

Corporate Governance & material price sensitive
information: Need for listed entities to frame
effective materiality policy

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Overview (Executive Summary)

Good governance is possible with effective policy making as it facilitates compliance in letter and spirit. In case of a listed entity as well governance by way of framing detailed policy cannot be undermined. In this article, the authors have analysed the materiality policy framed by top 50 listed entities by market capitalisation to ascertain the effectiveness of the policy framed under Reg. 30 of Listing Regulations.

The article explains the glaring need to revisit the policies in order to uphold the spirit of corporate governance considering the fact that it has been about 5 years since enforcement of this requirement. The authors have concluded that listed entities are required to frame an effective mechanism to ensure timely identification of material information, ensuring none of the designated persons are able to indulge in insider trading and ensuring uniform and fair disclosure of such information.

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Introduction

The requirement to have systems and processes to identify material information and timely disclosure of the same timely to the Stock Exchanges ('SEs') cannot be undermined as the material information impacts the prices of the securities of the listed entity. Corporate Governance standards have been made more elaborate and stricter for listed entities over the years and the requirement to provide adequate and timely information to the stock exchange and investors in order to avoid insider trading and abusive self-dealing continues to be a key principle for listed entities.

Reg. 30 of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ('LODR') mandates disclosure of all events or information which, in the opinion of its board of directors are material. In this regard, the listed entities are required to frame a policy for determination of materiality and also authorize one or more of its Key Managerial Personnel ('KMPs') for the purpose of determining materiality of an event/ information and making disclosures to stock exchanges.

Before the enforcement of LODR, Clause 36 of the Listing Agreement required listed entities to immediately inform the SE all price sensitive information and the events which have bearing on the performance/ operations of the Company. The concept of determining, whether an event/information is 'material' in nature and forming of a policy for the same was introduced by LODR.

This article analyses the significance of having a detailed policy for determining materiality, corresponding requirement in other jurisdictions and analyses the effectiveness of the policies framed by top 50 listed entities by market capitalization as on March 31, 2020.

Material Information in India

In general parlance 'materiality' means the quality of being significant or relevant. In accounting and auditing parlance, 'material' has been defined to mean the influence that omission or misstatement of the information is likely to have on the economic decisions that users make on the basis of financial statements¹.

Although, LODR does not explicitly define the term, Reg. 30(4) lays down criteria for determining materiality of events/information, which include:

- a. *the omission of an event or information, which is likely to result in discontinuity or alteration of event or information already available publicly; or*
- b. *the omission of an event or information is likely to result in significant market reaction if the said omission came to light at a later date;*
- c. *in case where the criteria specified in sub-clauses (a) and (b) are not applicable, an event/information may be treated as being material if in the opinion of the board of directors of listed entity, the event / information is considered material.*

The criteria laid down in LODR are inclusive. While clauses (a) and (b) lay down two parameters, the third clause provides that in situations where both these clauses will not apply, the board is required to use its own understating of the term 'material'.

¹ As defined in IND-AS 101 on [Presentation of Financial Statements](#)

Concept of materiality in other jurisdictions

United Kingdom (U.K.)

Chapter 9 of the Listing Rules² issued by the Financial Conduct Authority (FCA) lists out the disclosure requirements of listed companies in UK. The following information's are to be notified to a Regulatory Information Service by listed entities, without delay:

1. Any major new developments in its sphere of activity which are not public knowledge and which may:
 - i. lead to substantial movement in the price of its listed securities;
 - ii. in the case of a company with debt securities listed, lead to substantial movement in the price of its listed securities, or significantly affect its ability to meet its commitments. (Rule 9.1)
2. All relevant information which is not public knowledge and concerns a change in the company's financial condition/performance of its business; or expectation as to its performance and which, if made public, would be likely to lead to substantial movement in the price of its listed securities.

United States (U.S.A)

As per rule 405 of the Securities Act, 1933 an information will be considered as material if a reasonable investor would attach importance to it, while determining whether or not to purchase a particular security. In the view of the Securities Exchange Commission (SEC) the component of the materiality should take into account the specific facts and circumstances relevant to each public company. Public companies vary enormously in the industries in which they operate, whether a piece of information is material for any one public company requires a facts-and-circumstances analysis.³

When it comes to disclosure of information SEC follows the prescription approach. In addition to annual and quarterly periodic reports that address certain specified disclosure items, all public domestic companies are required to file current reports in Form 8-K in the intervening period, regarding the occurrence of a comprehensive list of corporate events that are presumptively material.

