

Chapter V

Regulation of Public Offering of Equity Shares and Convertible Securities in India³⁰⁷

In this chapter we identify the principal institutions / players at each stage of the public offer process and the roles they play. As in the last chapter the reference is to the Indian capital market and the process followed in the Indian market. We then survey the elements of regulation governing the activity of various categories of participants. We confine ourselves to the SEBI regulations governing the securities markets. Among the various SEBI guidelines, our primary attention is on the Disclosure and Investor Protection Guidelines 2000 (referred to as DIPG 2000, hereafter). The survey of regulatory provisions has been based on a compendium of the original regulations of SEBI under DIPG as of May 2007. The DIPG, like many other guidelines of SEBI, is constantly evolving and has undergone changes since then. However to keep the analysis manageable we had to freeze the updation as of May 2007. We also briefly survey the statutory provisions applicable to the public offering and issue of equity shares and convertible securities and regulations governing intermediaries to the extent they are relevant.

In the previous chapter we developed a series of policy implications based on the literature on capital structure related aspects of corporate finance, aspects relating to the market for public offerings and the institutional aspects of securities market regulation. In this chapter we apply that framework to examine how the regulation of the primary

³⁰⁷ A version of this chapter was presented as a paper at the Conference on Policy in Practice: Designing and Promoting Effective Institutions, organized by Center for Public Policy and Centre for Software Management at IIM Bangalore from September 23-25, 2005.

market in India fares in relation to the framework. To make the analysis more readable we classify these implications into the six categories that we list below.

- Provisions that specify conditions that issuers need to fulfill in order to make a public offer of securities
- Provisions relating to disclosures and certification of disclosures: These lay down all the disclosures that issuers need to make at various stages of the issue and disclosure obligations post listing of securities that issuers need to accept while seeking listing of securities. A few of the disclosure and certification requirements are discussed as part of the obligations of the intermediaries to highlight their role in the information production process.
- Provisions that align interests of managers / owner managers to those of external shareholders for mitigating agency problems. These include provisions relating to the distribution of securities issued which signal the issuers intention regarding subjecting themselves to monitoring by shareholders
- Provisions relating to the management of the issue process. These are discussed in the context of the roles and responsibilities of various intermediaries and their incentive to discharge their roles.

Each of the categories above deals with an important aspect of the issuance of securities. We then examine the relevant provisions in DIPG 2000 and critique them from an economic standpoint.

Our review is limited to the study of the legal provisions applicable to the *regulation of public offerings of equity shares and convertible instruments*. Thus it does not include provisions relating to debt instruments or equity offerings by way of rights issues and private placements of any kind. The scope of the research is limited in this

fashion because we believe that the economic issues posed by public offering of equity shares are different from the issues posed by other types of offerings which are excluded from the scope of our review. Further, from a materiality perspective, the data on offerings from the primary markets (discussed in Chapter VIII) suggest that these offerings account for the largest volume. The survey focuses on the economic aspects of the regulation rather than on the jurisprudential. Reference to the legal and jurisprudential issues will be subsidiary and incidental.

The SEBI Act has conferred power on the Central Government and the SEBI constituted under that statute (hereinafter called 'SEBI' or the 'Board') to make rules and regulations and issue guidelines to regulate both the primary and secondary market and thereby facilitate the healthy growth of the securities market.³⁰⁸ The SEBI Act confers power on the Central Government to make rules for carrying out the purposes of the Act³⁰⁹ and authority on the Board³¹⁰ to make rules consistent with this Act and the rules made thereunder to carry out the purposes of the Act.³¹¹ In the exercise of the power under the SEBI Act, the Central Government and SEBI have made rules, regulations or guidelines to regulate the primary and secondary market.³¹²

³⁰⁸ The relevant provisions are Ss 29 and 30 of the Securities and Exchange Board of India Act, 1992. While S 29(1) confers power on the Central Government to make rules for carrying out the purposes of the Act, the Board wields authority under S 30 to make rules consistent with this Act and the rules made thereunder to carry out the purposes of the Act. See S 29 (i) and S 30 (i).

³⁰⁹ S 29(1) of SEBI Act

³¹⁰ Under S 30

³¹¹ See S 29 (i) and S 30 (i).

³¹² A list of the important rules, regulations and guidelines / directives issued by SEBI, relevant to the present research study and in addition to the SEBI Act, is given below. We list here a host of regulations that we believe will impact the functioning of the public offerings market in some identifiable manner. However, not all regulations mentioned here are covered in our analysis as part of this research. We adopt this approach because for reasons of tractability we confine ourselves to those regulatory and institutional mechanisms that affect the functioning of the market most significantly. For eg., the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995 is a regulatory mechanism that may be invoked to prevent schemes for pumping of public offering stocks at or around the time of the IPO. However, we do not include the provisions of this scheme in our analysis.

As noted at the beginning of this chapter our focus is on DIPG 2000. The DIPG is a comprehensive piece of regulation that governs the entire gamut of issuance activity on the primary market, comprising equity, debt and instruments convertible into equity. It includes specific provisions for special instances such as the issue of capital by financial institutions and private placements of securities to specific classes or categories of investors such as Designated Financial Institutions or on certain specific markets such as the Over The Counter Exchange of India [OTCEI]. We also review the SEBI regulations that govern the licensing and functioning of various intermediaries connected with an offering of securities.

It is important to clarify at this juncture that the researcher has not delved into the issue of the binding nature of “guidelines” which are

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1. SEBI Disclosure and Investor Protection Guideline, 2000
 2. SEBI Guidelines on Preferential Issues, 1994
 3. SEBI (Merchant Bankers) Regulations, 1992
 4. SEBI (Merchant Bankers) Rules, 1992
- A large number of circulars relating to the public issue of securities have been issued under the "RMB (GI Series). Many of these have been incorporated into DIPG. The impact of those circulars is reflected in our analysis to the extent that they have been included in the DIPG.
5. SEBI (Registrars To An Issue and Share Transfer Agents) Regulations, 1993
 6. SEBI (Underwriters) Rules, 1993
 7. SEBI (Underwriters) Regulations, 1993
 8. SEBI (Registrars to an Issue and Share Transfer Agent) Rules, 1993
 9. SEBI (Registrars to an Issue and Share Transfer Agent) Regulations, 1993
 10. SEBI (Debenture Trustees) Regulations, 1993
 11. SEBI (Debenture Trustees) Rules, 1993
 12. SEBI (Bankers To An Issue) Regulations, 1994
 13. SEBI (Bankers To An Issue) Rules, 1994
 14. SEBI (Stock-Brokers and Sub-Brokers) Regulations, 1992
 15. SEBI (Stock-Brokers and Sub-Brokers) Rules, 1992
 16. SEBI (Mutual Funds) Regulations, 1996
 17. SEBI (Venture Capital Funds) Regulations, 1996
 18. SEBI (Foreign Institutional Investors) Regulations, 1995
 19. SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 1995
 20. Depositories Act, 1996
 21. SEBI (Depositories and Participants) Regulations, 1996
 22. SEBI (Custodian of Securities) Regulations, 1996
 23. SEBI (Portfolio Managers) Rules, 1993
 24. SEBI (Portfolio Managers) Regulations, 1993
 25. SEBI Appellate Tribunal (Procedure) Rules, 1995

inferior in status compared to rules and regulations made under the Companies Act, 1956, Securities Contract Regulation Act, 1956 and SEBI Act, 1992. It is assumed that the guidelines referred to here have regulatory force.

We identify provisions in the DIPG 2000 that fall under each of the heads above. In the main discussion we deal with the substantive aspects of the regulations and analyse the economic aspects of the same. We paraphrase the specific provisions of the guidelines carefully into footnotes and provide them under the relevant parts of the main discussion.³¹³

It shall also be noted that the Companies Act, 1956, SEBI Act, 1992, SCRA, Depositories Act, 1996 and allied statutes are all Acts of the Parliament and hence instances of supreme legislation. On the other hand, the rules and regulations made under these statutes including SEBI Rules, regulations and guidelines are cases of subordinate legislation and must give in to supreme legislation in the event of a conflict. [For the distinction between the two, see P J Fitzgerald (Ed.) Salmond on Jurisprudence, 12th edn., para 21 and 22.]

Participants in the IPO market

The principal actors common to most IPOs, or for that matter to any public offering of equity shares, are the following: The issuer company, investors, a host of intermediaries such as stock exchanges, investment banks, the registrar, depository, banker to the issue, underwriters and brokers. A brief description of some of the more

³¹³ We cite provisions as "Regulations" followed by the number of the provision. This is to distinguish the provisions of the regulations from sections of laws enacted by Parliament. Where necessary we draw references to "sub-clauses" of, provisos and explanations to the main clause of the regulation.

important participants is provided as part of the discussion governing these categories of participants. We survey the regulatory provisions relating to each of these categories of players.³¹⁴

5.1 SEBI (Disclosure and Investor Protection) Guidelines, 2000

These are the core of the SEBI regulations governing the public issue of securities³¹⁵ and are intended to regulate the conduct of the issuer. The DIPG 2000 is perhaps one of the most voluminous among the various SEBI regulations and is the result of considerable evolution and change since it was first announced in 1992.

5.2 Criteria for making Public Offerings

The DIPG has laid down conditions which unlisted companies have to fulfill to make a public offering of equity shares or any security which may be converted into or exchanged with equity shares at a later date. These include the following parameters: (i) Minimum networth and asset size (ii) Consistent track record of profits (iii) Absence of any ban or restriction on the company from accessing the capital market (iv) Widespread ownership of the issuer's shares. These regulations are summarized below³¹⁶.

³¹⁴ In addition, there are a whole host of other service providers such as accountants, lawyers, printers and advertising and communication agencies who do not come formally or directly under the purview of the regulatory institutions. We do not cover these institutions in this survey.

³¹⁵ The DIPG as well as the various other regulations governing various categories of intermediaries have all been issued either under S 11(1) of the SEBI Act which allows SEBI to frame rules and regulations governing the securities market. Specific instructions to market participants may flow from time to time as modifications or clarifications (as SEBI chooses to call them) from these regulations under the same rule making powers.

³¹⁶ Net tangible assets of Rs 3 crore in each of the three preceding years, less than 50% of which may be held in the form of monetary assets. Net tangible assets have been defined as sum of all net assets of the company, excluding intangible assets as defined in Accounting Standards (AS) 26 of Institute of Chartered Accountants of India [Reg 2.2.2 B (i) of DIPG 2000]

- Networth of Rs 1 crore in each of the three preceding years

The access criteria reflect a "merit approach" to regulation (as opposed to a pure disclosure based regime). They specify minimum standards for companies to qualify for access to the public equity markets. The recently introduced requirement regarding minimum number of prospective allottees appears to ensure a broad-based public holding and may not be related to the quality of the issuer. Apart from this it is worth noting that the Companies Act does not prescribe any qualitative

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- Track record of distributable profits in accordance with the provisions of the Companies Act (S 205 of Companies Act, 1956) in each of the three preceding years
 - Not being subject to a ban from accessing the capital markets by an order or direction passed by SEBI (Reg 2.2.1 of DIPG 2000).
 - Not less than one thousand prospective allottees of securities.[Reg 2.2.2 A of DIPG 2000].

