New Listing and Disclosure Obligations: An Analysis

Introduction

On September 2, 2015, SEBI notified the Listing Obligations and Disclosure Requirements Regulations, 2015 (“**2015 Regulations**”) with two-fold objectives: firstly, to align clauses of the listing agreement with Companies Act and secondly, to consolidate the conditions under different securities’ listing agreements in one single regulation. The 2015 Regulations are applicable to any entity (whether a company or not) accessing the stock exchange, for listing equity shares (on main board, SME exchange, institutional trading platforms), debt securities, preference shares, depository receipts, securitized debt instruments, mutual fund units, and other securities as may be specified by SEBI. The 2015 Regulations will be effective after 90 days from notification date i.e. from December 1, 2015, except the provisions regarding approval of related party transactions and disclosure of shareholders’ class and conditions of reclassification, which are effective from the notification date. Further, SEBI will in due course, notify an abridged and revised version of the listing agreement in sync with the 2015 Regulations.

This newsletter aims to provide an analytical overview of selective key changes under the 2015 Regulations and its impact on listed entities.

1. Material disclosures

The 2015 Regulations have rearranged and augmented the existing disclosure obligations of a listed entity. Regulation 30 which corresponds to Clause 36 of the equity listing agreement requires every listed entity to make such event based and information disclosures which are “material” in the opinion of the board of directors.

1.1 Deemed material: Certain events as provided in Schedule III[1] are deemed “material” and they incorporate the earlier disclosures of Clause 36, such as (i) acquisition of control, shares or voting rights[2] (direct or indirect), (ii) forms of inorganic restructuring like schemes of arrangement, sale or disposal of units, business divisions, subsidiaries; (iii) organic restructuring of share capital like issuance, forfeiture, split-ups, consolidation, transfer restrictions; and (iv) revision of ratings. However, the 2015 Regulations also include new disclosure obligations with an objective to promote informed investor decision making.

Firstly, board decisions pertaining to dividends, cash bonuses, buy-back, funding, issue of bonus shares, re-issue of forfeited shares, capital alterations, financial results, and voluntary delisting shall be considered “material”. The listed entity must disclose such decision to the stock exchange within 30 minutes from the closure of the board meeting. Non-compliance may result in fines, suspension of trading, freezing of promoter or promoter group shares or any

[1] Paragraph A of Part A of Schedule III

[2] Acquisition of shares or voting rights by the listed entity is such that (i) it holds 5% or more of the shares or voting rights of the acquired entity, or (ii) there is a 2% or more change in acquired company’s holding as per last disclosures due to every subsequent acquisition of shares or voting rights

other action as determined by SEBI. Under the old clause, there was no such requirement; and listed companies were only mandated to disclose the relevant information immediately. This permitted companies to make disclosures within a reasonable time period. With specified time-frame under the 2015 Regulations, companies have to ensure that the compliance officer prepares the disclosure statement in prescribed formats[3] and uploads it with the stock exchanges within 30 minutes. This short time frame may be unrealistic and is likely to create technical issues such as failure of connectivity, inadequate detailing, etc. if the prescribed formats are too elaborate.

Secondly, it is mandatory to disclose frauds and defaults committed by promoter, key managerial personnel or the company itself, as well as any arrest of the promoters or key managerial personnel. Fraud is committed when there is an act or omission with intent to deceive, irrespective whether there is any gain or not. In a fraud allegation, the accused must prove that the intent was absent based on lack of active participation, connivance or any knowledge of the alleged acts. Generally, such argument will necessitate production of documented proofs of board processes like meeting papers, minutes, etc. Further, involvement in fraud and statutory default are disqualifications for continuation and appointment as directors or key managerial personnel under the Companies Act. Thus, it becomes extremely important that directors and managerial personnel highlight their reservations and insist on recording their dissent in board noting and minutes. It also mandates companies to put in place effective vigil mechanism which will ensure protection of whistleblowers against any victimization, and not just as a listing compliance.

1.2 Materiality thresholds: Apart from disclosure of deemed "material" events and information, certain events as specified in Paragraph B of Schedule III shall be disclosed if they trigger the materiality thresholds. These events include (i) commencement of business of any unit/division or delay in commencement; (ii) change in the character and nature of the business; (iii) capacity addition or product launch; (iv) effects due to change in the regulatory framework; (v) granting, withdrawal, suspension or cancellation of licenses; (vi) litigation, disputes or regulatory assessment and their impact; etc. An event or information is material if omission of the event or disclosure of information is likely to result in (i) discontinuity or alteration of already available public information; or (ii) significant market reaction. Based on these guidelines, the board must frame a policy for determination of materiality, identify suitable events and information for reporting, and upload details on the website. The board is also empowered to authorize one key managerial personnel for the purpose of determining materiality.