Singapore

As per Rule 703 of the Singapore Exchange Limited (SGX) Listing Rules⁴ an entity is required to announce any information known to/concerning it or any of its subsidiaries/ associate companies which:—

- a. is necessary to avoid the establishment of a false market in the issuer's securities; or
- b. would be likely to materially affect the price or value of its securities.

The test of whether information is materially price-sensitive is an objective one and companies must assess how investors will react to any particular information when

² See: <https://www.fca.org.uk/publication/ukla/listing-rules-august-2002.pdf>

³ The Materiality Standard for Public Company Disclosure: Maintain What Works October 2015. Accessible at <https://s3.amazonaws.com/brt.org/archive/reports/Materiality%20White%20Paper%20FINAL%2009-29-15.pdf>

⁴ See: <http://rulebook.sgx.com/rulebook/703-0>

disclosed.⁵ While determining the materiality of an event factors like prevailing market conditions, liquidity of the issuer's securities, macroeconomic or sector-specific factors and the general market sentiment are also to be considered.

The listing rules also provide exceptions to the disclosures to be made and rule 703 will not apply to particular information if:

1. a reasonable person would not expect the information to be disclosed;
2. the information is confidential; and
3. the information :
 - a. concerns an incomplete proposal or negotiation;
 - b. comprises matters of supposition or is insufficiently definite to warrant disclosure;
 - c. is generated for the internal management purposes of the entity;
 - d. is a trade secret.

Australia

Chapter 3 of the Australian Securities Exchange (ASX) listing rules⁶ dealing with continuous disclosures states that *'Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information'*.

The test for determining whether information has material effect on price or value of the security is set out in section 677 of the Corporations Act⁷ which states that an information is said to have a material effect on the price or value of an entity's securities if it "would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of those securities".

The test being subjective in nature, gives rise to practical difficulties for listed entities in assessing whether or not they have an obligation to disclose information. Listed Entities are required to assess the situation by answering two questions:

1. "Would the information influence the decision to buy or sell securities in the entity at the current market price?"
2. "Would the entity be exposed to an action under insider trading if it were to buy or sell securities in the entity at their current market price, knowing the information had not been disclosed to the market?"

If the answer to either question is "yes", then the information is market sensitive and, if it does not fall within the exceptions laid down in the rules, it needs to be disclosed to ASX under.⁸

⁵ See Practice Note 7.1 Continuing Disclosure issued by SGX. Accessible at <http://rulebook.sgx.com/rulebook/practice-note-71-continuing-disclosure>

⁶ See: <https://www.asx.com.au/documents/rules/Chapter03.pdf>

⁷ See: http://www5.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s677.html

⁸ See ASX Listing Rules Guidance Note 8. Accessible at https://www.asx.com.au/documents/rules/gn08_continuous_disclosure.pdf

ASX listing rules provides exemption from disclosure if a particular information:

- a. concerns an incomplete proposal or negotiation;
- b. comprises matters of supposition or is insufficiently definite to warrant disclosure;
- c. is generated for the internal management purposes of the entity; or
- d. is a trade secret; and
- e. It would be a breach of a law to disclose the information.

Thailand

The Stock Exchange of Thailand (SET) has categorized information disclosure of material events into three categorized, depending on the urgency of information which may affect the securities price⁹.

Sr. No.	Type of Information	Timing of Disclosure
1.	Information about corporate actions or information which could potentially affect the securities prices, or investment decision, or shareholders' benefits	Immediately
2.	Information which does not directly affect trading or investment decision, but should be disclosed to investors	Within 3 working days
3.	Information which SET has to collect for future reference	Within 14 days/ 7 working days

Need for policy under LODR

Para A, Part A of Schedule III to LODR lays down list of 18 items that are deemed to be material and is required to be disclosed mandatorily to SEs; some within 30 minutes from conclusion of board meeting and the rest, as promptly as possible, but not later than 24 hours from the occurrence of event or information. [Reg. 30 (6) of LODR]

The need for a policy for disclosure of material events arises mainly for three purposes, first for designating KMPs who will be responsible for identification and disclosure of material information to the SEs, second for determining criteria on the basis of which events specified in Para B, Part A of Schedule III will be considered as material, requiring disclosure and lastly for determining criteria for events/ information relating to the subsidiary that will be considered as material for the listed entity.