Listed companies whose paid up capital after taking into account all the offerings during the year, including the proposed issue, will be more than five times the pre issue capital will be treated as unlisted companies and will be subject to the same market access criteria as unlisted companies. The rationale here perhaps was to plug the possibility of promoters circumventing the access criteria for unlisted companies by merging with or acquiring listed companies. (Reg 2.3 of DIPG 2000)

Companies, which change their names to indicate their involvement in a specific business would need to derive at least 50% of their revenue from the new business, they claim to be engaged in. [Reg 2.2.1 (d) and proviso to Reg .2.3.1.]

Unlisted companies that do not meet the above criteria may access the public market if the issue is made through the book building process, with not less than 50% of the issue being allotted to Qualified Institutional Buyers (QIBs) at least 15% of the cost of the project proposed to be financed by financial institutions and banks, with 10% of the cost being funded by the bank or institution that is appraising the project. Further, in the latter case, 10% of the issue has to be allotted to QIBs.

Additionally, minimum post issue capital of the unlisted company has to be Rs 10 crores OR the shares shall be supported through compulsory market making for a period of at least two years from the date of listing of the shares.

Public as well as rights issues of debt instruments, convertible into equity or otherwise, would need to have credit rating of not less than investment grade from at least two credit rating agencies. Further, the issuer cannot be in the list of willful defaulters of Reserve Bank of India, nor can it be in default of interest payment to the public on debentures for more than six months. [Reg 2.5.1 A of DIPG 2000]. Where the issuer has ratings from more than two agencies all the ratings will have to be disclosed and all ratings obtained during the three years preceding the issue have to be disclosed as well. [Reg 2.5.2 of DIPG 2000 The issue has to be allotted to not less than fifty allottees. [Reg 2.5.1.B]

There shall be no outstanding options in favour of incumbent shareholders to acquire equity shares in the company after the public issue (Reg 2.6 of DIPG 2000) or partly paid up shares (Reg 2.7 of DIPG 2000).

All issuers have to indicate "firm arrangements of finance through verifiable means" for at least 75% of the project outlay apart from the proposed offer. The guidelines do not specify what "firm arrangements" and "verifiable means" stand for.

criteria for public companies to have access to the primary market though they are required to comply with the prospectus provisions and other publicity requirements.³¹⁷ These regulations, which as we noted earlier are subordinate legislation, fetter the rights of a company while issuing shares under the Companies Act. While the provisions of the DIPG are of considerable economic significance, their legal tenability has not been tested in a court of law, as is the case with many of the regulations of SEBI.

The access criteria suggest that the regulator has chosen size and profitability track record as proxies for quality. Apart from the question of appropriateness of these proxies, it is submitted that a single static benchmark cannot be used across sectors or time. Such a benchmark will have to be recalibrated from time to time. It may be pointed out that these criteria have considerably evolved over time.³¹⁸

The alternate criteria seem to indicate that the quality of an issuer may be “certified” by the participation of financial institutions and banks, presumably on the belief that banks are equipped with better ability to seek and analyse information. The certification value of a lending bank, whose risks as a lender are much lower than that of an equity investor, is somewhat questionable. Further, the agency conflict between a lender and equity investors has been widely acknowledged by practitioners as well as in theory [in books such as those by (Richard Brealey and Stewart Myers³¹⁹ and Lalita Som³²⁰.)] The mandatory allotment to Qualified Institutional Buyers (QIBs)³²¹, who

³¹⁷ See Ss 55 to 67 (prospectus provisions), S 81(1A) approval for issue by the general meeting, Ss 69 to 73 (provisions governing allotment of shares and listing of securities) and S 68 B (dematerialization of securities).

³¹⁸ Key aspects in their evolution have been traced in the following chapter.

³¹⁹ Brealey and Myers (2003), supra note 150

³²⁰ Som (2006), supra note 183

³²¹ QIBs have been defined as (i) public financial institutions defined in S 4A of Companies Act, 1956 (ii) Scheduled Commercial Banks (iii) Mutual Funds (iv) Foreign Institutional Investors Registered with SEBI (v) Multilateral and Bilateral Development Financial Institutions (vi)

are primarily institutional equity investors, could potentially help in the discovery of the price of the securities at the time of issuance as well as in subsequent monitoring of the performance of the company. As such this might be a better alternative for as a criterion for market access.

The criterion about the minimum paid up capital or market making as alternative criteria appears to reflect a concern about liquidity. The concern regarding liquidity might well be genuine. However, does size as measured in terms of paid up capital, guarantee liquidity is a point that deserves empirical examination.

The problem with precise or quantified access criteria is that in an industrial economy that is evolving rapidly these criteria lose their significance quickly as issue sizes increase. For eg., given the substantial increase in the paid up capital and issue size in the period between 2000-01 and 2005-06 these cutoffs appear irrelevant. Another consequence might be that investment opportunities in certain businesses such as biotechnology, healthcare, electronic commerce or other high technology sectors, which eminently qualify for public market subscription on criteria other than size may not be available even to sophisticated investors because of the size criterion. Many technology companies go public on the NASDAQ and other second tier markets at an early stage, much before they start posting profits, and eventually become profitable and successful enterprises.³²²

Venture Capital Funds registered with SEBI (vii) Foreign Venture Capital Investors registered with SEBI and (viii) State Industrial Development Corporations (ix) Insurance Companies registered with the Insurance Regulatory and Development Agency (x) Provident funds with minimum funds of Rs 25 crores and (xi) Pension funds with minimum corpus of Rs 25 crores (Reg 2.2.2 B (v) of DIPG 2000)

³²² For eg., see the finding reported in Chapter IV about the reducing number of years taken by companies to go public.

Finally, it would appear that SEs may be in a better position to define quality standards for admitting securities for listing and trading on their exchange since they have a natural incentive to ensure quality investment opportunities are available for their clients, namely investors and brokers, to trade. SEBI might merely mandate the disclosure standards to help investors decide if the securities meet those standards. More fundamentally, the investor is perhaps better suited to decide whether a company or industry suits his investment preferences based on its industrial organisation characteristics, rather than have a regulator decide on the same.

5.3 Provisions relating to disclosures and certification of disclosures

5.3.1 Prospectus

The most important information and disclosure related requirements pertain to the need for preparation of a prospectus, the procedure for filing the prospectus and publication of the prospectus. Matters to be included in the prospectus are stated in subsection (1) of that section.³²³ The only instances where the company is relieved from the statutory obligations of preparing and filing a prospectus with the ROC are provided in the second proviso to subsection 3 and subsection 5 of S 65.³²⁴ Further, the contents of the prospectus should also comply

³²³ S 56 (1) reads as follows:

Every prospectus issued

(a) by or on behalf of a company, or

(b) By or one behalf of any person who is or has been engaged or interested in the formation of a company

shall state the matters specified in Part I of Schedule II and set out the reports specified in Part II of that Schedule; and the said Parts I and II shall have effect subject to the provisions contained in Part III of that Schedule.

³²⁴ The exemption from the S 56(1) is available in the relation to shares or debentures (i) which were not offered to the public, (ii) to an issue to existing members or debentureholders of a company whether an applicant for shares or debentures will or will not have the right to renounce in favour of other persons and (iii) to the issue of a prospectus or form of application relating to shares or debentures which are, or are to be, in all respects uniform with shares or debentures previously issued and for the time being dealt in or quoted in a stock exchange; but

with the requirements of Parts I and II of Schedule II of the Act. Part I deals with the matters to be included in the prospectus and Part II deals with the reports to be included in the prospectus. In addition to the disclosures required under the Companies Act³²⁵ the DIP Guidelines provide that the prospectus shall contain all the matters specified in Section I of Chapter VI of the guidelines. Section II of Chapter VI specify the contents of the abridged prospectus. Thus the disclosure requirements under the Guidelines are much more considerable than those under the Act. The guidelines require that as far as possible the contents will follow the sequence provided in the guidelines.³²⁶

All issuers are required to prepare and file a prospectus or an offer document. The offer document "shall contain all material information which shall be true and adequate so as to enable the investors to make informed decision on the investments in the issue".³²⁷ The contents of the offer document and the statutory provisions relating to the same are incorporated in the Companies Act and Schedule V thereto. The guidelines concretise these in relation to a company that is planning to make a public offer. Further, the prospectus has to be approved by the Board of Directors of the issuer and is to be issued under the signature of all the Directors, including the Managing Director, Chief Executive Officer and Chief Financial Officer of the issuer. The signatories have to certify that the disclosures in the prospectus are true and correct.³²⁸ The declaration is consistent with the affirmative statement required at the outset, casting "absolute

subject as aforesaid, this section shall apply to a prospectus or a form of application, whether issued on or with reference to the formation of a company or subsequently.

³²⁵ S 56 read with Schedule II of the Act

³²⁶ Reg 6.3 of DIPG 2000, further summarized in Schedule VIIA.

³²⁷ Reg 6.2 of DIPG 2000. We use the term offer document and prospectus interchangeably in this discussion. We think that the language in this statement which defines the fundamental character and purpose of the offer document could do with some improvement.

³²⁸ Reg 6.15.2 of DIPG 2000

responsibility" on the issuer for providing "true and correct" information.³²⁹

5.3.1.1 Issue Related Information

These are details of the issue such as the objects of the offering³³⁰, requirement of funds³³¹, means of financing the requirement of funds,³³² progress in implementation,³³³ details of deployment of funds³³⁴ and terms of the issue.³³⁵ The guidelines provide for disclosure of the results of the appraisal of the project.³³⁶ The appraisal can be viewed as an additional certification mechanism. These are the broad details of the issue and are required to be provided in the early sections of the prospectus.

5.3.1.2 Substantive Business and Issuer Related Disclosure Requirements

³²⁹ Disclaimer under Reg 6.4.2.2 (vi)

³³⁰ Reg 6.8.4.1 of DIPG 2000. As to whether it is for fixed assets, working capital and so on

³³¹ Reg 6.8.4.2 of DIPG 2000. Activity wise break-up, if the company proposes more than one activity and phase wise requirement in case the implementation is in phases

³³² Reg 6.8.4.3 of DIPG 2000. The issuer has to undertake to make firm arrangements through verifiable means for 75% of the requirement, excluding the amount to be raised through the proposed issue and the arrangement for the remaining amounts may be mentioned without specifics in case there are no firm arrangements for the same.

³³³ The issuer has to provide details of the physical progress of the project.

