

Capital Markets Hotline

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SEBI PROPOSES TO STRENGTHEN CORPORATE GOVERNANCE OF LISTED ENTITIES

INTRODUCTION:

The Securities and Exchange Board of India ('SEBI') in its press release dated March 29, 2023¹ has announced the board meeting's decision to amend the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ('LODR') to increase the involvement of shareholders of listed companies in decisions and situations that may directly or indirectly impact their interests adversely. One of the amendments to the LODR is in relation to "disclosure of certain types of agreements binding listed entities". The proposed amendments were initially discussed by SEBI within the consultation paper titled "Strengthening Corporate Governance at Listed Entities by Empowering Shareholders" dated February 21, 2023 ('Consultation Paper')². The Consultation Paper proposes four changes to the existing regime under the LODR, which broadly relate to (i) the manner in which disclosures and approvals are sought for agreements binding listed entities, (ii) special rights granted to shareholders and their treatment under the LODR, (iii) sale of assets through media separate from the statutory schemes of arrangement, and (iv) board permanency within listed entities. All four of these proposed amendments have been accepted in the aforesaid board meeting, as per the press release dated March 29, 2023.

In this hotline, we focus on the first amendment, viz. the proposal for creation of a disclosure and approval mechanism relating to existing and future agreements binding / changing the management and control of listed entities (the 'Proposed Amendment'). We have mapped the Proposed Amendments against existing law and have correspondingly analyzed its potential impact on the corporate governance landscape for listed companies in India.

BACKGROUND:

Broadly, the requirement for the Proposed Amendment stems from Regulation 30 of the LODR. Regulation 30 relates to the disclosure of material events and information by a listed company to stock exchanges. The underlying guideline for the determination of materiality of an event under Regulation 30 of the LODR is three-fold and is as follows: first, whether the omission of disclosure of such an event or circumstance, which when disclosed, would lead to a change of the information already available to the public, second, whether the disclosure would result in a significant market reaction and third, in case of inapplicability of the criteria mentioned hereinabove, whether the information has been deemed material by the board of directors of the Company.³

Additionally, Regulation 30 provides for particular specified matters which would require disclosure as 'material events' under the LODR Regulations. Such events are provided under Schedule III and further subdivided into three categories:

(a) Para A of Part A Schedule III provides for events which would have to be mandatorily disclosed without any application of the aforementioned guiding principle for determination of materiality, as they have been "deemed material" under Regulation 30(2).

(b) Para B of Part A of Schedule III is based on Regulation 30(3) and provides for events which would have to be disclosed based on the applicability of the aforementioned guiding principle for determination of materiality.

(c) Para C of Part A of Schedule III provides for the disclosure of any event which is likely to affect the business of the company or is known exclusively to the listed entity and is required to be disclosed to the public to maintain information symmetry.

(d) Para D of Part A provides a residuary category under which any information deemed relevant by the board of directors can be disclosed by the listed entity.

Another requirement for the disclosures under Regulation 30 is that the listed entity should disclose such material information to the stock exchanges 'as soon as possible' and not later than 24 hours from the occurrence of such an event.

Changes to the disclosure regime vis-a-vis agreements binding the listed company:

Proposal 1 relates to disclosure and approval requirements in relation to agreements entered into by the shareholders, concerned stakeholders or the listed companies that bind the listed company.

■ Existing requirement for disclosure:

As per Clause 5 of Para A of Part A of Schedule III, any agreement (including revisions, amendments and terminations) which is binding in nature and not in the normal course of business of the listed entity shall be disclosed. The LODR also provides specific examples of such agreements such as a shareholder's agreement, joint-

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■ Proposed Amendment vide the Consultation Paper:

The rationale for the Proposed Amendment stems primarily from shareholders agreements ('SHAs') and adequate disclosures in relation to the same to shareholders of listed companies. SHAs can either be entered into by the shareholders or between the shareholders and the company. Generally, the rights and obligations of an SHA need to be incorporated into the Articles of Association ('AoA') of the company. This is because as per the Companies Act 2013, in case of any conflict between a provision of the SHA and the AoA of a company, the AoA shall prevail. Additionally, since any amendment of the AoA of a company requires the approval of shareholders through a special resolution, any SHA being incorporated into the AoA would require the same. The SEBI therefore identified an anomaly whereby SHAs that were not incorporated into the AoA were escaping the scrutiny of shareholders in the form of the aforesaid special resolution, thereby defeating the purpose of the disclosures under Schedule III of the LODR.