⁹ See: https://www.set.or.th/en/regulations/simplified_regulations/disclosure_materials_event_p1.html

Analysis of materiality policy of 50 listed entities

We reviewed the policy for disclosure of material events framed by top 50 listed entities on BSE¹⁰ and NSE by market capitalization as on March 31, 2020, as uploaded on its website. The policies were analyzed on the basis of several criteria framed keeping in view the provisions of reg. 30 of LODR. The criteria's of the study and the results have been elaborated below:

Authority of determine materiality

As per reg. 30 (5) the board of a listed entity is required to authorize one or more KMPs for the purpose of determining materiality of an event/information and for the purpose of making disclosures SEs and the contact details of such personnel are be also disclosed to the SE and as well as on the entity's website. The rationale behind the provision being to designated a particular officer of the company as being responsible for all disclosures and also all queries arising out of such disclosures.

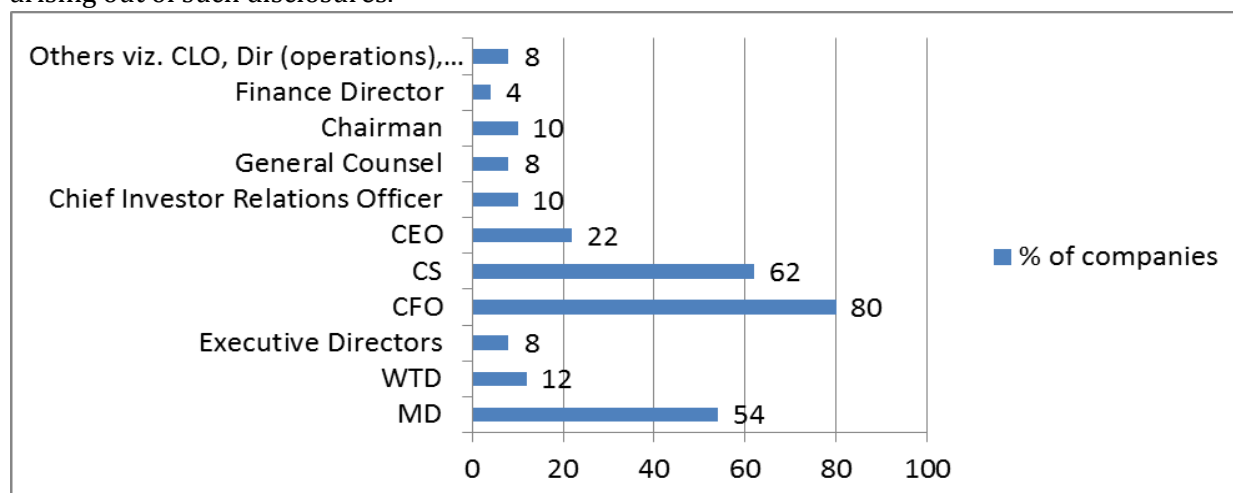


Figure 1: Authority to determine materiality

As evident from Figure 1: Authority to determine materiality, majority of the companies have identified the Chief Financial Officer (CFO), the Company Secretary (CS) and the Managing Director as authorized KMPs. Certain companies have also authorized CIRO, Chairman of the Company, Executive Directors as persons authorized to determine materiality for events listed in Para B, Part A of Schedule III.

Flow of information to authorized persons

Where the policies provide persons authorized to determine materiality, the manner of flow of information to the authorised persons has not been provided in the policy. A material event may not emanate in the registered office only; it would come to the notice of other managerial persons/ employees of the listed entity before the information reaches the authorized persons.

As evident from Figure 2: Flow of Information to authorized persons only around 18% of the listed entities have determined in their policies, officers who are responsible for reporting to the authorized persons about the occurrence of a material event and the flow of information.