³³⁴ Actual expenditure incurred on the project as of no earlier than two months from the date of the prospectus source of funds already deployed, yearwise breakup of the expenditure proposed to be incurred and plans for deploying unutilized funds. [Reg 6.8.4.6 to Reg 6.8.4.9 of DIPG 2000]

³³⁵ Issue Overview

The regulations require a disclosure of the basic terms of the issue and detailed discussion of the basis of the issue price. It is not clear as to what the guidelines mean by "basic terms" since these have not been defined anywhere. The basis for issue price and the related disclosure requirements have been discussed under Pricing.

³³⁶ Details required to be disclosed in this regard are (i) scope, purpose and date of appraisal (ii) cost of project and means of financing as per appraisal and changes in the same after the date of appraisal and (iii) weakness and threats identified in the appraisal to be included in risk factors. [Reg 6.8.4.4 of DIPG 2000]

The substantive requirements of disclosure relating to the issuer are quite similar to those specified in Schedule V of the Companies Act in terms of broad contours.³³⁷ The requirements in the Companies Act

³³⁷ Business and Corporate Overview

The prospectus has to provide summary details of the offering, the industry and business of the issuer, consolidated financial and operating data and corporate details such as location of the registered office, composition of the Board of Directors, names of key parties such as lawyers, company secretary, merchant bankers and auditors [Reg 6.8.1 to 6.8.2.8 of DIPG 2000], debenture trustees, details of the monitoring agency, appraising entity [Reg 6.8.2.10 to 6.8.2.12 of DIPG 2000]. These are required as part of the general introduction to the company. These appear to be details that will define the identity of the issuer at a superficial level.

In addition, details of credit rating in the case of debentures and IPO grading in the case of equity shares or securities convertible into equity shares are also required to be provided. [Reg 6.8.2.9 and Reg 6.8.2.9 A of DIPG 2000].

Issue related details and affirmations

Issue related particulars are to be provided in detail. These include terms of the issue (ranking of equity shares, mode of payment of dividend, face value and issue price / floor price / price band, rights of instrument holders, market lot, nomination facility). The issuer has to undertake to the investor to comply with the provisions of the Companies Act relating to the requirement of minimum subscription. The LMB has to ensure that the requirement of minimum subscription is fulfilled jointly and severally. The issuer has the option to make arrangements for providing liquidity on odd lots of shares through a third party and if the issuer chooses to do so details of the arrangement have to be provided. Investors are required to be notified about (i) spillover of unsubscribed portion from one reserved category to another category of investors entitled to reservation among whom there is a demand and (ii) unsubscribed portion, if any thereafter being offered to the public and (iii) *vice versa*, if there is under subscription in the net offer to the public. [Reg 6.8.3.2 (i) of DIPG 2000]

Restrictions, if any, on transfer and transmission of shares have to be disclosed. (i) Details of issue type (book built or fixed price), details of bid form, minimum bid/ application size, bidding process, (ii) Providing an option to the investor to receive physical certificates or in dematerialized form (iii) Modality of application, availability of forms, prospectus and mode of payment indicating appropriate, distinct procedures for application by mutual funds, non resident indians, (iv) Details of escrow account and mode of payment into the same (v) Steps in the book building process such as electronic registration of bids, build up of book, price discovery and allocation, issuance of certificate of allocation note and allotment in the issue, general instructions for application and submission of bids, payment instructions, disposal of application and application monies, basis of allotment or allocation, method of proportionate allotment, procedure and time schedule for allotment and issue of certificates, letters of allotment or refund orders, mode of making refunds, undertaking from the issuer to pay interest in case of delay in dispatch of allotment letters or refund orders within the maximum time allowed respectively for book built and fixed price issues.

Issue related Undertakings and Assurances

The issuer has to provide the following undertakings additionally (i) to attend to the complaints relating to the issue expeditiously and satisfactorily (ii) to complete formalities for listing within seven days of finalisation of basis of allotment (iii) apply in advance for listing of shares allotted on conversion of debentures / bonds (iv) to make available funds to the RTI to make refunds to unsuccessful applicants (v) that investors will receive intimation that electronic refunds have been made through electronic funds transfer (vi) that promoters' contribution shall be brought in full before the issue opens for public subscription and the balance will be brought in pro rata before the calls are made on the public (vii) that certificates or refund orders will be dispatched

to NRIs within specified time (viii) not to make further issues of securities until the securities offered through the proposed issue are listed or monies refunded on account of non-listing or under-subscription and in the case of debenture issues the issuer undertakes to (i) furnish to the trustee half yearly statements, on utilization of funds from the debenture issue, certified by the statutory auditor (b) to disclose the name and address of the debenture trustee on the annual report (c) provide a certificate of compliance with the terms and conditions of issue of debentures, to the trustee every year (d) confirm that the security created by the company in favour of the debenture holders is properly maintained and adequate to meet payment obligations towards debenture holders (e) to provide true and adequate information to the credit rating agencies as long as the debt obligations are outstanding.

The Board of Directors of the issuer will assure the investor that (i) proceeds of the share or debenture issue shall be transferred to a bank account other than referred to in Section 73(3) of the Companies Act (ii) utilization of the proceeds and purpose of the same will be disclosed in the balance sheet under an appropriate head (iii) similar disclosure will be made for unutilized funds indicating the avenues where they have been invested.

Details of litigation and pending proceedings

There is an elaborate set of requirements relating to outstanding litigations and material developments. [Reg 6.11 of DIPG 2000] These cover litigations against the company as well as against other companies that might materially adversely affect the position of the issuer, litigations against directors involving violation of statutory regulations and proceedings for economic offences. These requirements apply to subsidiaries of the issuer. Details of non payments or defaults [including amounts involved] to financial institutions and banks, debenture holders, statutory dues relating to group companies and their impact if any on the issuer company are required to be provided. These requirements apply even if the promoters are not associated with the companies any longer but their names are included in the litigation. Litigations against promoters relating to violation of statutory regulations, criminal offences, economic offences by promoters, firms and companies promoted by them and instances of penalties levied in the past for such offences are also required to be provided. The LMB is required to ensure that these details in the prospectus and also incorporate them as risk factors where appropriate. Similarly, details of Government approvals required and obtained / pending are to be included.

Group Company Details

The offer document has to provide disclosures confirming compliance with issue related processes such as necessary statutory filings, details of SEs where listing has been sought, issue expenses and fees, details of previous public and rights issues during the preceding five years [issue and listing dates, terms of issues] and similar details relating to issues by companies under the same management as per Section 370(1)(B) of Companies Act, 1956. [The guidelines (Reg 6.12.19)] state that the information required in the case of companies under the same management applies to companies that have "made any capital issue during the last three years". It is not clear whether that includes private placements or if it is limited to just public issues alone. Practically it would make sense to limit this requirement to companies which made public issues.] A comparison of promises made at the time of previous issues [three most recent issues in the case of the issuer and issues during the [preceding three years in the case of companies under the same management under S 370 (1)(B) and last one issue in the case of group / associate companies] is required to be disclosed.

The DIPG extends the information required for companies under the same management (as defined in S 370(1)(B) of Companies Act, 1956) to all companies promoted by the promoters, listed as well as unlisted. (Reg 6.10.3 of DIPG 2000). In the case of a listed issuer, the financial information detailed in this paragraph need not be disclosed for companies not covered under Section of 370(1)(B), if the issuer has been filing periodic financial statements, these statements are accessible on a common electronic platform and the issuer has a mechanism for redressal of investor grievances.[Proviso to Reg 6.3 of DIPG 2000]. In case there are listed companies in the group the financial information may be provided on the five largest companies [in terms of market capitalization] in the group and on companies in the group which are sick or being wound up or have a negative networth. Details required include

nature of activities, equity capital, reserves, sales, profit after tax, earnings per share, net asset value, highest and lowest market price during the preceding six months, issue price and current market price along with a comparison of the cost and progress of projects as given in the prospectus and as at the moment of the proposed issue in the case of companies that had made a public or rights issue in the preceding three years. Details of intra group transactions among the companies such as sales or purchases in excess of 10% of the individual companies in question, financial significance of the intra group transactions, overlap among companies and the conflict of interest arising out of the same are also required to be mentioned. Information is to be provided regarding adverse developments such as whether the company is under winding up, or has turned sick or has incurred a loss in the preceding year and instances of promoters dissociating from any of the group companies during the preceding three years with the reasons for the same. The nature of the information sought is such as to enable the prospective investor to assess the managerial competence of the promoter team as well as to bring out potential instances of self-dealing within the promoter group. The guidelines go beyond the definition of S 370(1)(B) so as to provide for a more inclusive definition of businesses under the control of the promoters.

If the issuer is a listed company, data relating to share prices such as high, low and average market price during the preceding three years, monthly high and low for six months preceding date of filing the draft prospectus with the Board which is to be updated till filing the prospectus with the RoC, number of shares traded at the high and low prices above, market price immediately on the Board of Directors passing a resolution approving the issue, volume of securities traded in each of the six months preceding the filing of the prospectus with the RoC and the volume of business transacted along with the high, low and average prices of the shares for the "respective periods". The data on price and number of shares traded has to be shown separately for the period during which the capital structure of the company has undergone a change [such as bonus or rights issue], starting with the date on which the change was announced till the trading of shares after the implementation of the change (such as trading on ex rights or ex bonus basis).

Details regarding establishment of Company and Share Ownership

The guidelines require a discussion on the major events in the evolution of the company, objects and details of subsidiaries. [Reg 6.9.4.1 to 6.9.4.3 of DIPG 2000] It calls for personal details of the promoters, history of the promoters and details of changes in management, if any, and holders of current controlling interest [as defined in the takeover regulations] where the promoters are companies.

The guidelines require the names of the ten largest shareholders and the number of shares held by them to be disclosed, including the shares that they would own upon exercising options to convert. These details are required as on the date of filing the prospectus with the RoC, ten days prior to filing the prospectus with the ROC and two years prior to filing the prospectus with the RoC. This set of information is to be given separately for shares acquired during a public offering, if any, during the preceding two years. The shares acquired by subscription to the public issue and through firm allotments / reservations have to be shown separately. [Reg 6.8.3.2 (j) of DIPG 2000].

The aggregate shareholding of the promoter group and that of the directors in case the promoters are companies and details of their trading activity in these shares such as aggregate number of securities, maximum and minimum prices at which these trades were made during six months preceding the date on which the draft prospectus is filed with SEBI are also to be disclosed. In case details about the trading activity of a promoter are not available a statement has to be included to that effect. [The basis for reckoning the two years has not been specified. It is reasonable to presume that the reference point here again is the date of filing the prospectus with the RoC.] [Reg 6.8.3.2 (k) of DIPG 2000]. The guidelines provide an elaborate definition of promoter and promoter group.

