

Assessing the Sweep of a Recently Introduced Disclosure Requirement in the SEBI Listing Regulations

INTRODUCTION

On June 14, 2023, the Securities and Exchange Board of India (“**SEBI**”) notified certain amendments to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“**SEBI Listing Regulations**”). The amendments are designed to strengthen corporate governance in listed entities by enhancing shareholder suffrage and disclosure of material events. Notably, the amendments introduced a new Regulation 30A that is to be read with a newly inserted Clause 5A of Paragraph A of Part A of Schedule III to the SEBI Listing Regulations (“**Clause 5A**”).¹ Regulation 30A mandates shareholders, promoters, promoter group entities, related parties, directors, key managerial personnel, and employees of a listed entity or of its holding company, subsidiary, or associate company (“**Specified Persons**”) to notify the listed entity as and when any of them enters into agreements covered by Clause 5A (“**5A Agreements**”).

This note highlights the key features of Clause 5A and outlines certain practical considerations for Specified Persons and listed entities.

Clause 5A states:

“Agreements entered into by the shareholders, promoters, promoter group entities, related parties, directors, key managerial personnel, employees of the listed entity or of its holding, subsidiary or associate company, among themselves or with the listed entity or with a third party, solely or jointly, which, either directly or indirectly or potentially 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 the listed entity, shall be disclosed to the Stock

¹ The amendment became effective on July 14, 2023.

Exchanges, including disclosure of any rescission, amendment or alteration of such agreements thereto, whether or not the listed entity is a party to such agreements:

Provided that such agreements entered into by a listed entity in the normal course of business shall not be required to be disclosed unless they, either directly or indirectly or potentially or whose purpose and effect is to, impact the management or control of the listed entity or they are required to be disclosed in terms of any other provisions of these regulations.

Explanation: For the purpose of this clause, the term “directly or indirectly” includes agreements creating obligation on the parties to such agreements to ensure that listed entity shall or shall not act in a particular manner.”

Broadly, 5A Agreements fall into two categories: (i) agreements executed by Specified Persons to which the listed entity is not a party; and (ii) agreements entered into by Specified Persons to which the listed entity is a party, each of which can be subdivided into two types: (a) agreements that directly or indirectly or potentially or whose purpose and effect is to impact the management or control of the listed entity; and (b) agreements that directly or indirectly or potentially or whose purpose and effect is to impose a restriction on or create a liability for the listed entity. The table below sets out the two categories and types of 5A Agreements:

5A Agreements	Agreements executed by Specified Persons to which the listed entity is <u>not</u> a party	Agreements entered into by Specified Persons to which the listed entity is a party
Agreements that directly or indirectly or potentially or whose purpose and effect is to impact the management or control of the listed entity	Category I(A)	Category II(A)
Agreements that directly or indirectly or potentially or whose purpose and effect is to impose a restriction on or create a liability for the listed entity	Category I(B)	Category II(B)

CATEGORIES (I)(A) AND (II)(A): 5A AGREEMENTS THAT IMPACT THE MANAGEMENT OR CONTROL OF THE LISTED ENTITY

Categories (i)(a) and (ii)(a) cover agreements entered into by Specified Persons of a listed entity that impact the management or control of the listed entity (*i.e.*, control transaction

agreements). The SEBI's intent to introduce these categories is to cover control transaction agreements that are executed by Specified Persons of a listed entity (e.g., promoters or promoter related entities) irrespective of whether the listed entity is a party. Both categories therefore target the same type of agreements, but with one difference: the listed entity is a party to control transaction agreements falling in category (ii)(a) but not category (i)(a).

A contract between shareholders of a listed entity for the sale of controlling shares of the listed entity is a classic example of a control transaction agreement. A contract of this type can bring about fundamental changes in the listed entity's ownership or management structure. It can also trigger a public offer obligation under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. It is no surprise, then, that the SEBI treats control transaction agreements with utmost seriousness. It views the per se impact of such agreements as a sufficient reason warranting their disclosure.

