Disclosure duplication a waste of time and money

Sandeep Parekh argues that quality, not quantity, is the answer to India's disclosure issues

The philosophy of disclosure in the securities markets is premised on the idea that securities represent a bundle of rights that are not visible to a potential buyer of securities and that the buyer must know the nature of the bundle of rights before investing. Disclosure also reduces the possibility of wrongdoing. Even if a disclosure is not read by anyone, the fact that something needs to be disclosed will provide a good prophylactic against wrongdoing. The idiom that sunlight is the best disinfectant succinctly describes a whole philosophy in the securities market. Every disclosure made by a regulated entity has effort and costs attached to it – and these costs are ultimately paid by the investor. To the extent the marginal cost of compliance exceeds the marginal benefit, time wastage should be eliminated. To the extent disclosure is duplicative, the added cost of disclosure has no value addition and the duplication must be removed. To the extent disclosure is made, but is not truly accessible, there is a need to that ensure the disclosure enters the public domain.

When a company attempts to access the public for raising capital, it must go through a complex and lengthy examination process. Much of the process relates to collecting, collating and presenting information about the company to prospective shareholders of the company. While disclosure is a good thing, it costs a good deal of money. A typical primary market issue could cost over 10% of the capital raised (though much of it also relates to costs incidental to disclosure costs). This cost is borne by the shareholders of the company. Further, management is often diverted from its usual productive function in gathering information for an issue, so there is a direct economic opportunity cost to the company, and to the economy in general.

Efficient capital market hypothesis

The theory of integrated disclosure is premised on the efficient capital market hypothesis (ECMH). According to the ECMH, information released into the public domain is promptly impounded in the price of a security. Once information is out in the public domain, no value will be added by repeating the same information when capital is raised.

Integrated disclosure

The pursuit of integrated disclosure has two objectives. Firstly, to make disclosure as meaningful, as non-duplicative and as non-burdensome as possible. Second, to make disclosure truly available and accessible, particularly when filings with a regulator make a document theoretically public but the process of access is made so cumbersome and the availability so fragmented that it fails to effectively enter the public domain.

Reduced duplication of disclosure would reduce time wastage by companies, which are stuck with filling and filing hundreds of forms with large overlapping disclosures. With thousands of listed companies and nearly 700,000 unlisted companies, the waste to the Indian economy can be staggering. The reduced filing would automatically result in a reduced workload on the regulator, which can then use its energies more efficiently in enforcement and policy issues. The regulator would also be able to catch fraud and non-compliance more easily as it would need to tap only one source to check data. Fewer bottlenecks would result in faster capital raising and reduced risk, making corporations more agile.

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The US philosophy

A 1966 article by Milton Cohen in the *Harvard Law Review* "Truth in Securities revisited" was a seminal piece on the need for non-duplicative disclosures. Cohen advocated that continuous disclosure should be strengthened and issue of capital should invite minimal and only transaction-based information. Any correction, updates or supplementation to the continuing disclosure can also be provided to prevent staleness of company information. It later translated into the adoption of a single standard of company information for both primary issues and continuous disclosure for seasoned issuers. A seasoned issuer could incorporate by reference company information that was already out in the public domain. Where a company was coming to the primary market for the first time, the standards remained the same as in the past. Also introduced was the concept of shelf registration. Shelf registration allows multiple issues of securities with a single prospectus with a requirement to update the prospectus periodically and to distribute transaction details with each issue.

In India we have a sample of integrated disclosure in the form of shelf registration. However, the limited scope of the section makes it available only to a select group of financial institutions and for specific types of debt securities.

Primary market and secondary market integration

A public company that has previously tapped the capital market must comply with continuous disclosure norms under company law requirements, securities laws as laid down by the Securities and Exchange Board of India (Sebi) regulations and the listing requirements of stock exchanges. For instance, each company must file an annual report and quarterly reports. To the extent that company-related information is already in the public domain, part of the disclosure made in tapping the capital markets is repetitive and adds no value. It is important to distinguish between company information and transaction-based information. The former is already in the public domain, while the latter relating to the particular issue of capital needs to be published in a prospectus. Such transactional details should include details of types of securities offered, underwriting commissions paid, and intended proceeds of capital raised. By contrast, company detail would

include the issuer's business, management compensation, capital structure and recent financial results.

A quick look at the statutory prospectus for primary issues in India, whether first time offerings or not, shows that it contains a mish-mash of company information and transaction information. The first step towards integrating primary market and secondary market disclosure is to segregate company information and transaction information in the prospectus into two distinct parts. The second step is to make sure that to the extent that the primary market company information provides superior disclosure, the secondary market disclosures (like the annual report) should also make such disclosure. The goal should be to make the company information in the continuous disclosures (annual report, quarterly reports) fungible with the company information in the prospectus.

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A benefit of such fungibility would be the reduced cost of compliance. If a company goes to the capital markets for the first time in an initial public offering (IPO), it would find that because of the fungibility of company information, the cost and effort in creating an annual report would be reduced. Conversely, a seasoned listed company (which is listed for over one year and in compliance with the rules) already has its company information out in the public domain and could merely copy and paste this information into its prospectus along with any material updates and add the transaction-based information. This again would reduce the cost of compliance. An even more efficient means of integrating the information would be to incorporate the company information by reference into a prospectus. Incorporation by reference exists in the US markets (in form S-2, for example). Of course, any updates since the last annual or quarterly reports must be published as material updates in the prospectus along with the transaction-based information about the securities on offer. Integration could reduce the cost of compliance while at the same time improve the disclosure being made to investors.