Promoters have been defined as persons who are in overall control of the company or instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public or named in the prospectus as promoters. This excludes directors and officers who are acting in their personal capacity. Promoter group has been defined as

comprising the promoter, an immediate relative of the promoter (spouse, parent, brother, sister, child of the person or the spouse). Further, it includes (i) any company in which 10% or more of the equity share capital or Hindu Undivided Family (HUF) or firm in which a share of 10% or more is held by the promoter or an immediate relative of the promoter or a firm or a HUF in which the promoter or any one or more of his immediate relatives is a member (ii) a company in which a company specified in the previous point holds 10% or more of the share capital. Where the promoter is a company it comprises the subsidiary of the company or the holding company, any company which owns 10% of the promoter or a company of which the promoter company owns 10% of the equity, a company in which 20% of the equity is held by a group of individuals or companies who also hold 20% of the issuer company. Banks, financial institutions and foreign institutional investors are considered promoters only in the case of their subsidiaries or in the case of companies promoted by them or mutual fund schemes sponsored by them. They are otherwise exempt from the definition of a promoter even where they hold 10% or more of the equity capital of a firm. [Technically, the explanation belongs to sub clause (l) although the guidelines have introduced the explanation after sub clause (m) which deals with details of ESOPs]. [Explanations I to III to Reg 6.8.3.2 (m).]

Details of options granted or shares issued to employees of the issuer under any employee stock option plan or stock purchase scheme are also to be provided. [Reg 6.8.3.2 (j) to 6.8.3.2 (m) of DIPG 2000].

Property transactions between issuer and promoters

It also calls for details of the beneficial interests of the promoter in the company such as details of property acquired from the promoter, if any, payments made or benefits given within the preceding two years / to be made as consideration for becoming a promoter / director and details of related party transactions as per financial statements. [Reg 6.9.6 of DIPG 2000] Similar details of interests are required in the case of directors who may not be promoters. [Reg 6.9.5.5 of DIPG 2000] Details of agreements among shareholders that the issuer is aware of even if it is not a party to the same and other contracts that are not in the routine nature of the business entered into up to two years before the date of the prospectus, strategic and financial partnerships, if any, are to be provided. [Reg 6.9.4.4 to 6.9.4.7 of DIPG 2000]. The guidelines require that copies of important documents and material contracts be made available for inspection from the date of the prospectus till the closing of the subscription list, at a time and place to be mentioned in the prospectus. [Reg 6.15 of DIPG 2000] The list of shareholders agreements and non-routine contracts is to be included in the list of material contracts required as part of the disclosure requirements.

Board of Directors, Top Management and Organisation Structure

The requirements call for details of members of the board of directors, details of their terms of compensation entered into upto two years prior to the date of filing the prospectus, their shareholding details, compliance with corporate governance requirements and nature and details of their interests in the company are required to be disclosed, changes in directorships if any in the past three years and the reasons for the same. [Reg 6.9.5.1 to 6.9.5.6 of DIPG 2000] The requirement of compliance with corporate governance [Reg 6.9.5.3] has not been spelt in detail in the requirements. It is not clear if compliance with the requirements of Clause 49 of the standard listing agreement is what is intended here.

Details of organization structure of the top management, key management personnel as of the date of filing the prospectus with SEBI, such as their name, qualifications, date of joining, prior employments, incentive compensation such as shareholding or bonus plans, changes other than in the nature of retirement within one year prior to the filing the prospectus are required to be provided, as are details of employees and employee stock option plans. Other payments made or benefits provided to officers of the issuer company within two years preceding the date of the filing the prospectus are also required to be provided. [Reg 6.9.5.7 to 6.9.5.11 of DIPG 2000]. If a listed company has been filing information with the SEs regularly in the past three years and the filings are accessible on a common electronic platform and the company has a mechanism for redressal of investors' grievances, details of information under Reg 6.9.5.8 providing details of key management personnel and their incentive compensation need not be disclosed in the prospectus. [Proviso to Reg 6.3 of DIPG 2000]. This is one of the

three exemptions provided under the said proviso. It is not clear though whether this exemption is warranted given that the information relating to key management personnel is not covered in this manner and detail as part of continuing disclosure requirements. Considering that the quality of management is an important determinant of the success of a company in the market, it might be useful not to exempt this information from the purview of the prospectus.

Products/Services, Manufacturing / Delivery Arrangements, Markets

The disclosures require a more detailed discussion on the products / services of the issuer, data on the market providing historical demand and supply data and forecasts of the same and details of marketing approach and organisation. [Reg 6.9.2.1 (e)] At the micro level (level of the issuer company) the guidelines require a statement about business strategy, details of capacity installed and utilization, plans to achieve the higher utilization in case the planned utilization is higher than the historical utilization by more than 25%. (Reg 6.9.2.2 (a) (ii) of DIPG 2000). It also requires elaborate details of properties proposed to be purchased. [Reg 6.9.2.4 of DIPG 2000]. More importantly, the Companies Act requires the prospectus to discuss future prospects to the extent of the year in which the company is expected to earn cash and net profits. (Clause V (k) of Part I of Schedule II of Companies Act, 1956) The guidelines do not require this presumably because the guidelines generally do not permit forecasts to be included in the appraisal (Reg 6.9.2.2 (a) (iii) of DIPG 2000), because they are "forward looking statements".

Considerable additional detailing is required regarding plant and machinery (Reg 6.9.2.1(b) of DIPG 2000), the technical collaborator (Reg 6.9.2.1 (c) of DIPG 2000), infrastructure facilities (Reg 6.9.2.1 (d) of DIPG 2000), board composition, compensation of managing and whole-time directors, compliance with corporate governance requirements, directors' shareholdings, other business of directors, historical share price and volume data around capital structure changes (Reg 6.7.13 of DIPG 2000).

It does raise an interesting question of whether an issuer who wishes to make a forward looking statement may do so under the cover of the requirement of the Companies Act which is considered to prevail in the event of a conflict or inconsistency between the guidelines and the Act. The guidelines ask for capacity utilisation for each product for three years in the past as well as in the future and explanation for any proposed increase of more than 25% in future. (Reg 6.7.12.1 of DIPG 2000).

Financial Data relating to the Issuer

The guidelines do not lay down a framework or format for financial reporting. They have numerous requirements intended to enhance the detail of disclosure. All significant accounting policies and standards followed in the preparation of the financial statements is to be disclosed, [Reg 6.10.2.7 (a) of DIPG 2000] as are changes in accounting policies. [Reg 6.10.4]. Financial statements may be based on more than one accounting standard in which case the material differences on account of the differences in accounting policies have to be disclosed. [Reg 6.10.2.8 of DIPG 2000].

Turnover to be broken down into manufactured and traded products, traded products further broken down into products that are frequently dealt in by the company and those that are not. Details of other income such as its source, whether it is out of normal business activities and whether it is of recurring nature, where it exceeds 20% of the net profit before tax.

Impact of activities such as discontinuance of lines of business or loss of agencies which may have a material impact on the profit or loss for five years.

For each of the period for which financial information is given, the guidelines further require the prospectus to provide earnings per share (calculated after excluding extraordinary items), return on net worth and net asset value (both calculated after excluding revaluation reserves). These ratios are to be based on financial statements prepared in compliance with the Indian Accounting Standards.

Details of capitalization as per format in Schedule XII, (indicating total debt, net worth and debt / equity ratios before and after the proposed issue) including a note explaining changes in the same since the date of the financial information provided in the prospectus, details of unsecured loans availed of by the issuer company and terms of the same and details of unsecured loans availed of by the promoters/group companies/associate companies are to be provided. It may be noted that details of capital structure are also to be presented as part of the general information. The details required in that context (both in terms of number of securities and value, instrument wise) are (i) authorized, issued, subscribed and paid up capital (ii) capital proposed to be raised broken down into promoters' contribution, firm allotments, (iii) paid up capital after the issue and conversion of securities, where applicable (iv) and share premium account. The details on share capital are to be accompanied by notes detailing (i) promoters' contribution along the format in Schedule VIII, (ii) affirmative statement that the promoters' contribution has been brought in fully from those defined as promoters under the guidelines and that the promoters undertake to accept full conversion where the contribution is in the form of optionally convertible instruments subscribed to by the public, (iii) an affirmative statement that oversubscription to the extent of 10% of net offer may be retained to meet the requirement of rounding off allotments to the nearest multiple of a minimum allotment lot (iii) details of buy back and standby arrangements from promoters, directors, LMBs, [Reg 6.8.3.1 and Reg 6.8.3.2 (a) to (f).] The guidelines require detailing of special tax benefits for the issuer company and its shareholders. [Reg 6.8.4.12 (a) of DIPG 2000] Tax provisions and workings have to take into account tax shelters as well as the timing impact of tax liabilities due to aspects such as difference in book and tax depreciation as per format in Schedule XII. [Reg 6.10.2.7 and 6.10.2.8 of DIPG 2000]

Statement of assets and liabilities and profit and loss to be adjusted for [i] accounting issues that attracted audit qualifications [ii] events relating to prior years that have a material impact on the profit [iii] changes in accounting policies, restating the profit or loss of those years as if there had been no change in the accounting policy [iv] incorrect accounting policies [v] extraordinary items in computing the profit and loss as well as without adjusting for extra ordinary items, as per format prescribed in Schedule X and [vi] revaluation reserves from the assets and liabilities as per format prescribed in Schedule XI.

In addition, in case the issuer has subsidiaries the auditor is required to report on [i] the profits or losses of the issuer separately as well as present them in combination with the profits or losses of the subsidiaries insofar as they affect the members of the issuer [ii] assets and liabilities, similarly, although the accounting mechanics provided for in this instance are slightly different from that in the case of the profit and loss account. [Reg 6.10.2.3 of DIPG 2000], [iii] the profits or losses of the issuer for five years preceding the issue of the prospectus, distinguishing items of a non-recurring nature, in case the issuer has no subsidiary [iv] assets and liabilities as of the last date on which the accounts of the issuer company were made up, in case the issuer has no subsidiary. [Reg 6.10.2.2 of DIPG 2000]. [v] the history of shares on which dividend payments have been made in the past five years and those where dividend payments have not been made and [vi] a certificate validating a statement from the issuer presenting profit or loss and assets and liabilities for the period for which no accounts were made by the issuer during the preceding five year period, provided such statements do not stop at a period more than six months prior to the date of the issue of the prospectus [Reg 6.10.2.1 (b) of DIPG 2000].

The guidelines require a discussion, by the management, of the financial conditions and results of the operations as reflected in the financial statements [Management Discussion and Analysis or MDA hereafter.] [Reg 6.10.5 of DIPG 2000] The MDA is required to cover [i] overview of the business [ii] developments since the last financial statements which might materially and adversely affect trading, profitability or asset values over the ensuing twelve months [iii] factors that may affect operations [iv] summary of the financial results for the past three years after adjustments as required by the auditors and discussion of the same, covering some essential aspects listed in the requirements.

