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Analysis



SEBI's Proposed Disclosure Regime: Impact on Public M&A and Directors' Liabilities

Key Takeaways

- Most proposals are well thought through – unintended impact in a few cases
- Mandatory clarification of media rumours – M&A dealmaking compromised and potential creation of a false market?
- Objective materiality thresholds introduced – could inadvertently lead to over-disclosure and a failure to disclose material information
- Open-ended and ambiguous proposals cast a wide net – likely to increase directors'/ KMPs' liabilities

Introduction

Institutional investors, listed companies, and retail shareholders – three key market participants – will be watching SEBI with eagle-eyes while it attempts to implement a new disclosure regime, as set out in its recent consultation paper (***Consultation Paper***). Most of SEBI's proposals are well-intentioned and workable.

If at all, SEBI (and other market players) must remain cautious of the risks the proposals potentially open up. Flooding the market with too much information, increased liabilities for directors, and challenges for strategic and financial investors may compromise many of the benefits which the changes seek to bring.

We analyse certain key changes proposed and their potential effect on key market players.

From standards to rules: what has changed?

Mandatory disclosure of mainstream media reports

SEBI has proposed that the top 250 listed entities must "*necessarily confirm or deny any event or information reported in mainstream media… which may have a material effect on the listed entity under this regulation*." The law currently leaves this to the discretion of the listed entity. SEBI's rationale for the change seems to be that market rumours may fuel false market sentiment and adversely impact price discovery, thereby impacting public shareholders.

In an ideal world, this would be great for public shareholders. However, the proposal presents three key issues. First, there is a presumption that the media will necessarily act in the best interests of the public and listed companies. As the proposal stands today, all media reports may just have to be clarified by listed companies (since the term 'mainstream media' remains undefined), which may have the effect of giving the media a free hand to push listed companies to disclose information which may be uncertain or in primitive stages and which may be for the benefit of certain vested interests. Ultimately, public shareholders who make decisions on the basis of incomplete information will suffer if the listed company decides to make a decision the other way.

Second, it is unclear how much and how frequently a media rumour should be clarified, and whether listed companies need to continuously provide updates thereafter. If the media has only picked up on certain parts of a deal, it is uncertain whether the listed company should clarify only those parts or everything on the deal – since a partial disclosure may be viewed by SEBI as an incomplete disclosure. Next, let us say the listed company has gone ahead and responded to rumours about a potential contract that it intends to enter into. The contract is supposed to be signed three months later, but several developments

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take place in that time span, significantly changing the contours of the agreement (e.g., a 30% discount). Are listed companies also obligated to continuously disclose each such development – because the public markets will presume, and possibly rely on, the validity of the last disclosure? Finally, even if listed companies wanted to disclose information, there is the concern of external information (e.g., Alibaba's stake sale in Zomato) which the listed company may not know about. Are they expected to disclose such events as well? These questions currently remain unanswered – and insofar as the consequence may be an incomplete or partial disclosure, there remains a risk of a false market potentially being created.

Third, deal and price certainty are founded on the touchstone of confidentiality. If market leaks are responded to, deal prices (which are calculated on a look-back basis under listing regulations) shoot up, potentially making the deal unviable. This provides market players an avenue to abuse the process and further complicate deal-making. The impact of a deal being called off is not just on investors and listed companies. Public shareholders may take up media reports on potential deals and invest into the company, only to discover the basis for their investment was misplaced. The risk then is not just of compromised deal certainty, as disclosure of uncertain transactions also contributes to the creation of a false market.

Objective thresholds for materiality

Under existing law, certain events use objective thresholds to determine whether an event is 'material', thus warranting disclosure. For other events, the law intentionally retains a subjective threshold, allowing listed companies discretion to decide whether an event is 'material' or not. For the latter set of events, SEBI has now proposed to also include objective thresholds as well: if the 'expected impact' of such an event exceeds the financial thresholds in SEBI's proposal[1], it must be disclosed (although SEBI has not clarified how it has arrived at these specific percentages).

The aim seems to be to avoid subjectivity and provide certainty to public shareholders. However, the risk is two-fold. On the one hand, we may see over-disclosure. For example, a technology company with a turnover of INR 5000 crore and a net worth of INR 500 crore would have a threshold of INR 10 crore for materiality, which could trigger events immaterial to the overall business, such as termination of housekeeping services across multiple offices. Immaterial disclosures may flood the market with information and may result in retail investors missing out on events which are actually material. On the other hand, we may see a counter-productive result as well, where highly material events are not disclosed to the market purely because they do not the meet the objective thresholds

[1] Based on the last audited standalone financial statements of the listed entity, such an event is proposed to be 'material' and needs to be disclosed if the lower of the following thresholds are crossed: (a) 2% of turnover; (b) 2% of net-worth; or (c) 5% of absolute value of post-tax of profit/loss for the past 3 years.