In fact, even before Clause 5A was adopted, Clause 5 of Paragraph A of Part A of Schedule III to the SEBI Listing Regulations ("**Clause 5**") imposed a similar disclosure requirement to control transaction agreements that are now also contemplated in category (ii)(a). Clause 5 mandated every listed entity to disclose the following agreements to which it is a party:

"Agreements (viz. shareholder agreement(s), joint venture agreement(s), family settlement agreement(s) (to the extent that it impacts management and control of the listed entity), agreement(s)/treaty(ies)/contract(s) with media companies) which are binding and not in normal course of business, revision(s) or amendment(s) and termination(s) thereof."

Clause 5 agreements and 5A Agreements falling in category (ii)(a) have much in common, and since both clauses are in force, it creates an overlap wherein almost identical information is required to be disclosed under two separate provisions. The SEBI can consider removing the overlap by merging Clause 5 and Clause 5A into a single provision.

CATEGORY (I)(B): 5A AGREEMENTS NOT EXECUTED BY A LISTED ENTITY THAT IMPOSE A RESTRICTION ON OR CREATE A LIABILITY FOR THE LISTED ENTITY

Category (i)(b) covers agreements executed by Specified Persons of a listed entity – either among themselves or with third parties – that impose a restriction on or create a liability for the listed entity without it being a party to such agreements.

The memorandum that placed these amendments for the SEBI's approval ("**SEBI Memorandum**")² sheds light on the intent behind introducing agreements that fall in this category. The SEBI acknowledged the possibility of Specified Persons of a listed entity

² https://www.sebi.gov.in/sebi_data/meetingfiles/apr-2023/1681703127125_1.pdf.

executing contracts that impose a restriction on or create a liability for the listed entity without its knowledge or agreement.³ In the SEBI's own words, "*there is a likelihood that such types of agreements may be entered into behind the back of the listed entity and its shareholders.*"⁴ It was this concern that led the SEBI to enact a disclosure requirement for such agreements.

The primary issue with this approach is that it ignores the doctrine of privity of contract. Under the doctrine, only the parties to a contract can be bound by it. Barring trust, agency or veil-piercing cases, a stranger or a third party to an agreement cannot generally be held liable under the agreement. In simple terms, the doctrine shields a non-party from liability arising out of a contractual breach. Being a non-party, the listed entity can always mount this defense and avoid liability. The imposition of a disclosure requirement for such an agreement is therefore debatable. In these instances, the lack of knowledge of the agreement could be a defense and requiring the listed entity to acknowledge it by mandating its disclosure may not be necessary.

Moreover, Regulation 30A also mandates Specified Persons to disclose 5A Agreements that they may have executed in the past. Putting out past agreements in the public domain could antagonize counterparties who expect confidentiality provisions in their contracts to be honored. The requirement therefore places Specified Persons in an awkward position. They are left with no choice but to comply with the regulation and risk being sued by their respective counterparts.

Another implication of this requirement is that it will raise the compliance costs of Specified Persons, especially promoter group and related party entities. For instance, a group has an unlisted holding company X, an unlisted subsidiary Y and a listed subsidiary Z. Suppose Y wants to raise funds and enters into an investment agreement with a financial investor. The agreement obligates X (Y's holding company) to ensure that neither X nor X's affiliates will engage in any business that competes with Y's business. Since the listed entity Z is X's affiliate, the non-compete covenant could be viewed as imposing a restriction on Z, thereby triggering the disclosure requirement of Clause 5A.

Depending on the drafting, many other affiliate clauses in agreements of Specified Persons with third parties could meet a similar fate. These agreements may have innocuous (boilerplate) clauses relating to transfers of shares to affiliates with a deed of adherence requirement or confidentiality provisions. And yet they may need to be made publicly available.