The prospectus has to provide details of mechanisms for redressing investor grievance and the time taken for disposal of investor grievances. These requirements apply to the issuer as well as companies under the same management under Section 370(1)(B) of the Companies Act "for the period of three years prior to the date of filing of the prospectus with the RoC / SE".

are too broad and general to be able to ensure that issuers provide the details necessary for informed decision making.³³⁸ The detailing of information in the DIPG makes an important contribution to the disclosure regime governing IPOs, by enabling an investor to arrive at a better assessment of the quality and the value of the securities on offer.

The substantive requirements of the guidelines may be discussed under the following broad headings: (i) Overview Information (ii) Issue related information (iii) Business and Issuer related Information (iv) Financial data for the issuer and the business (v) Group Company related information. The detailed provisions have been paraphrased in the footnotes. Broadly, the flow indicated above is in line with the approach that systematic investment analysis might flow.

5.3.1.2 (i) *Overview Information:* provide information that identifies the issue, issuer and various other intermediaries involved in bringing the issue to the market.

5.3.1.2 (ii) *Issue related information:* These relate to terms and procedures of the issue in considerable detail. The provisions under this category also require the issuer to provide commitments on many aspects such as dematerialisation, transfer of shares, book building procedures and so on. In addition, the issuer also provides

[Reg 6.12.23 of DIPG 2000] The requirements relating to companies under the same management is confusing. Does it apply to the details of the mechanisms that have been there? Or, does it refer to companies that have been under the same management for three years? If it is the former why does the time element apply to companies under the same management when there is none for the issuer itself?

Transactions in securities of the issuer from the time of filing the offer documents with the RoC or SEs, as the case may be, till the closure of the issue are to be reported to SEBI within twenty four hours of the transaction. (Reg 5.3.5 of DIPG 2000) The issuer is also required to submit to SEBI some minimum personal identification data on the promoters (Reg 5.3.6 of DIPG 2000) to pre-empt instances of outright fraud by fly by night operators.

³³⁸ We have already noted that if disclosure levels are left to the market, there might be a risk of under-production of information.

undertakings on important matters relating to allotment, listing and maintenance of credit rating and so on.

5.3.1.2 (iii) *Issuer and Business Related Information:*

5.3.1.2 (iii)(a) Issuer related information

Issuer related information deals with the management of the issuer, organization structure and so on. It also requires financial information, a discussion of financial performance, details of shareholding, transactions in the company's shares among the promoters to indicate to the investor if the promoters are trading (in the company's shares) while making an issue. Both buying and selling have signal values and the nature of the signals depends on the circumstances. The definition provided for the promoter in this context is noteworthy for the endeavour to comprehensively include a wide gamut of possible shareholding / ownership relationships. The definition is a pointer to the elaborate attempts made by Indian business families to maintain control while appearing to have an arm's length relationship or something close to it. The definition is also a demonstration of SEBI's attempt to bring as many of such group affiliations as possible under the definition of a promoter. These definitions seem to reflect the complex ownership structure, sometimes taking the shape of an ownership pyramid that exists among businesses managed by Indian business families. Further, details of property transactions between the promoters and the issuer and beneficial interests enjoyed by the promoter with the issuer during the preceding two years are also required. Details of litigation, both directly related to the issuer as well as those might impact the issuer indirectly through group companies or the promoters are required. Disclosures relating to transactions with the promoters are critical to pre-empt expropriation through self dealing

by owner managers. In our framework in Chapter IV we noted how important it is to prevent self dealing.

Finally, a justification for the price is required. In the absence of projections this justification has to be based on book or accounting or historical measures. The tendency in contemporary corporate finance is to value assets based on future cash flows. Further, assets can also be made to look more attractive using accounting based measures by playing adjusting the accounting policy. The usefulness of the justification required is thus questionable.

The relevance of these disclosure requirements may be debated in terms of whether they serve any useful purpose and whether they are adequate to mitigate the problems of hidden information or hidden action on the part of owner managers. That aside, it has to be acknowledged that these requirements have gone to a great extent to enhance the disclosure requirements of the Companies Act. Further, it remains to be evaluated whether these have been enforced in letter and in spirit and if they have enabled investors to make better investment decisions as suggested by Carol Simon³³⁹ in the American context.

5.3.1.2 (iii)(b) Business related information

Business related information include details relating to the project such as the details of the plant and machinery, capacity (historical and forecasted), demand and supply at the industry level, market estimation for the products / services and so on.

³³⁹Simon (1989), supra note 19

Central to these requirements is the idea of a “project”. Though not rigidly defined, it conveys the notion of a specific investment programme. Often issuers may propose to raise capital to recapitalise (refinancing excessive debt), to build a war chest for acquisitions that have not been identified or cannot be disclosed and so on. It is not clear how the regulators would view such requirements. Further cash flow is fungible, which makes it meaningless to “ earmark” cash flows in this manner. While the need for committing the issuer to a stated utilization of funds is desirable, tying him down to a “project” may only encourage issuers to “package” the funding needs accordingly in a contrived manner, even if the issue were not to be intended to be deployed / utilized in that fashion.

5.3.1.3 (i) *Financial Data relating to Issuer and Business:* This comprises mainly historical information relating to the issuer and the issuer’s existing businesses. Financial data relating to the project are not permitted since that might amount to “forward looking statements”, which are prohibited. The key features of these requirements are disaggregated turnover data in the case of companies with multiple businesses / product lines, elaborate details of historical and proposed capital structure, impact of discontinuance of lines of business on profitability, tax details, key accounting ratios and the accounting policies on which the data have been prepared and details of changes, if any, in the accounting policies. These are in addition to the statements of assets and liabilities and profit and loss accounts adjusted for a number of issues that might otherwise distort the true and correct picture, statements of the issuer adjusted for subsidiaries, price and volume details of transactions in the shares from the time of filing the offer document and till closure of issue. Disclosure based on more than one standard is also allowed. Finally, these disclosures are

required to be rounded off by a discussion and analyses of these results by the management of the issuer.

Generally, the levels of disclosure of financial information are considerable. Along with the business related information mentioned earlier these financials should make it possible to build a model for financial forecasting for an analyst. Thus an analyst would not miss forward looking statements if the issuer complies with the spirit of these requirements. Research reports, which we discuss later in this section, should further help analysts and investors evolve a picture of the financial future for the issuer.

5.3.1.4 *Group Company Related Information:* includes primarily financials of group companies.³⁴⁰ In some instances these requirements extend to companies which are part of the group even though they may not be covered by the definition of companies under the same management according to the Companies Act.³⁴¹ This treatment of the idea of “group companies” is however not uniform as we point out later. The coverage of information on group companies includes details of companies that have not performed well in the recent past,³⁴² their record in accessing the public securities markets in the recent past and a comparison of their actual performance vis a vis promises made in the prospectus and so on, highest and lowest price during the six months prior to the filing of the prospectus, details of intra group transactions, extent of business overlap, their financial impact on the issuer and details of companies from which promoters of

³⁴⁰ The term group company is used in the guidelines to denote all companies, ventures, etc. promoted by the promoters of the company concerned and goes beyond the concepts of holding and subsidiary companies as defined in S 4 of the Companies Act, 1956. (See DIP Guidelines 6.10.3.1)

³⁴¹ S 370 (1)(B) and 372 (11) of the Companies Act 1956. But since the Companies Amendment Act, 1999 came into force S 370 and S 372 have no operational relevance.

³⁴² Companies that have incurred loss or have been referred to the BIFR (after the establishment of National Company Law Tribunal, S 10 FB of the Companies Act, 1956 to NCLT under S 424 (Part VIA) of that Act) as sick companies or are under winding up.

the issuer may have dissociated in the recent past. Earlier we noted that the disclosures regarding litigations are required to include litigations involving group companies and their defaults to banks and financial institutions.

In short, the endeavour of these provisions appears to be to provide an insight into the functioning of the promoter group, their managerial track record and history of rewarding public investors and their creditworthiness. These disclosures assume importance in the light of the observations about the group affiliations of Indian FOCs and their tendency to maintain managerial control among members of the family. It is also possible that these requirements were motivated by a trend among promoters to bring several new companies promoted by them to the capital market even though other companies under their management had made public floatations earlier had not provided adequate returns to investors. The group related information requirements, which are a later development, were perhaps intended to plug these trends.

5.3.2 Critical Assessment of Disclosure Provisions

The current disclosure requirements are vastly improved over the previous regime. They cover not just the substantive aspects of the content of disclosure but also various aspects of presentation such as the layout and the information to be presented on the front cover page,³⁴³ the size of the font where it matters, as in the case of issue

³⁴³ Reg 6.4 of DIPG 2000. These requirements detail the information that needs to be carried in the cover pages and their layout. The information is mostly from the detailed contents of the prospectus and are presumably those items of information that SEBI considers important enough for the investor to not miss them. In addition, it also requires some disclaimers informing the investor of risks in investing in equities in general, issuer's absolute responsibility for correctness of disclosures. The specific contents of these pages are discussed at the appropriate places.

advertisements³⁴⁴ and the order in which the information is to be presented.³⁴⁵ The guidelines have requirements that can help identify sources of intra group conflict among companies within the promoter group *per se* and self dealing between promoter and issuer. They also should help a professional analyst assess the competence of the management and its attitude towards capital providers, develop a picture of the financial future of the company, identify sources of risk and value the business. There has been a practice among Indian promoters to sell their properties to the issuer company which is under their management and finance the purchase of the same through the proceeds of the public issue. Companies may also access public markets to support each other. To identify such transactions data is called for regarding transactions in properties.³⁴⁶ Thus there are disclosure requirements, *inter alia*, to bring out instances of self dealing between the promoters and the company. Interestingly, similar concerns have been sought to be addressed by certain provisions of the Companies Act, 1956, from its early days.³⁴⁷ So also details of benefits provided / payments made to the promoters and directors as

³⁴⁴ Reg 9.1.12 (b) of DIPG 2000

³⁴⁵ Reg 6.3 states that the information is to be presented "as far as possible" in the order in which they are listed in the Chapter VI of the guidelines and in Schedule VII A.

³⁴⁶ Reg 6.9.2.4 of DIPG 2000

³⁴⁷ The two provisions of the Companies Act, 1956 which have relevance in this context are Ss 297 and 299. Subsection (1) of S 297 provides as follows: Except with the consent of the Board of Directors of a company a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director, shall not enter into any contract with the company-

- (a) for the sale, purchase or supply of any goods, materials or services; or
- (b) after the commencement of this Act, for underwriting the subscription of any shares in, or debentures of, the company:

Provided that in the case of a company having a paid-up share capital of not less than rupees one crore, no such contract shall be entered into except with the previous approval of the Central Government.