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prescribed under law, thus diluting any flexibility or value that a subjective threshold contributes (e.g., sale of an undervalued business vertical which has a strong future value).

Does this mean SEBI should completely do away with a numerical threshold? Not necessarily, as there are grounds to justify a hybrid approach – where the existing materiality thresholds are retained as is, with the added stipulation of well-reasoned, objective thresholds which do not result in market flooding. A combination of these should help take care of some of these concerns.

Director/ KMP liabilities – doomed if you do; doomed if you don't

SEBI's intent could not have possibly been to increase directors' or key managerial personnels' (***KMP***) liabilities in ambiguous situations. However, if the current proposals are implemented as-is, this is the likely consequence as several ambiguities in the proposals have left directors and KMP in a rather precarious position.

Take, for example, the obligation to disclose material events e.g., regulatory actions, if their "expected impact" crosses the proposed thresholds. There is no clarity on how to calculate the expected impact. If the actual impact of a disclosed event turns out to be higher than their initial communication to the market, then directors and KMPs risk opening themselves up to significant liability (in certain cases, penalties of several lakhs rupees and prohibitions on entering listed markets). They may even decide to not disclose an event which they calculate as having a low expected impact, but the which ends up becoming much higher.

Similarly, the obligation to "confirm or deny" market rumours also puts directors on the spotlight. As we have highlighted here, directors or KMP may become liable for market manipulation or fuelling market speculation if they confirm a market rumour about a deal which subsequently falls through. The market has received incomplete information (even if the disclosure caveats that the deal is subject to negotiations) and may act on the expectation that it becomes true. As a consequence, directors may also have a fiduciary duty to continuously keep updating the market on media rumours, with uncertainty on how frequently or to what extent such disclosures are required. Then, directors are cornered into a dilemma of whether they should preserve deal sanctity or risk potential liability at SEBI's hands.

As a result, we expect an uptick in D&O insurance, especially where institutional investors are concerned. Boards would also do well to prepare proactive and reactive strategies in advance, which will enable them to respond appropriately in situations that may warrant disclosures. Similarly, listed companies may consider setting out parameters for calculating materiality and expected impacts in their materiality policy; such an upfront clarification in the policy may avoid regulatory scrutiny when a disclosure is actually made.

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Other key changes worth noting

1. No more 'shopping' for the right rating: SEBI has now mandated that all credit ratings should be disclosed, whether new, revised, requested or not. This should be beneficial for both retail and strategic or financial investors. SEBI had formally reasoned that rating agencies disclose ratings online even if they are withdrawn and the changes should be viewed as an effort towards information parity – but the history around abuse of credit ratings may suggest that SEBI is attempting to solve for a more systemic issue.

2. Exemptions for wholly owned subsidiaries: Transactions between a listed company and their wholly owned subsidiaries have been granted various exemptions under SEBI's current rules. The Consultation Paper however has opened up the question on whether they should be scrutinised further. As we have analysed here, such transactions may not always be beneficial for public shareholders as they may result in value-accretive businesses moving away from the public eye and may result in value leakages for shareholders. While mandating disclosures of such transactions may not solve for these concerns entirely, it may just be SEBI's first step towards further oversight.

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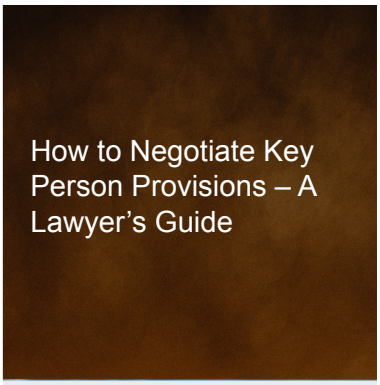
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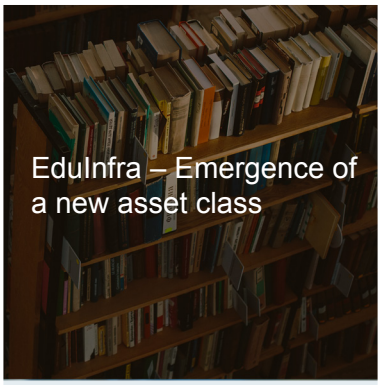
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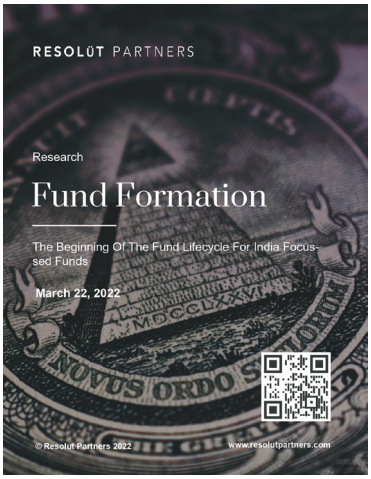
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