¹⁰ <https://www.bseindia.com/static/about/downloads.aspx>

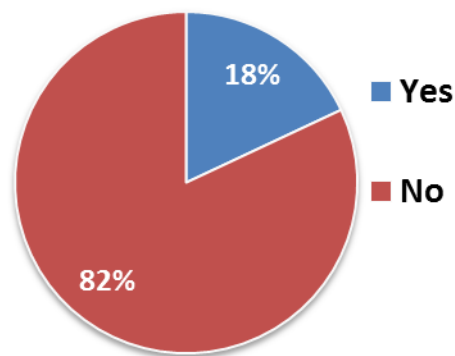


Figure 2: Flow of Information to authorized persons

Officers designated for coordinating

Further to the point discussed above, where entities have identified the officers to ensure timely flow of information to the authorized persons, 44% of entities have made the functional heads responsible, as evident in Figure 3: Officers designated for coordinating.

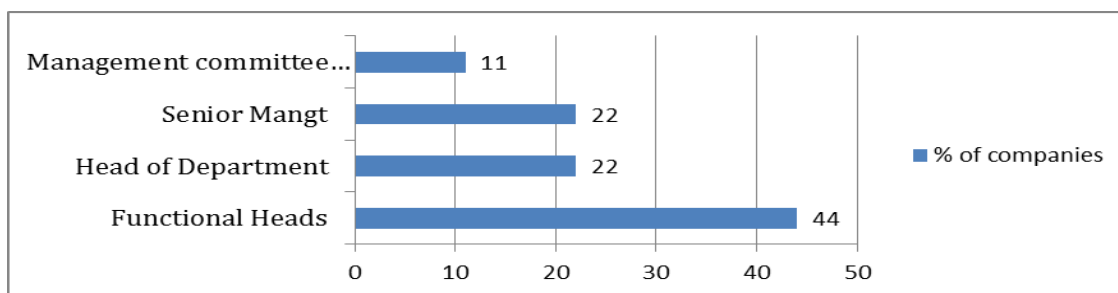


Figure 3: Officers designated for coordinating

Requirement to record the decision of KMP

The authorized persons determine the materiality by applying the test of materiality and accordingly ascertain if disclosure is required to be made to stock exchange or not. The policy should provide the mechanism in which the decision will be taken by the authorized KMP including manner of recording the same. This serves as a precedent for future decision making as well as a record to clarify queries from stock exchange/ SEBI in future. However, as evident from Figure 4: Requirement to record decision of KMPs majority of the companies do not provide for the same in its policies.

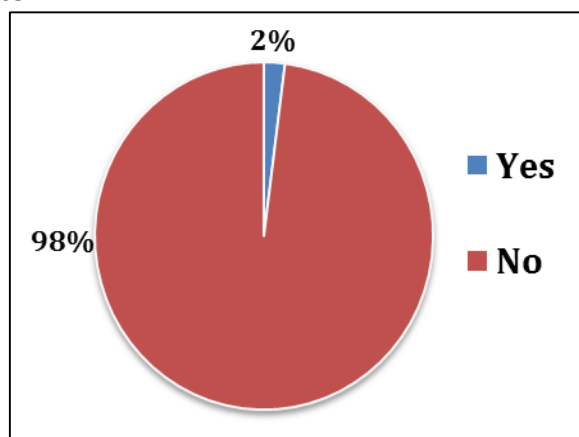


Figure 4: Requirement to record decision of KMPs

Quantitative criteria for determining materiality

The basis for determining materiality laid down in Reg. 30 (4) is qualitative in nature, which may not provide the correct parameter for determining materiality. Each of the items provided in Para B, Part A of Schedule III should have a different quantitative criteria. For instance the launch of new product will be considered as material only if it contributes to a certain percentage of the company's net profit or turnover. As evident from *Figure 5: Companies providing quantitative criteria* only 40% of the companies have laid down such quantitative criteria in its policies.

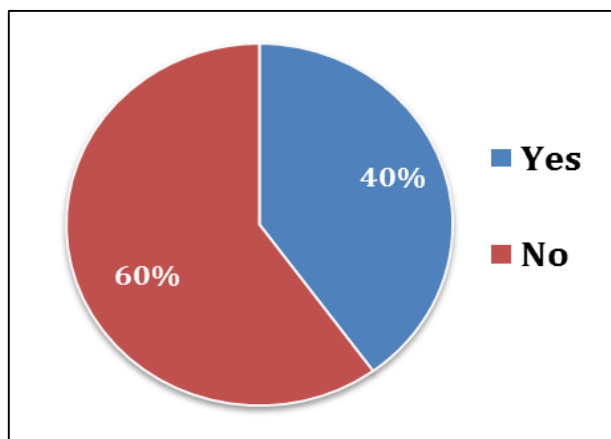


Figure 5: Companies providing quantitative criteria

Out of the above 40%, around 60% of the companies have prescribed single uniform quantitative criteria while the rest have prescribed different criteria's for different kinds of transactions as can be seen from *Figure 6: Kind of quantitative criteria*. A uniform quantitative criteria is not a correct way to ascertain materiality. For example, if the quantitative criteria is set to 5% of the consolidated turnover of the listed entity, the said threshold becomes a factor for determining materiality even for items like litigation, fraud, guarantees to third party etc, which is appropriate.