Another issue purportedly identified by SEBI pertained to scenarios where the promoters of the listed companies have entered into agreements with third-parties and had not made the listed company a party to such agreement, because such agreements may otherwise create direct or indirect liabilities or obligations on the company (although it is not immediately apparent how obligations can be created on a non-signatory to a contract). SEBI observes that, ordinarily, in the event that the company itself were a party to such agreement, the shareholders would have received a copy of each such agreement for their perusal and review, helping them assess whether such agreement may potentially have a detrimental impact on their interests. Since the LODR just requires disclosures of agreements that are binding on the listed companies, the promoters were therefore able to by-pass the scrutiny of the existing shareholders by excluding the listed company as a party to the agreement. In light of the same, SEBI pointed out that there is need to ensure information symmetry on any agreement which impacts the management or control of the listed company, irrespective of whether such agreement has the listed company as a party or not. SEBI's proposals for such agreements are divided into two categories – (a) agreements to be entered into in the future (i.e., on or after March 31, 2023) and (b) existing and subsisting agreements as on March 31, 2023.

For the agreements to be entered into in future: The Consultation Paper proposes the introduction of a new clause in para-5 of para-A of Part A of Schedule III of the LODR ("Clause 5A").

The proposed Clause 5A is as follows:

"5A. (i) Agreements which either directly or indirectly or whose purpose and effect is to, impact the management or control of the listed entity or impose any restriction or create any liability upon listed entity shall be disclosed to the Stock Exchanges, whether or not the listed entity is a party to such agreements. Provided that revision(s) or amendment(s) and termination(s) of such agreements shall also be disclosed. Provided further that only such agreements which are binding and entered into by the shareholders, promoters, promoter group, related parties, directors, key managerial personnel, any other officer of a listed entity or of its holding, subsidiary, associate company, solely or jointly with the listed entity or a third party shall be disclosed.

Provided further those agreements, other than those impacting the management or control of a listed entity, entered into by a listed entity in the normal course of business shall not be required to be disclosed.

(ii) Notwithstanding the above, agreements entered in the normal course of business shall be disclosed if they are required to be disclosed otherwise in terms of the provisions of these regulations."

Clause 5A also provides that such agreements shall be required to be disclosed if they are binding and entered into by either of the following with the listed entity or a third party: shareholders, promoters, promoter group, related parties, directors, key managerial personnel, any other offices of the listed entity or of its holding, subsidiary, associate company.

The Proposed Amendment also provides for additional obligations vis-a-vis such agreements falling under the ambit of the new clause. Such obligations include (i) disclosure in the annual report of the listed entity, (ii) obligation on the parties to an agreement to inform the listed company about such an agreement within 2 working days from date of entering such agreement (if the listed entity is not a party to it), (iii) a prior obligation on the board to provide the shareholders with a detailed rationale on whether such agreement is in economic interest of the listed company, and (iv) an approval by special resolution of the shareholders of the listed company and "majority of minority."

For existing and subsisting agreements: For all existing and subsisting agreements as on March 31, 2023 that fall within the scope of the proposed Clause 5A, the Consultation Paper prescribes that they should be disclosed on or before June 30, 2023 and in the annual report of FY 2022-2023. Additionally, in cases where the listed entity is not a party to the agreement, the parties shall inform the listed entity of such agreement on or prior to March 31, 2023. The agreements shall be placed before the board for them to analyze the economic impact of the agreement on the company, pursuant to which they will be subject to ratification by the shareholders in the first general meeting after April 1, 2023. In this regard, therefore, all the future obligations arising out of such agreements would be contingent to them being approved by the shareholders of the company in the first general meeting held after April 01, 2023.

ANALYSIS :

It is widely acknowledged that the Indian listed security space is disclosure heavy. SEBI has, time and again, taken more and more steps to reduce the information asymmetry between the listed entities and the market participants through enactment of amendments and regulations that increase transparency and stakeholder participation in the affairs of listed companies. However, while doing so, SEBI has to preserve the intricate balance between promoting greater relevant disclosures and imposition of simultaneous onerous obligations on the concerned stakeholders. While the intent of the Proposed Amendment is aligned with SEBI's general approach towards disclosures, the language and current form of the amendments might be considered as onerous and over broad by market players if not refined further.

■ Absence of clarity on the scope / guiding factors for the applicability of the Proposed Amendment

The proposed Clause 5A in its current form covers all agreements which directly or indirectly or has the purpose or effect of (a) impacting the management and control of the listed company; or (b) imposing any restrictions /creating any liability on the listed entity, whether the listed entity is a party to such agreement or not.

Firstly, this language in its current form is so broad that it is likely to cover within its ambit unintended categories of contracts. For example, a contract between a shareholder and his nominee director would fall within part (a). It may be of no relevance to the shareholders of the listed entity, and may even include confidential information in relation to the nominee, but would need to be disclosed to the exchanges, nonetheless.

Secondly it is difficult to understand how a contract could impose restrictions or impose liabilities on a listed company if the company is not a party to such contract. If such restrictions or liabilities are the result of the undertaking of shareholders of the company to vote their shares in a particular manner then the same would be covered under (a), rendering (b) otiose.