Accumulative nature of regulations cause inefficiency

Much of the duplication in corporate disclosure can be attributed to the slow accretion to the body of regulations. New regulations add to the old, sacrificing an efficient quantum of disclosure at the altar of not missing any detail. Duplication also arises in the Indian context because some remnants of the Companies Act requirements relating to issue of capital from the public remain on the books, while Sebi has a comprehensive set of regulations. Sebi, although able to implement a holistic framework, is unable to delete statutory provisions like those contained in the Companies Act, which have outlived their relevance.

The argument for duplication

There are however cogent reasons for allowing duplication of disclosure. Unless one is able to overcome the arguments for duplication, it is difficult to justify the introduction of an integrated form of registration.

First, if information is not in the public domain, then a last mile delivery of company and transaction detail in a prospectus will become important. Disclosure after all is different from a theoretical filing with the registrar. The registrar of company offices in India are known for making public information difficult to access. So information has not entered the public domain and needs to be disclosed.

Second, if the two disclosures are qualitatively different, then a superior primary market disclosure would be necessary, even though parts of the disclosure are duplicative. The quality of primary market disclosure is also superior because it passes through various due diligences, particularly by the investment bank.

Third, if there are different liabilities attached to primary market versus continuing disclosure, then management would be more careful of disclosing information to prospective primary market shareholders than to the prospective secondary market shareholders, who could be more tolerant of mistakes. This is pronounced in the detailed liabilities attached to issuer, management, directors, signatories and experts under the Indian Companies Act for prospectus-based violations. The liability for inaccurate disclosure in the annual report is by contrast more generic.

Fourth, listed companies are mandated to file audited annual financial accounts in the annual reports to shareholders. They also file quarterly numbers and make them public. However, if such information is used for the issue of shares there is a possibility that the information has become out of date by up to three months.

Fifth, a listed company's continuing disclosure may be less coherent or readable because of the dozens of filings made in the past to the stock exchange, registrar, Sebi or other bodies. It would not be fair to expect the investor to sweep the public domain for bits and pieces of information and piece them together to get the real picture. By contrast, primary issue prospectus is information contained in a single readable document.

Sixth, Sebi examines a primary market prospectus more thoroughly than annual filings.

Arguments supporting integrated disclosure

Each of the arguments against an integrated approach and for continuing the status quo must be tested. If the arguments can be met by some modifications to our current thinking, it may be appropriate to modify some of the requirements.

Public domain

While public bodies may not be forthcoming in making filings truly public, there is nothing that stops companies from putting up the same information on their website. In fact this would be one of the basic premises of a streamlined means of disclosure. For a company to enjoy the benefits of integrated disclosure, it must fulfill certain conditions; the first of which is to make all theoretically public information truly public by posting it on the corporate website.

Superior prospectus disclosure

It is certainly true that the information contained in a prospectus is qualitatively superior to that filed in annual and quarterly reports of the company. However, that is not an argument in itself for discarding integrated disclosure. That is instead, a reason why continuing disclosure should be strengthened. Such improvement will not only bolster prospective primary shareholders but also

protect existing shareholders who until now have received inferior information.

Liability issues

Specific and more burdensome liabilities attach to primary issue violations as contrasted with more generic penalties for misstatements in the annual report and quarterly figures. If continuing disclosure attracts an easier burden of proof, one could argue that wrongdoers would have an easier time under the proposed mechanism. This issue too can be addressed. Top management could be required to file an attestation that they are not aware of any misleading disclosure and have not omitted any relevant material information. The liability of various intermediaries would apply as they would to a prospectus. The underwriter would need to conduct due diligence at a regular interval or before issue of capital. Any correction or update to the continuing duties of reporting would be made before an issue is made of securities. This would accompany the transaction-based details that would be distributed before each issue. These transaction details would be included as assessment of risk factors by the management.

Problem of staleness

The problem of information becoming out of date can easily be rectified, as discussed above. With each issue the management and directors would need to circulate two important categories of information. First any corrections and updates to the information related to the company and second, comprehensive transaction detail. Because a higher duty would be placed on updating the continuing disclosures even absent an issue, the duty to update and correct would presumably be minimal.

Coherence and readability

With filings being made to multiple regulatory authorities, the ability to patch different pieces of information to create a collage is a daunting task even for an analyst who is spending considerable time collating the information. The answer to the problem really lies with the company, which needs to make sense out of the mass of information. The company information can easily be put into a single document known as the continuously updated report (similar in structure to the annual report), with hyperlinks to various public filings made by it to various authorities. With today's technology such hyperlinks can provide a readable document that does not compromise on depth of information. The basic document would be in readable simple English with links to more detailed, complex and subtle information. A company wishing to make use of integrated disclosure should be required to have such a readable document that does not compromise on detail or complexity. In India there is already an abbreviated prospectus attached to a public issue application. This is highly readable, and a great and unique system that ought to continue.

Sebi scrutiny

This is perhaps the most difficult issue to overcome. While the regulator combs prospectuses for disclosure violations, its control over a company would be diluted in the proposed regulatory environment. With India's list of 9000 listed companies (the highest in the world), many of which do not fully comply with listing norms, it would be giving invitation to scandal to implement the scheme for all listed companies. Taking the Indian reality, implementing the scheme would need to be done cautiously, selectively and in phases. A company-based registration should be allowed only for seasoned companies with good track records that have complied with disclosure norms for at least five years.

Quality over quantity

Relying on a regulatory framework based on the requirements of a different era is a costly error that India may already be making. If, with today's technology, India could improve the quality of information available while reducing the quantity, such information would become more readable, more widely accessible, and the empty formality of registration could be translated into true on-tap disclosure, available to all. In 1966 Cohen predicted: "At some point in the foreseeable future it will surely be economically feasible, as it is probably now technically feasible, to record all filed information in a computer for instant retrieval and communication – to produce a prospectus on call, so to speak." With India's much vaunted technology edge, it surely has the technology today, but does India have the vision? ■

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