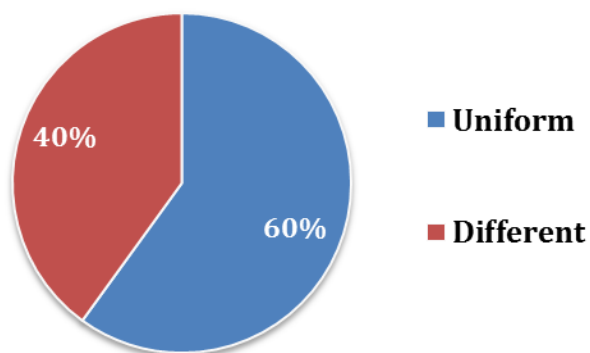


Figure 6: Kind of quantitative criteria

It was observed that majority of entities have based their quantitative criteria as a percentage of the consolidated Turnover or Net Worth of the Company. Only few companies based it on specific criteria, for instance the materiality of an issue/grant of ESPO/ESPS determined on the basis of the paid up equity capital, materiality of frauds and defaults and litigation determined on the basis of monetary ceiling of about Rs. 5 crores. A summary of the various quantitative criteria's used by companies can be seen in *Figure 7: Basis of Quantitative criteria*.

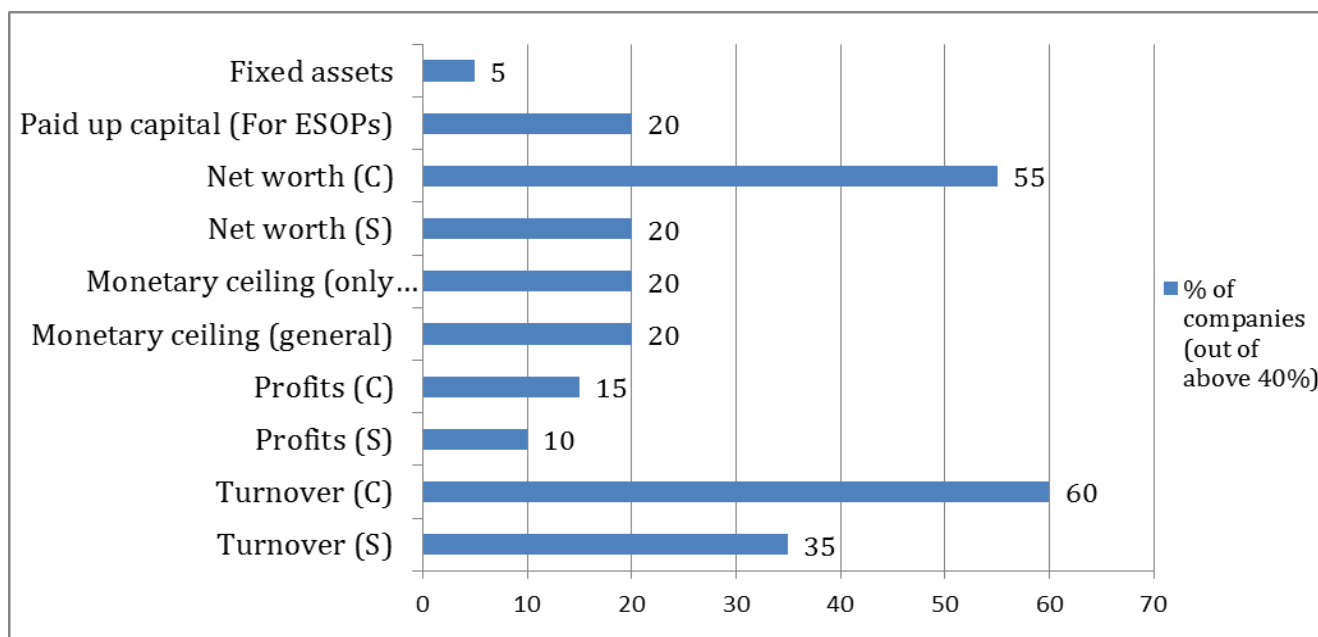


Figure 7: Basis of Quantitative criteria

Manner of handling queries from SEs:

As per Reg. 30(10) of LODR, listed entities are obliged to provide specific and adequate reply to all queries raised by SEs with respect to any events or information. However, the manner of handling queries from the stock exchanges, personnel responsible to provide clarification, timelines to provide the clarification, person responsible to respond to the stock exchange etc is also required to be covered in the policy. Our study yielded while only 14% of the entities have addressed the matter as can be seen from Figure 8: Manner of handling queries from SEs, very few entities have elaborated on the manner.

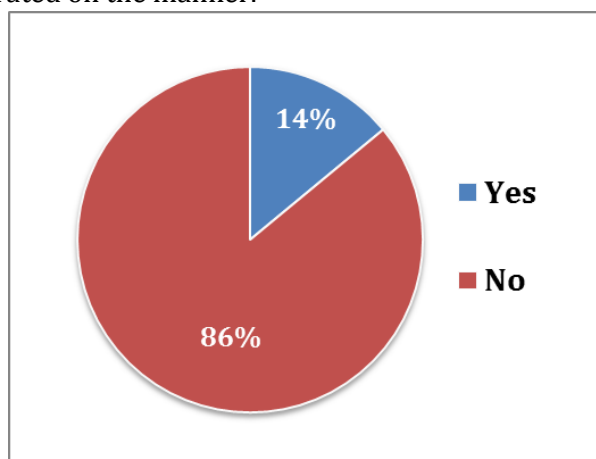


Figure 8: Manner of handling queries from SEs

Internal guidelines/ SOP

It is not mandatory for a listed entity to incorporate everything in the policy itself. An SoP or internal guidelines can detail the compliance to be ensured in Reg. 30 as the same is an internal document. As evident from Figure 9: Reference to internal guidelines/ SOP, majority of the companies have merely framed policies.

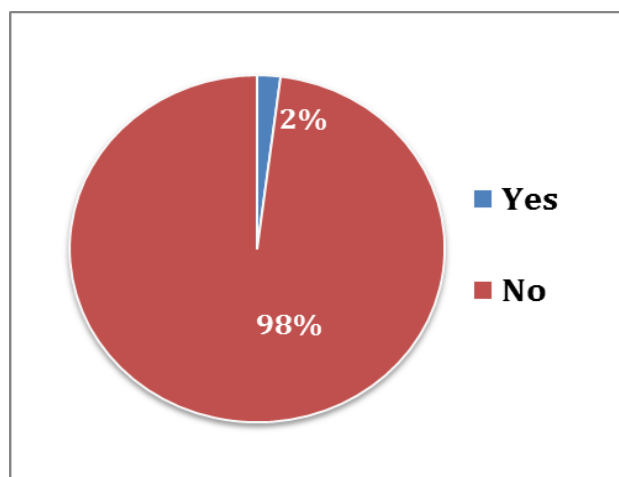


Figure 9: Reference to internal guidelines/ SOP

References to PIT Codes in the Policy

The provisions of materiality under LODR results in UPSI under PIT Regulations, and cannot be regarded as distinct. Material information under LODR requires prompt disclosure to the stock exchange to ensure the information becomes generally available information.

Until the disclosure is made, those in possession of the information cannot trade in the securities, being in possession of UPSI. The Compliance officer may determine selective closure of trading window for those in possession of UPSI and not every designated person, from the date of its emergence till the time such information is disclosed as per LODR. Further, the disclosure will also be guided by the Code of Practices and Procedures for Fair Disclosure framed under PIT Regulations.

As evident from *Figure 9: Reference to internal guidelines/ SOP* only around 28% of the entities specify that the policy is to be read along with the Code of Practices and Procedures for Fair Disclosure framed under the PIT Regulations.