S 299(1) mandates that every director of a company who is in any way directly or indirectly concerned or interested in a contract, arrangement, etc., entered into by or on behalf of a company shall disclose the nature of his concern or interest at a meeting of the Board. Even though some of the directors may not be directors in the technical sense they may in most cases be treated as "shadow directors" within the meaning of S 7 and hence may incur liability as a fiduciary. Further, it is a statutory duty of the company to keep a register of contracts or arrangements to which S 297 or S 299 apply. [S 301]

consideration for their interest in the company are required to be provided.³⁴⁸

It is possible to argue that some of the disclosures such as those relating to the personal details of the promoters appear to be on the excessive side and possibly of limited use to an average investor. Equally, the drafting of the requirements as in the case of financial details of group companies³⁴⁹, not defining terms such as “association of promoters with companies”,³⁵⁰ or the idea of compliance with the corporate governance requirements³⁵¹ or period of “the last three years” while providing accounting ratios to justify issue price, where the basis for reckoning three years has not been provided³⁵² and in a few other places could do with greater precision. Similarly the guidelines cast responsibility on the LMB not to proceed with an issue in case the accounting ratios do not justify the price.³⁵³ Apart from specifying the ratios required and some guidelines for the method of computation of the same, the guidelines provide no idea of what might be an acceptable justification for the price. Substantively, the requirements do not appear to be consistent in many places. For eg., the number of prior issues relating to which a comparison of actual and promised performance is required does not appear to be consistent across the issuer, companies under the same management and listed ventures which may be considered to be group / associate companies. For that matter even the coverage of companies which the promoters are associated with or have managerial control over does not appear to be consistently defined. In certain instances the guidelines extend to companies that are under the management of the promoters, no matter

³⁴⁸ Reg 6.9.6.4 of DIPG 2000

³⁴⁹ Reg 6.10.3

³⁵⁰ Reg 6.10.3.3

³⁵¹ Reg 6.9.5.3 of DIPG 2000

³⁵² Reg 6.8.4.11 of DIPG 2000

³⁵³ Reg 6.8.4.11 (b) of DIPG 2000

whether they are “companies under the same management under Section 370(1)(B) of the Companies Act or not,³⁵⁴ whereas in some other instances the ambit extends to “companies under the same management under Section 370(1)(B) of the Companies Act”³⁵⁵, and in another instance it is simply “companies / firms promoted by the promoters”³⁵⁶ or “group / associate companies”.³⁵⁷ More importantly, the conceptual bases for many requirements are not apparent or clear. The requirement relating to details of prices and volumes³⁵⁸ is a case in point. The requirements seeking details of “business transacted” is not just ambiguous, but also raises the question of the usefulness of that data. Investors’ concern about liquidity in the shares is best addressed by more meaningful data on the number of shares. [Elsewhere in the same context³⁵⁹ the regulations seeks data on number of securities traded.]³⁶⁰ Similarly, details of unsecured borrowings of group / associate companies³⁶¹ do not seem to convey much usable insight about the gearing of the issuer company, unless they impact the issuer directly as a lender or guarantor or indirectly in some other manner. Finally, and fundamentally, as a matter of philosophy it may be worth looking at many of these requirements to see if they might be applicable more universally to a large majority of companies. Take for example the provision relating to an instance where accounts have not been drawn up by an issuer during the preceding five year period. It is unlikely that there will be many companies to which this provision might apply. SEBI could very well

³⁵⁴ Reg 6.10.3 of DIPG 2000. The guidelines explicitly state “irrespective of whether these (companies) are covered under Section 370 (1)(B) of the Companies Act, 1956”. So also in 6.11.1.3 in the case of details of disciplinary action by the Board / SE .

³⁵⁵ Reg 6.12.23 in the case of redressal of investor grievances and Reg 6.12.19 requiring details of capital issues made during the previous three years

³⁵⁶ Reg 6.11.1.3 (a) relating to details of pending litigations

³⁵⁷ Reg 6.12.20.2 (a) requiring details of performance of listed ventures of promoters that made issues and Reg 6.10.2.7 (h) (i) requiring details of unsecured borrowings

³⁵⁸ Reg 6.12.22

³⁵⁹ Reg 6.12.22.1 (c)

³⁶⁰ The term “business transacted” has not been defined anywhere in the guidelines but going by common commercial parlance it is meant to refer to value of shares traded

³⁶¹ Reg 6.10.27 (h) (i) of DIPG 2000

suggest this remedy when it encounters this issue in the specific instance of a company rather than have a general set of provision to address that situation.

In general, for provisions to be simple and easy to comprehend and administer they should address the more general of situations leaving specific variations to the discretion of the administrator. Looking at some of the provisions of the DIPG as it stands one wonders if it may have been made less unwieldy by not allowing many such requirements that appear to be of a specific nature to creep in.

On the whole, though, it cannot be denied that the current set of disclosure requirements equip the investor with a great deal of information that can help him arrive at an informed view on the quality of the investment. In any case it requires a lot more disclosure than the Companies Act does. They provide a good starting point for further improvements in this area under the aegis of the relating to the constitution and role of the National Council for Accounting Standards (NACAS)³⁶².

5.3.3 Risk Factors

The final set of disclosures relate to risk factors and management perceptions of the same, which are required to be discussed as part of the prospectus.³⁶³ The guidelines do not specify the types of risk factors to be identified in the prospectus in terms of marketing, management, access to critical resources and so on. They are required to be categorised as those that are specific to the project and

³⁶² NACAS is a statutory committee set up under section 210-A of the Companies Act, 1956 to advise the Central Government on the formulation and laying down of accounting policies and accounting standards for adoption by companies. (Source: Ministry of Company Affairs Press Release dated February 6, 2007.)

³⁶³ Reg 6.7 of DIPG 2000 and Clause VIII of Part I of Schedule II of Companies Act, 1956.

internal to the issuer and those that are external to and beyond the control of the issuer. Risk factors need to be included if they are considered collectively material, even if they do not matter individually, irrespective of whether their impact is quantitative or qualitative and irrespective of whether they might matter in the future or at present. The discussion on risk is required to include proposals to mitigate the same, apart from listing the sources of risk.³⁶⁴

The disclosures relating to risk appear to be rather broadly defined, which is in contrast to the various other heads discussed earlier. Given the diversity of businesses, it may not be feasible or advisable to specify the discussion on risk in greater detail. As with other aspects of disclosure, it is quite possible that some, if not much of the level of disclosure required by the regulator may be achieved through the comments and observations of SEBI on the draft offer document.

5.3.4 Contracting Investor protection

As part of the disclosures in the offer document the issuer also provides an undertaking to SEBI regarding addressing issue related complaints, listing of the issue within the stipulated time, providing requisite funds for despatching refund orders, making available allotment letters / certificates to the RTI, bringing in the promoters' contribution in full before the issue opens and underwriting the public portion of the issue. Further, the issuer has to certify to SEBI that refund orders and allotment certificates have been despatched in the case of earlier issues, if any, and that the instruments have been listed as mentioned in the offer documents.³⁶⁵ A public or a rights offer cannot be made unless the issuer has entered into an agreement with

³⁶⁴ Reg 6.7.5.1 of DIPG 2000

³⁶⁵ Clause 3.2, RMB (GI Series) Circular No 2 (93-94) dated 26-5-1993

a depository for dematerialization of securities already issued or proposed to be issued to the public or ensuring shareholders and the subscribers or the existing shareholders, as the case may be, are given the option to hold or receive securities in the dematerialised form.³⁶⁶

5.3.5 Collateral Disclosures

Apart from mandating the disclosures in the offer document, SEBI also regulates the other modes by which issuers purvey information about the issue, such as advertisements, communication to / through the press and dissemination of information to professionals such as investment analysts. These have become necessary in the light of the huge marketing game that garnering investment support has turned out to be in the past decade.

For eg., advertisements relating to a public offer are required to be "truthful, fair and clear and not contain any statement which is untrue or misleading".³⁶⁷ Statements without appropriate substantiation and which provide an exaggerated picture of the company or statements which imply an inaccurate picture of the past or that the performance of the past will be sustained are considered misleading. Towards these, the guidelines have a number of detailed provisions, spelt out below.³⁶⁸

³⁶⁶ Reg 2.1.5 of DIPG 2000

³⁶⁷ Reg 9.1.1 of DIPG 2000

³⁶⁸ The guidelines prohibit selective extracts from the offer document, (Reg 9.1.2 of DIPG 2000) require clear, concise and understandable language and prohibit the use of models, slogans, brand names, fictional characters, celebrities, landmarks and so on. If the advertisement has to carry financial data the minimum financial data that has to be included has been specified as well. (Reg 9.1.11 of DIPG 2000) All issue advertisements [including corporate advertisements during the twenty one day period after filing of prospectus till closure of that corporate], except issue opening and closing announcements, have to highlight risk factors in fonts of minimum prescribed size. (Reg 9.1.12 and Reg 9.1.13 of DIPG 2000) Issue of advertisements announcing opening, closing and level of subscriptions to issues have been specified to possibly pre-empt abuse of such communications to create inaccurate impressions of the level of interest or quality of such issues. (Reg 9.1.16 to Reg 9.1.19 and Reg 7.5.2 of DIPG 2000) The LMB has to ensure that advertisements providing details of oversubscription, basis of allotment, date of despatch of certificates and refund orders have to be released within

Similarly, the LMB is responsible for ensuring compliance with the provisions relating to issuance of research reports.³⁶⁹ These provisions seek to ensure that the research reports are not used to circumvent disclosure regulations to provide an informational advantage to a certain set of investors or to provide misleading information. Further, the Companies Act, 1956 has given an extended meaning to the term "untrue statement" for the purpose of liability connected with mis-statements in the prospectus. An omission of a material fact concerning the issuer company will be treated as an untrue statement for the purpose of prospectus liability under the Act if it is calculated to mislead.³⁷⁰ The term "calculated to mislead" has been interpreted by the courts to cover those omissions which may fall within the ambit of the maxim "*suppressio veri suggestio falsi*".³⁷¹ The directors of the issuer company and others responsible for the issue of the provisions of S 56 which mandates that even prospectus issued by or on behalf of a company shall state matters specified in Schedule II of the Act.³⁷²

ten days of completion of "various activities" in one newspaper each in English language, Hindi and the regional language daily circulated at the place where the registered office of the issuer is situated. (Reg 7.5.1 of DIPG 2000) (The guidelines do not define "various activities" but it is reasonable to assume that it means the finalisation of the basis of allotment and despatch of securities, obtaining demat credit or despatch of refund orders and applying for listing. It does not require that listing permission have been obtained.) The LMB has to obtain an undertaking from the issuer that the material used in issue related communications will be limited to the material available in the offer documents and has to further approve the material in all communications before they are released.

³⁶⁹ The LMB has to ensure that research reports cannot use or be based on information beyond what is available in the offer documents and that there is no selective disclosure of information to limited constituencies. [Reg 9.3.1 (i) and (ii) of DIPG 2000] It is presumed that the reference here is to information relating to the company and the issue and not to industry, technology and so on that may be gleaned by the analyst from other published and non-published sources. However this has not been clarified in the regulations. This replaced the requirement that issue of research reports by the issuer or any member of the issue management team or syndicate has been prohibited for a period starting 45 days immediately preceding the filing of the draft offer document and ending 45 days after commencement of trading in securities. The latter requirement which was deferred appeared to be a better defined requirement.

