Such transactional details would include details of types of securities offered, underwriting commissions paid, intended proceeds of capital raised, etc. The first step towards integrating initial and continuous disclosures is to divide company information and transaction information in the prospectus into two distinct parts. The second step is to make sure that the extent of disclosures made by the company at the time of IPO is replicated on a continuous basis also. The goal should be to make the company information in the continuous disclosures regime (annual report, quarterly reports and other disclosures) fungible with the company information in the prospectus.

Just like in an offer document or an annual report, top management of companies will be required to attest that there are no misleading disclosures and that all relevant information has been disclosed, to the best of their knowledge. Regulations may be suitably amended to make them liable for any errors.

Implementation in India

Shelf Prospectus

We have already witnessed an example of integrated disclosures in the form of "Shelf Registration" under Section 60A of the Companies Act, 1956, which provides for multiple issues of capital with a single prospectus. Each additional tranche of securities needs only incremental disclosures and transaction details. However, this provision is available only for a select set of companies for raising funds through specific types of securities, mainly debt by select financial institutions. The Companies Act, 2013, gives SEBI the discretion to determine the class of companies which may file shelf prospectus, and SEBI has slightly extended the same to issuance of Non-Convertible Debt Securities by (i) issuers authorized by the notification of CBDT to make public issue of tax free secured bonds; (ii) Infrastructure Debt

Funds Non-Banking Financial Companies (IDF-NBFC) regulated by RBI; and (iii) Non-Banking Financial Companies registered with RBI, Housing Finance Companies registered with National Housing Bank and other entities; subject to certain conditions. While there is need to further enlarge the scope and allow more companies to access this route, a more powerful change in disclosure norms would be a better way forward.

Sub-Committee on Integrated Disclosure

In February 2005, the Sebi Committee on Disclosures and Accounting headed by Y H Malegam, created the Sub-Committee on Integrated Disclosure. The sub-committee which had members from two stock exchanges, investment bankers, market professionals and SEBI officials, pored over thousands of pages of disclosures which fall within SEBI's domain and came out with a report in January, 2008.

The main objectives of the Sub-committee were to make disclosures meaningful, non-duplicative and non-burdensome to the extent possible and to make disclosures truly available and accessible to all. Consequently, investors will be able to look at one place to see all information that is publicly available regarding a company, companies will reduce the time being wasted in making over-burdensome and repetitive disclosures and the regulator may more efficiently and effectively exercise its power to catch fraud or non-compliance.

The Sub-committee discussed the importance of bringing up the quality of the disclosure on a continuing basis to the level of the disclosures in a public offering. There is no reason for SEBI to treat primary market investors on a higher pedestal than investors in the exchange market. Additionally, a major benefit of the proposed fungibility between initial disclosures during the IPO and subsequent continuous disclosures would be the reduced cost of compliance. Particularly, if a company goes to the capital market for the first time in an IPO, it would find that because of the fungibility of company information, the cost and effort in continuing disclosures and in creating an annual report would get reduced drastically. Similarly, the consistent high quality disclosures on a continuing basis would vitiate the need for the prospectus to exist in its current form for subsequent public offerings of capital. In other words, if a company was already listed and sought to raise more capital from the market, as the company's information was already in public domain, there will be no need to come out with a 500-page prospectus. A five-page document annexed with the last annual disclosure would suffice. The effort which goes into further raising of capital could come down.

The Sub-committee looked not just at integrating disclosures made by issuer, but also by investors. To ellaborate, investors are required to make separate disclosures under the Insider Trading Regulations and the Takeover Regulations, allowing for a situation where each transaction may have four separate disclosures being made, 2 from each transacting party. This is further added to if either of the parties are part of the promoter/ promoter group or if they are a director of the issuer. If an integrated approach is taken, the various disclosures could be consolidated and the information could be made available at a single reference point for investors and the regulator simultaneously.

Amendment to the ICDR

However, there has been hardly any development in this regard since the report was tabled before SEBI. In SEBI's board meeting held in August, 2012, SEBI considered the recommendation that companies must annually update the prospectus so as to create a single document that would contain all subsequent disclosures. This would enable secondary market investors to obtain the information they require without having to sift through various fragmented disclosures. Further, they considered whether it may be feasible to replicate the annual filing under 20-F, with suitable modifications if necessary, as is done in the US markets. This would help make the process of further public offers simpler. It was suggested that, for companies which are planning IPOs, this requirement should commence with the IPO, and for existing listed entities, SEBI should consider introducing this provision in a phased manner.

While the Board decided that the requirement of annual updation of prospectus shall be in addition to the continuous disclosure obligations specified in the Listing Agreement, the only change brought about was a minor amendment to the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. The new provision, titled "Annual Updation of Offer Document", requires companies to annually update disclosures made in the red herring prospectus which was issued during an initial public offer. However, in the absence of a specific framework to require companies already listed, this amendment did not fully address the issue.

Annual Information Memorandum

Finally, in March, 2014, SEBI released a discussion paper on "Annual Information Memorandum" providing a framework for issuing an Annual Information Memorandum under the new provision in the ICDR Regulations with a view to bridge the information asymmetry between the primary and the secondary market investors. In line with an IOSCO principle, the emphasis has been to provide reliable, timely and readily accessible information that is fundamental for investors. While presently, the only comprehensive disclosure that is available for investors is an offer document during a public issue or annual reports published by companies, SEBI felt the need to consolidate the fragmented set of disclosures in one place to facilitate investors in making informed decision in relation to their investments.

As per the discussion paper, listed companies will be required to file an Annual Information Memorandum with up-to-date information about their financial and operating performance along the lines of disclosures under Form 10K, 10Q, 20F, etc. in the US. This is bound to bring down compliance costs and aid in any future capital raisings. In addition, the disclosure requirements under the annual report would be restricted only to disclosures required under the Companies Act, 1956/2013. However, SEBI has not provided clarity on whether the Annual Information Memorandum may be used as a shelf prospectus at a subsequent date and further streamline the process of further issue of capital. SEBI had sought public comments on this proposal.

However, none of the proposed changes have been given effect to till date. In in its Board Meeting held in November, 2014, SEBI approved the proposal to replace the existing listing agreement with the SEBI (Listing Obligations and Disclosure Requirements) Regulations. Within this, SEBI has included an enabling provision that requires listed entities to submit an Annual Information Memorandum to stock exchanges. The manner in which this becomes applicable will be decided on a later date after the notification of the Regulations.

Conclusion

Apart from giving investors fundamental information regarding a company and reducing the costs of compliance, disclosures also reduce the possibility of wrongdoing. Even if a disclosure is not read by anyone, the fact that something needs to be disclosed and is in public domain will provide a good prophylactic against wrongdoing. The idiom that 'sunlight is the best disinfectant' succinctly describes this philosophy in the securities market.

While SEBI's move to towards consolidation of information under the Annual Information Memorandum is welcome and would go a long way in aiding secondary market investors to make informed investment decisions, with the date of implementation nowhere in sight, it remains uncertain when we will benefit from the changes.