This element of subjectivity and the board's determination of appropriate timing for making disclosures may not necessarily be binding on SEBI. For instance, SEBI recently imposed a penalty of INR 20 million (about US$ 308,700)[4] on NDTV for delayed disclosure of tax claim amounting to INR 4.5 billion (about US$ 70 million) raised by the Income Tax department.[5] NDTV informed the stock exchanges about the claim after a stay order was passed by the Income Tax Appellate Tribunal in the matter. While imposing the penalty, SEBI

[3] The prescribed formats are yet to be notified
[4] 1 USD = INR 65 approximately
[5] Adjudication Order No. AO/PJ/JAK 1 of 2015 dated June 4, 2015

observed that the belated disclosure as such did not affect the scrip price, nonetheless such disclosure was material and should have been made as soon as the claim was raised. This indicates the cautious approach of SEBI regarding material disclosures. Accordingly, companies must ensure that they determine materiality of events and disclosure timing rather meticulously and provide impact assessments of such disclosures to the stock exchanges.

2. Stricter governance requirements on board of directors

The 2015 Regulations in certain instances moves beyond mere alignment with governance requirements and thresholds as provided under the Companies Act and adopts a stricter approach towards the composition of board, its committees and the duties of directors. It tends to retain the higher requirements of Clause 49 of the equity listing agreement as well as amends some of the voluntary guidelines, to make them mandatory.

2.1 Board composition and its committees: For instance, as per Companies Act, at least 1/3rd of the board of directors of a listed company must comprise of independent directors. However, Regulation 17 retains the earlier threshold requiring 50% of the board to be independent, if the chairperson is not a non-executive director. Similarly, while the Companies Act requires that the audit committee members must be financially literate (i.e. capable of reading and understanding financial statements), Regulation 18(1)(c) maintains the mandate of having at least 1 member who possesses "accounting or related financial management expertise".[6] Further, it also retains the requirement of valid quorum of at least 2 independent directors for conducting an audit committee meeting, thereby making it indirectly imperative for all listed companies to appoint at least 2 independent directors. The 2015 Regulations also provide for constitution of "risk management committee" for top 100 listed entities determined on the basis of market capitalization at the end of previous financial year. Earlier, the listing agreement merely mandated the board to inform the shareholders regarding risk assessment and minimization procedures adopted for the same without requirement of a specific committee as such. Furthermore, constitution of remuneration committee and framing of whistleblower policy are now made mandatory compliances as opposed to voluntary practice under the listing agreement. Additionally, Regulation 46 requires disclosure of composition of various board committees on company's website.

2.2 Duties of the board: Section 166 of the Companies Act codifies the fiduciary duties of directors and breach of the duties is punishable with fine between INR 100,000 (about US$ 1,500) to INR 500,000 (about US$ 7,700). The 2015 Regulations further elaborate these codified duties, and provide principle-based guidelines in Regulation 4. These principles impose a collective duty on the board of directors for ensuring good governance. For instance, it is mandated that the board must (i) disclose any matter that directly affects the company; (ii) conduct itself so as to meet expectations of operational transparency while maintaining confidentiality; (iii) monitor effectiveness of governance practices; (iv) align managerial remuneration with long term interests of the company and the shareholders; (v) ensure

[6] A director will be considered to have "accounting or related financial management expertise" if he (i) possesses experience in finance or accounting, or (ii) is professionally qualified in accounting, or other such expertise, resulting in financial sophistication. Generally, holding position of CEOs, CFOs or other senior finance office will suffice

transparent nomination; (vi) monitor and manage conflict of interest; (vii) ensure integrity of accounting and financial reporting systems; etc. These principles are subjective and whether the duty has been fulfilled or not will be determined on a case-to-case basis. Further, it is expressly provided that in case of any ambiguity or inconsistency between the principles and the specific regulations, the principles shall prevail. It is unclear at this stage as to how will listed companies' boards ensure collective compliance with these ideologies and whether breach by any individual will result in impugning liability on the entire board as officer-in-default.

3. Related Party Transactions

Related party transactions ("**RPTs**") continue to garner constant attention for Indian companies. The Companies Act initially mandated special resolution for specific RPTs exceeding prescribed threshold. The Ministry of Corporate Affairs through an amendment in 2015 replaced the requirement of special resolution by an ordinary resolution. It also issued a circular[7] clarifying that only such related parties who are related to the particular transaction should abstain from voting on the proposed resolution. One of the objectives for notifying the 2015 Regulations was to streamline the process of RPT approval for listed companies in light of these changes.