³⁷⁰ S 65 (1)(B).

³⁷¹ See *RV Kysant* (1932) 1 KB 442

³⁷² See S 56 (i) and S 56 (ii)

5.4 Provisions Aligning the Interests of External Shareholders and Owner Managers

The provisions for aligning interests may broadly be discussed under four broad categories. These relate to (i) Ensuring an enduring stake for the promoters (ii) Ensuring through non-price mechanisms that the capital structure of the firm brings about convergence of economic interests between the promoters and the external providers of capital (iii) Pricing of share allotments and (iv) Distribution of shareholding. We outline briefly outline the broad remit of these provisions and then discuss the details of the mechanisms below.

Ensuring an enduring stake for the promoters: This category of provisions ensures that promoters have at least a minimum equity stake in the company, acquired for cash and that this stake may not be liquidated for a minimum period. During this period, it is probably hoped, the promoters would develop the enterprise to some level of stability. We divide these provisions again into two sub-categories: (i) Those ensuring a minimum financial commitment or stake in the company and (ii) Those restricting liquidity in the stake required as part of the minimum financial commitment.

Capital structure related provisions: These provisions try to ensure that promoters do not expand, dilute or modify the capital structure in any other manner to the detriment of the financial interests of the outside shareholders. Examples of such changes to the capital structure are preferential issues of bonus shares to the promoters, low priced warrants and options and so on.

Distribution of shareholding: These relate to the distribution of shareholding. We have noted in Chapter IV that the pattern of share

ownership may also impact governance of companies. Recent developments in securities law suggest that regulation views shareholding pattern as much as a governance device as it used to be an instrument for pursuing distributive goals.

Pricing of shares: Differential pricing is one of the means by which insiders may redistribute wealth from external shareholders to themselves. Provisions relating to pricing endeavour to restrict such opportunistic behaviour by owner managers at or around the time of a public offering or in the form of preferential allotments after the shares are listed.

5.4.1 Pricing of Securities

Regulations relating to pricing may adopt one of two approaches. One, the regulator may lay down criteria for valuing shares or even determine the issue price, as one extreme instance of merit regulation.³⁷³ At the other extreme, pricing regulations may be limited to ensuring that free pricing of securities is not misused by a group of shareholders, who have majority or significant minority control, to issue themselves shares at prices below the intrinsic worth of the shares.³⁷⁴ In either case, the endeavour is to ensure that the owner managers do not enjoy a price advantage vis a vis the external shareholder.

The current regulations allow free pricing in the case of all companies that qualify to make a public issue of equity shares. An exception is the case of banks where the pricing is subject to regulations of the RBI.³⁷⁵ Further, they provide for the price to be discovered and firmed

³⁷³ This was the case, for example, under the regime under the erstwhile Controller of Capital Issues.

³⁷⁴ The current regulations governing private placements and preferential allotments to QIBs are intended to achieve these objectives. [Chapters XIII and XIII A of DIPG 2000]

³⁷⁵ Reg 3.3.1 of DIPG 2000

up close to the time of opening of the issue for subscription.³⁷⁶

Restrictions on announcement of prices prior to the issue by listed companies may help preserve market integrity. Any prior hint of the proposed price may lead to unhealthy speculation and volatility.

There have been instances in the past where mere announcements of intention to issue new shares or offers for sale from large incumbent shareholders in the case of state owned enterprises are reported to have triggered speculative activity in those shares with the intent of pulling down prices.^{377,378}

5.4.1.1 Differential Pricing and Preferential Allotment

Indian companies turn to their principal (insider) shareholders for meeting their requirements of capital. Often, these shares allotments were limited to owner-managers, strategic partners or other institutional shareholders and were intended to increase the shareholding of the insiders, at prices lower than the fair value. Allotment to a limited set of shareholders was known as preferential allotment, as opposed to a rights issue or a public offering. One important consequence of preferential allotments was that the welfare of outside shareholders, especially that of small shareholders from the public market, was adversely affected. Institutional shareholders with substantial shareholding could prevent the owner managers from proceeding with such transactions either contractually or on the

³⁷⁶ The issuer may indicate a price band instead of a specific price, the upper limit of the range being not more than 20% over the lower limit or the floor. The exact price may be determined by the Board of Directors through a resolution. Listed companies need to provide to the SEs on which they are listed a notice period of 48 hours for the meeting to decide the price. In the case of further issues by listed companies, the price or price band may not be disclosed in draft letter of offer or draft prospectus as the case may be. [Various clauses in Chapter 3.5 of DIPG 2000.]

³⁷⁷ Also please see the discussion under book building on the price discovery process, later in this chapter.

³⁷⁸ These are based on media reports and there has been no official confirmation of these incidents. The idea here appears to be that if the market prices of these scrips are depressed, the offer for sale may be made at a correspondingly lower price. This may allow abnormal short term gains due to the inefficiencies induced in pricing in the market.

strength of their voting power. However, in companies without substantial external institutional shareholding, small shareholders could not effectively protect their interests from this kind of expropriation. It was in this backdrop that SEBI introduced a few restrictions on such preferential allotments, apparently with the attention to pre-empt opportunistic behaviour by those in control of the company such as the promoters or other large shareholders.³⁷⁹ The restriction that differential pricing may be allowed only so long as it is higher than the public issue price and the restriction on offering discounts appear to be intended to plug the tendency noticed among issues where firm allotments were made to certain categories of investors at prices lower than that offered to the public, with the idea of garnering their investment support or simply to provide an unfair price advantage to those categories of investors.

The restrictions on differential pricing raise several questions. If the differential pricing has to be justified in the prospectus why limit the differential pricing to higher prices in the case of firm allotments.

The other major restriction on pricing is that linking the offer price in the case of private placements of blocks of new shares by listed companies in favour of certain sets of shareholders. The idea here has been to ensure that groups of shareholders who wield control do not get wealthy at the expense of other, especially minority shareholders, by allotting themselves shares below the market price. Preferential allotment pricing provisions are attracted in the case of participation by promoters in a public issue beyond the 20% that they

³⁷⁹In a given issue differential pricing is permitted only in the case of a combined public and rights issue. Differential pricing in favour of certain sets of subscribers such as firm allottees is permitted only in the form of higher price. (Reg 3.4 of DIPG 2000) Justification for the price differential in either case is required to be provided in the offer document. (Reg 3.4.4 of DIPG 2000) Further, any attempt to subvert the uniformity of pricing through mechanisms such as discounts or commissions is prohibited. (Reg 3.6 of DIPG 2000)

are required to participate in the case of listed companies;³⁸⁰ in the case of listed companies they are excluded from the computation of promoters' contribution.³⁸¹

5.4.2 Ensuring minimum financial stake for the promoters

The regulations require that promoters or owner managers have a minimum shareholding in the company under certain conditions. These provisions are summarized below. The regulations have several definitions of the idea of promoters, provided in different contexts such as in the context of requirements of disclosure of shareholding details. There appears to be no definition of a promoter in the context of minimum promoters' holding. Instead, the regulations go on to define the shares that qualify to be reckoned as promoters' contribution, with a view to ensuring that the contribution indeed comes from insiders who may be considered to be promoters.

The term promoter is not a term of art and it is not defined in the Companies Act. In a leading text book on Company Law: (Gower & Davies: Principles of Modern Company Law, (7th edn)) it is stated thus: "who constitutes a promoter in any particular case is a question of fact. The expression has never been defined either judicially or legislatively." (p-91).

The definition section³⁸² of Companies Act, 1956 does not define the term, though S 62(1)(c) fastens liability on the promoters along with others for the untrue statements contained in the prospectus. Elsewhere³⁸³ the Act defines the term as follows. For the purposes of

³⁸⁰ (Reg 4.8.1 of DIPG 2000)

³⁸¹ (Proviso to Clause (a) of Reg 4.10.1)

³⁸² S 2 of Companies Act, 1956

³⁸³ Subsection (b) of S 62

this section, "The expression promoter means a promoter who was a party to the preparation of the prospectus or of the portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company". But the definition applies only for the purpose of S 62, which deals with the liability for the mis-statement in the prospectus and not for other purposes.

The DIP Guidelines also do not contain a definition of the term generally applicable to all the provisions of the Guidelines. But the relevant explanations³⁸⁴ contain an inclusive definition, the applicability of which is confined to specific provisions in the Guidelines.³⁸⁵

The requirements relating to promoters' contribution have exhibited a high level of persistence in spite of the numerous changes that they have been through across the years.

The key features of these provisions are summarised below.

The regulations require that promoters contribute to or hold at least 20% of the post issue paid up capital of an unlisted company that makes a public issue.³⁸⁶ In the case of a listed company promoters need to subscribe to 20% of the issue or ensure that they have 20% of the post issue capital of the company.³⁸⁷ In the case of issues by listed companies, composite [rights and public issue] or otherwise, it appears that the regulations expect that if the promoters do not subscribe to 20% of the issue they would at least need to ensure that promoters

³⁸⁴ Explanations I to III of Chapter 6.3.2 contain an inclusive definition, the applicability of which is confined to specific provisions in the

³⁸⁵ Explanation III excludes certain persons who would otherwise be covered by the previous explanations.

³⁸⁶ Reg 4.1.1 and Reg 4.2.1

³⁸⁷ Reg 4.3.1

hold at least 20% of the post issue capital. The regulations are not clear whether in the case of listed companies the lower or the higher of the promoters' contribution is expected to be complied with. However, a reading of Reg 4.10.1 would seem to suggest that the promoters' participation cannot be greater than the higher of the two options without attracting the provisions of the pricing for preferential allotments, especially where the issue price is lower than the price determined by the provisions of the preferential allotment pricing policy. Thus it would appear that the stance of the regulation on what is expected would at least to some extent depend upon whether the offer price is greater than or less than the price determined by the provisions of the preferential pricing policy.