Thirdly the manner in which the proposed amendment are proposed to be applied to existing arrangements is effectively making the laws retrospective in their application, since the parties to such arrangement would not have contemplated such arrangements being made public when they entered into the same, or that the same would require the approval of shareholders (in the manner specified) for them to be enforceable.

Additionally, as mentioned above, the proposed Clause 5A is included in Para A of Part A of Schedule III, which requires disclosure without any applicability of the guiding principle. This would, in essence, make a multitude of agreements entered into by the mentioned parties under Clause 5A amenable to being disclosed, even if they might not actually have any material impact on the information symmetry between the listed entity and the market participants. For instance, under the LODR, related party transactions are only required to be presented for board approval if they cross a specified materiality threshold, non-material related party transactions can be approved by the audit committee of a listed entity. However, as per the proposed Clause 5A, even if a non-material related party transaction imposes any restriction or liability on the listed entity and is not in the normal course of business will have to be disclosed, thereby creating an anomaly.

In all, the broad language of the proposed Clause 5A is likely to make the disclosure obligation problematic. SEBI has time and again reiterated how the norm in the Indian listed security market is to disclose based on an analysis of the guiding principle of Regulation 30. In *ICICI Bank Limited v. SEBI*¹, SEBI stated that when there is a doubt in relation to whether an event warrants disclosure, the correct step should be to disclose it and not to utilize finer legal interpretations to not disclose the same. With such jurisprudence already in place, adding mandatory disclosure requirements without adequate guidelines on the manner of interpretation might pose challenges for stakeholders.

■ Practical Challenges

The Proposed Amendment states that upon its enactment, all existing / subsisting agreements that would now require a disclosure are to be disclosed to the listed company by the concerned parties immediately, as (i) such agreements would have to be disclosed to stock exchanges on or before June 30, 2023; and (ii) they would have to be ratified by the shareholders in the first general meeting held after April 1, 2023. For concerned parties that anticipate that their agreements would require disclosure under the Proposed Amendment, this would lead to the following expedited process that is to be undertaken at their end: (i) they may try to pre-empt the applicability of the proposed Clause 5A to their agreements prior to the enactment of the amendments foreshadowed in the Consultation Paper, which itself is not easy given the broad language of the proposed Clause 5A; (ii) if (i) is not possible, they would have to ensure that such agreements are disclosed well in advance to the listed entity, which then has to initiate subsequent corporate actions for its ratification, so that future obligations arising out of these agreements are not unreasonably delayed. This may pose a major secretarial challenge to larger listed entities, as they will receive a significant number of disclosures that require ratification in the first general meeting. The current text of the Proposed Amendment mandates that each disclosed agreement is to be placed before the shareholders for ratification in the first general meeting after April 1, 2023, which may become a tedious process. Further, this may prove to be a challenge to the Board as it would be required to independently assess and analyze the economic impact of each such agreement prior to such general meeting.

■ Rise in the role of independent directors and proxy firms

The Proposed Amendment is likely to increase the participation (and consequential reliance) on independent directors and shareholder activist / proxy firms in the Indian listed security space. Circumstances may arise in which the agreements on which the board of directors has to provide an opinion is in a nature conferring a direct or indirect benefit on some members of the board. In the absence of a specific clarification in this regard within the Proposed Amendment, it is likely that listed companies will follow good governance principles and ensure that the conflicted board members have recused themselves prior to issuance of an opinion on the economic effect of the concerned agreement. Therefore, the opinion provided by the independent directors on the economic effect and potential impact of existing and future agreements falling under the scope of the proposed Clause 5A may prove to be significant for the shareholders' ratification of agreements in the general meetings. Additionally, it would also be interesting to examine whether, over time, leading Indian shareholder activist/proxy firms enter into this segment of the listed security space to provide their advice to shareholders on the potential decision to be given during their vote on ratification.

Lastly, given that the final text of the amendment to the LODR (as approved by the SEBI on March 29, 2023) is awaited, a nuanced analysis of the amendment and the final implications of the Consultation Paper on stakeholders will be undertaken upon our perusal of the same.

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You can direct your queries or comments to the authors

¹SEBI Board Meeting dated March 29, 2023, available at: https://www.sebi.gov.in/media/press-releases/mar-2023/sebi-board-meeting_69552.html.

²Consultation Paper on Strengthening Corporate Governance at Listed Entities By Empowering Shareholders – Amendments To The Sebi (LODR) Regulations, 2015, available at: <https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-strengthening-corporate-governance-at-listed-entities-by->

³Regulation 30(4) of SEBI (Listing Obligations Disclosure Requirements) Regulation, 2015.

⁴Appeal No. 583 of 2019.

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