3.1 Scope of RPTs: The 2015 Regulations defines RPT as transfer of resources, services or obligations between a listed entity and a related party, regardless of whether a price is charged. Further, "transaction" must be interpreted to include a single or a group of transactions under a particular contract. This definition is wider in scope than the Companies Act. As per Section 188 of the Companies Act, a transaction with related party is not an RPT and does not require prior board or shareholders' approval as long as it is at an "arm's-length" basis occurring in the "ordinary course of business". In light of the scope of RPTs under the 2015 Regulations, the exemption is taken away irrespective of the size of the listed entity and the value of the transaction in question. Hence, any transaction which is a RPT will require not only prior audit committee approval as mandated under Regulation 23(2), but also require board approval. However, shareholders' approval will be only necessitated if the transaction is a material RPT.

3.2 Approval of RPTs: Regulation 23(1) requires every listed entity to formulate a policy on materiality of RPTs. It also provides that any transaction with a particular related party (taken individually or combined with other transactions during the financial year) which exceeds 10% of listed company's annual consolidated turnover shall be considered a material RPT. It appears that a listed company may determine the variety of RPTs which will be classified as material ones. Since such materiality cannot transgress the threshold prescribed under the Companies Act; companies must take them into consideration while framing the policy on material RPTs. In order to align with the recent amendment in Companies Act, the 2015 Regulations substitute the old mandate of approving RPTs through special resolution, thereby permitting listed entities to approve RPTs through an ordinary resolution. But, the restriction on voting by related parties is not done away with, despite the clarification issued by the Ministry of Corporate Affairs which allows non-interested related parties to vote for approving a particular RPT. Regulation 23(4) read along with 23(7) states that while approving material RPTs, all related parties whether or not concerned with the particular RPT, must abstain from

[7] General Circular No. 30/2014 dated July 17, 2014

exercising their votes. Therefore, the RPTs approval process under the 2015 Regulations take away major exceptions and overall continue to remain stricter in comparison to the Companies Act.

4. Corporate governance for listed start-ups

In August 2015, SEBI amended the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 to enable listing of certain categories of start-ups[8] without undergoing an initial public offer. The underlying objective was to liberalize the stricter listing compliances and disincentivize start-ups opting to list on foreign stock exchanges. These start-ups must alter their structure into public companies prior to listing. Further, they can raise capital only through rights issue and private placement (which were otherwise available under Companies Act) and cannot invite retail investments or make any public offer. SEBI's model agreement for listing on the institutional trading platform did not relax the start-ups from complying with the corporate governance requirements as contained in the Companies Act. For instance, a listed start-up has to necessarily appoint 1/3rd of its board with independent directors, appoint 1 woman director, constitute board committees, set up vigil mechanism and put in place various internal controls and systems. Compliance with corporate governance provisions involves structural and compliance costs, substantial time for a start-up and continues to act as a deterrent for listing, despite floating of the alternative mechanism.

In order to exempt start-ups from such governance requirements, the 2015 Regulations seem to make a failed attempt. Regulation 15(2) exempts compliance with corporate governance practices for (i) companies with paid-up equity capital below INR 100 million (about US$ 1.5 million) and net worth less than INR 250 million (about US$ 3.9 million), and (ii) companies listed on SME exchanges. However, effect of such exemption is nullified by Regulation 15(3) which states that provisions of Companies Act shall apply where they are triggered. Thus, a listed start-up will continue to be governed by similar corporate governance parameters as that of a listed public company, even though it does not raise funds through a public offer.

Conclusion

Contravention of the 2015 Regulations will result in imposition of fines, suspension of trading, freezing of promoter or promoter group shares, or any other action as SEBI may deem fit. Further, the 2015 Regulations give statutory status to the contractual clauses of listing agreements and thus, breach of the 2015 Regulations will invoke penalty clauses under the SEBI Act. These regulations have stirred mixed reactions. Some brand them as "old wine in new bottle" while some are concerned about the method of its implementation. As discussed above, the new regulations retain stricter standards than the Companies Act in order to promote governance of listed entities and protect investor interests. The 2015 Regulations have adopted a unilateral approach for all kinds of businesses and the enthusiasm to ensure ethical

[8] Technology, intellectual property, data-analytics and other such IT intensive startups, having 25% paid-up capital held by qualified institutional buyers subject to other requirements (such as net tangible asset, funding restrictions) can list on the institutional trading platform of stock exchanges. Other startups which are not IT intensive will require to have paid-up capital held by 50% institutional investors

conduct has resulted in some level of disconnect with the business realities. The timely compliances will involve cost and resources for listed entities and may cause implementational difficulties for medium and small companies. This makes the 90 day time period fairly critical for listed companies to assess their preparedness for ensuring compliance and avoiding hefty penalties.

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