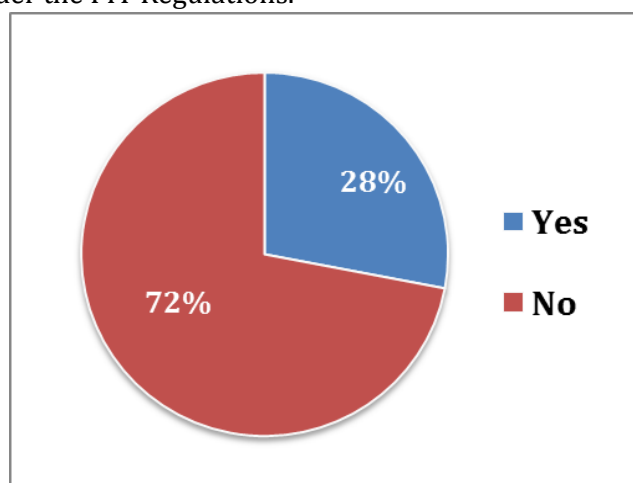


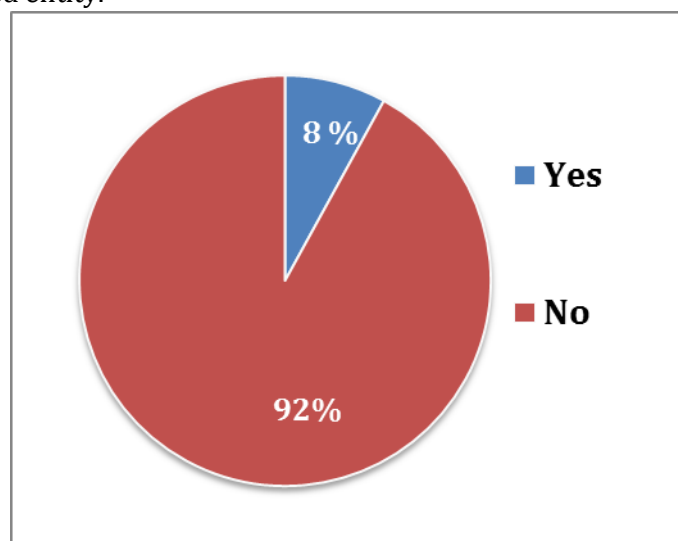
Figure 10: Reference to PIT Codes in the Policy

Events material w.r.t subsidiary

Pursuant to the provisions of Regulation 30(9) of LODR, the listed entity is required to disclose details of information w.r.t. subsidiaries, irrespective whether the subsidiary is material or not, which shall qualify as material for the listed entity. Hence, the test for materiality shall also apply for such cases. Further, if such information is considered material for the company, the trading window should be closed for DPs of the company till the disclosure is made to the stock exchanges.

Here, the disclosure is based on materiality of information for the company and not limited to materiality of subsidiaries. Therefore, in case of non-material subsidiaries also the company may require to close the trading window for UPSI if the information is likely to impact price of the listed entity.

As evident from **Error! Reference source not found.**, only 8% of the listed entities have adhered to this requirement and laid down quantitative criteria's for determining when events/ information relating to its subsidiary will be considered as material for them. Very few entities have listed down the names of the persons in subsidiaries responsible to share the information with the parent listed entity.



Conclusion

The requirement to frame a policy under any regulation is not to merely reproduce the provisions of law. The intent is to comply by framing a mechanism to ensure timely identification of material information, ensuring none of the designated persons are able to deal while in possession of such UPSI and ensuring uniform and fair disclosure of such information.

Operations of listed companies take place on a country wide scale and a KMP sitting at the corporate office cannot possibly have knowledge of every material event that takes place. Companies need to have designated officers in every department/ branch office/ operating unit etc. for determination of events/ information that are material. SOPs have to be laid down for flow of the information, the manner and time period within which the same has to be made. Most importantly the designated officers are to be sensitized with the provisions of LODR, the policy and the consequences of non-disclosure.

There is a need for listed entities to re-visit its policies to ensure compliance in letter and spirit.

Other relevant articles-

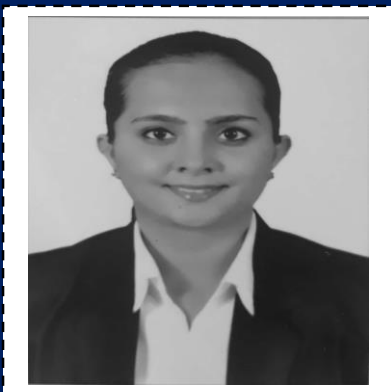
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