³ Paragraph 3.5.1(f) of the SEBI Memorandum.

⁴ Paragraph 3.2.8 of the SEBI Memorandum.

Thus, Specified Persons of a listed entity will henceforth have to exercise caution while entering into any agreement that creates restrictions (however small or insignificant) on the listed entity even though it is not a party to the agreement.

CATEGORY (II)(B): 5A AGREEMENTS ENTERED INTO BY A LISTED ENTITY THAT IMPOSE A RESTRICTION ON OR CREATE A LIABILITY FOR THE LISTED ENTITY

Category (ii)(b) covers agreements entered into by Specified Persons and a listed entity that impose a restriction on or create a liability for the listed entity. Unlike the previous category, the listed entity is an indispensable party to 5A Agreements that fall in this category. It has three striking features: (i) the lack of a definition for the terms “*restriction*” and “*liability*”; (ii) absence of a materiality threshold; and (iii) a ‘*normal course of business*’ exception.⁵

The SEBI Listing Regulations do not define the terms “*restriction*” and “*liability*.” In fact, the SEBI Memorandum argues against defining them. In the SEBI’s own words, “*these terms are themselves self-explanatory and any attempt to define them with precise words may lead to unwarranted interpretational issues which should be avoided.*”⁶ There is merit in the SEBI’s argument. Black’s Law Dictionary defines “*restriction*” as “*a limitation or qualification.*”⁷ The same dictionary defines “*liability*” as “*the quality, state, or condition of being legally obligated or accountable.*”⁸ Given the wide nature of these terms, they cannot be defined easily.

The SEBI contends that applying materiality thresholds to the terms “*restriction*” or “*liability*” is unnecessary because it views an agreement not falling within the normal course of business exception as “*ipso facto a material information for disclosure to the shareholders.*”⁹ This view would also have been meritorious if the normal course exception had bite. But the SEBI construes agreements eligible for the exception as only those that are connected to the business operations of a listed entity.¹⁰ For example, a listed entity whose primary business is to grant loans can avail of the exception when it enters into loan agreements with its client-borrowers. But since client-borrowers are typically not Specified Persons, these agreements will not be within the scope of Clause 5A. Therefore, in most cases, the need to examine the normal course exception will not arise.

Even if an agreement between a Specified Person and the listed entity falls within the ambit of Clause 5A, there are very few instances in which it will get the benefit of the normal course exception. In the loan company’s case, these instances would be limited to

⁵ The first two features are common to categories (i)(b) and (ii)(b).

⁶ Paragraph 3.5.1(b) of the SEBI Memorandum.

⁷ Black’s Law Dictionary (11th ed. 2019), at 1572.

⁸ *Id.* at 1097.

⁹ Paragraph 3.5.1(b) of the SEBI Memorandum.

¹⁰ Paragraph 3.2.3 of the SEBI Memorandum.

an agreement that relates to the company's core business (*i.e.*, a loan agreement) and the client-borrower is a Specified Person (*e.g.*, a shareholder or employee). Even in those instances, the agreement would likely face scrutiny under the related-party transaction regime and therefore require disclosure.

Thus, assuming that every contract places some restriction or imposes some liability, the absence of a materiality threshold coupled with a narrow construction of the normal course exception makes almost every agreement between a listed entity and a Specified Person (not otherwise notifiable under any other provision of the SEBI Listing Regulations) prone to disclosure under Clause 5A. This may have the unintended consequence of an information overload, whereby investors may find it hard to separate material agreements from agreements that are non-material or trivial in nature.

CONCLUSION

Clause 5A is designed to bolster the SEBI's investor protection efforts. Its passage comes from a recognition that the disclosure requirements of Paragraph A of Part A of Schedule III to the SEBI Listing Regulations should apply to certain categories of agreements executed by Specified Persons irrespective of whether the listed entity is a party. Specified Persons and listed entities will therefore need to pay careful attention to ensure compliance with this clause.

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