The regulations dwell at length on the securities that would not qualify to be considered as part of promoters' contribution.³⁸⁸ Securities that have been acquired for consideration other than cash, or as bonus shares against revaluation reserves during the three years preceding the public issue or shares acquired for a price lower than the public offer price during one year preceding the public issue are considered ineligible. Subscriptions against promoters' contributions are required to be from firms and individuals who are not business associates and have to be for a minimum of Rs 25000 in the case of individuals and Rs 100,000 in the case of applicants who are firms and companies. Promoters' contribution may not be raised through private placements solicited from "unrelated persons". Finally, the holders of securities to be included in promoters' contribution need to consent in writing to the inclusion. In the case of an issue of convertible securities if the conversion price has been determined upfront at the time of the issue the promoters have the option to bring in their contribution either in the form of the convertible instrument or in the form of equity subscriptions

³⁸⁸Reg 4.6 of DIPG 2000

directly. Even if the conversion were to take place in stages, the effective price at which the promoters bring in their contribution is required not to be lower than the weighted average conversion price of all the equity capital raised through the conversion-price. If the issue price has not been determined the promoters have to bring in the subscription in the same form or instrument as that on offer to the public. In no case does the promoter have the option not to convert into equity. The promoters' contribution has to be brought in entirely at least a day before the opening date of the issue. Promoters' contribution in excess of Rs 100 crore may be brought in advance of the calls on public investors on a pro rata basis.³⁸⁹

Exemption from the requirement of promoters' contribution has been provided for in the case of companies which have been already listed for a three year period and with a dividend payment record for the three preceding years, in the case of rights issues and in the case of companies which do not have an identifiable promoter. In the first two instances the promoters have to disclose their shareholding and participation in the issue.³⁹⁰

The promoters' contribution as determined above will be locked in for a period of three years from the later of the allotment in the public issue or the last date of month in which the issue commenced commercial production.³⁹¹ All other shares subscribed to by promoters, be they in excess of the minimum contribution in the case of listed or unlisted companies or be they in the form of shortfalls met by promoters in the case of firm allotments are locked in for a period of one year. The guidelines are silent on the date of commencement of the lock-in for this category. Further, the pre-issue capital that has not been held for

³⁸⁹Reg 4.9.1

³⁹⁰Reg 4.10.1

³⁹¹Reg 4.11 of DIPG 2000

at least one year at the time of filing the draft offer document with SEBI³⁹² as well as securities that are allotted on a firm allotment basis³⁹³ are subject to a one year lock-in from the same date as the minimum promoters' contribution above. Exceptions to these lock in requirements are pre issue capital allotted to venture capital investors of various categories registered with SEBI and pre IPO shares allotted to employees under an employee stock option / ownership plan that complies with the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

The alienation of promoters' shares that form part of the minimum contribution is further pre-empted by the restriction that the pledge of these shares is limited to where they are required as collateral against loans from banks and financial institutions. Transfer of locked in shares during the lock in period is limited to the promoters *inter se*.

A minimum equity contribution from the promoters indicates a demonstrated financial stake and possibly closer alignment of the financial interests between the external investor and the promoters or owner managers. This intent is further reflected in the provisions governing the terms of subscription and conversion prices in the case of issuance of convertible securities. The exemption in the case of companies which have a three year dividend record suggests that the concern essentially applies to issuers without an adequate record of performance.

³⁹²Reg 4.14 of DIPG 2000

³⁹³Reg 4.14A of DIPG 2000

5.4.3 Restricting liquidity of the promoters' stake

The regulations require that promoters' shareholding in the issuer shall not be disposed of for a certain minimum period. The duration of the restriction on disposal and the starting period for the same vary depending on the manner of acquisition of shares. The restriction on disposal of the core shareholding of the promoters is discussed below.³⁹⁴ Restrictions on disposal of shareholding acquired as part of a firm allotment process are covered under the discussion on firm and preferential allotments.

The different lock in periods also appear to suggest different considerations behind the lock in requirements. The three year lock in for the core contribution is presumably intended to bind the promoters' financial interests to the long term success of the company. This concern is further evident from the exemption from the three year lock-in for companies which have a three year dividend record. [The use of dividends here as a measure of performance, as opposed to book profit in the case of access criteria, appears appropriate since there is

³⁹⁴ The promoters' contribution as determined above will be locked in for a period of three years from the later of the allotment in the public issue or the last date of month in which the issue commenced commercial production (Reg 4.11 of DIPG 2000). All other shares subscribed to by promoters, be they in excess of the minimum contribution in the case of listed or unlisted companies or be they in the form of shortfalls met by promoters in the case of firm allotments are locked in for a period of one year. The guidelines are silent on the date of commencement of the lock-in for this category. Further, the pre-issue capital that has not been held for at least one year at the time of filing the draft offer document with SEBI (Reg 4.14 of DIPG 2000) as well as securities that are allotted on a firm allotment basis (Reg 4.14A of DIPG 2000) are subject to a one year lock-in from the same date as the minimum promoters' contribution above. Exceptions to these lock in requirements are pre issue capital allotted to venture capital investors of various categories registered with SEBI and pre IPO shares allotted to employees under an employee stock option / ownership plan that complies with the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

The alienation of promoters' shares that form part of the minimum contribution is further pre-empted by the restriction that the pledge of these shares is limited to where they are required as collateral against loans from banks and financial institutions. Transfer of locked in shares during the lock in period is limited to the promoters *inter se*.

a greater need to link the promoters' interests to a more binding performance commitment such as dividends. The role of dividends as a signal of prospects for the company and as more tangible evidence of performance than just book profits has been acknowledged in corporate finance theory.³⁹⁵ The shorter lock in periods are meant to restrict pre-issue shareholders of the company from offloading their shares to make a quick profit from early increases in the price in the after market. Sometimes these also help in preventing a huge selling pressure soon after the shares are listed and pre-empt extraordinary volatility in the early after-market.

The elaborate structure of the provisions relating to minimum contribution by promoters are indicative of how complex the regulation can get as it tries to catch up with the devices that promoters come up with to get around the regulation.³⁹⁶ Some of the amendments such as those relating to the retail mobilisation of promoters' contribution indicate the difficult balance between retaining the spirit of the original provisions and yet accommodating certain ground realities in raising a large amount of "promoters' contribution".³⁹⁷ It is quite debatable whether some of the categories of investors allowed to participate as

³⁹⁵ For a review of corporate finance theory on dividends see Chapter 16 of Brealey and Myers (2003), *supra* note 150.

³⁹⁶ The following chapter traces the numerous changes to the provisions relating to promoters' contribution from the time they were announced in 1992.

³⁹⁷ The ground reality referred to here is that the media have reported many instances of shares meant to be issued to promoters having been unofficially "placed" with investors who have practically no connection with the promoters. The motivations behind these "placements" have been varied. Two of the more common motivations have been (i) augmenting the promoters' resources in projects requiring large investment outlays and (ii) de-risking the promoters' financial exposure to the project. The amendments to the regulations appear to bring some of these practices into permissible activities, yet restrict them to categories of investors who have some business connection with the company, thereby ensuring that these stakeholders will work towards maximizing the value of the shares of the issuer since they are now shareholders. The fundamental problem with the approach though is that the original intent of the provisions was to align the interests of the owner managers with that of "outside" shareholders. And it is the dilution of this aspect that brings into question the relevance of this provision, which is anyway complicated, if not costly, to administer, as the numerous and frequent amendments in the early years suggest.

promoters' contribution really reflect the spirit of the idea of promoters as defined in the guidelines.³⁹⁸

The concern in this regard is that the percentage of equity held by the promoters need not necessarily be an unmixed indicator of the promoters' commitment to the interests of the external investor. Promoters could well view their share of equity as a measure of control rights over the cash flow. As an alternative to issuing shares with differential voting rights³⁹⁹ the promoter may seek to maximise his shareholding so as to be the majority or the single largest shareholder and exercise control over the cash flows. At the same time, minority ownership positions of the promoters in a company could be said to exert pressure on the owner managers to maximise shareholder value, failing which they would be subject to the market for corporate control. Stated differently, high promoter holdings do not necessarily mean that the owner managers would work to maximise the welfare of outsider shareholders, just as much as low holdings do not mean that they would not have enough incentive to maximise firm value.

Empirical evidence from corporate governance literature suggests that the relationship between firm value and insider ownership is often non-monotonic and non-linear.⁴⁰⁰ The nature of this relationship is different in the context of emerging economies where governance mechanisms are not considered to be as strong as those in the USA. This is consistent with the idea of different utilities that equity shareholding has for owner managers. Owner managers can be expected to maximize the value of the firm as long as they view their equity

³⁹⁸ Promoters have been defined in Explanations I to III, Reg 6.8.3.2 (m). One source of ambiguity is that the provision cited says that these definitions are for the purpose of the provisions relating to disclosure of details of shareholding of promoters.

³⁹⁹ S 86 (a) (ii) of Companies Act, 1956 allows shares with differential voting rights in the case of listed companies subject to Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001.

⁴⁰⁰ This is based on the estimation by Ekta Selarka. Please see Selarka (2006), supra note

shareholding as their share of the wealth. They can be expected to be indifferent to the value of the firm if they are interesting in controlling or expropriating the cash flow of the company and view their shareholding as a mechanism to control the cash flow. In the Indian context it has been observed that the value of the firm declines with ownership up to 45% and starts increasing from a level of 70%, suggesting a curvilinear relationship between firm value and inside ownership. The explanation for this observed relationship is that the capital markets view this level of insider ownership as high enough to signal that insiders would consider the value of their holding in the company higher than the value of the cash flow that they may have expropriated and so will be less likely to expropriate cash flow at those levels of shareholding.

The regulations further require that any participation in excess of the minimum required would have to be at the higher of the offer price or the price determined under the preferential allotment guidelines.⁴⁰¹

The effect of this provision would be to prevent promoters from increasing their shareholding through subscriptions in a public issue, at a price that is lower than that suggested by the market. Another possible apprehension may have been that promoters might use this as a device to generate some quick capital gains and thereby "recover" their mandated minimum investment. The problem with this provision might arise when the average of the market valuation as suggested by the guidelines for pricing of preferential allotments is not reflective of the valuation of the company.⁴⁰² This provision would be

⁴⁰¹ The price of a preferential offer is required to be the higher of the average of the monthly high and low over six months preceding the relevant date and the higher of the weekly high and low over two weeks preceding the relevant date. Relevant date is thirty days prior to the general meeting under S 81(1A) convened to obtain shareholders' approval for the proposed issue. [Reg 13.1.1.1 of DIPG 2000].

⁴⁰² One such scenario might be where the company announces a major expansion or diversification resulting in a substantial expansion in the equity. The resulting "dilution" of equity will bring down the price of the shares at the proposed offering. The problem lies with the pricing formula for preferential allotments. The average of the two weeks might reflect the expectation of the market after the proposed dilution; but the six month average will distort the

counterproductive where such ulterior motives are not prevalent in a public issue. For example, where the public issue is at a fair price and it is a genuine public offering for raising resources for the company, the regulations do not encourage the promoters to signal their belief in the prospects for the company by increasing their percentage holding. It would have been better to just leave the promoters to raise their stake at the same price as the public, subject to the overall restrictions regarding firm allotments and reservations.⁴⁰³

5.4.4 Distribution of Shareholding

The guidelines also seek to regulate the distribution of the post issue shareholding. Traditionally, there has been a policy tilt towards wider distribution of shareholding.⁴⁰⁴ A similar concern seems to have prevailed among the regulators in prescribing a basis for allotment of securities in case of an oversubscription. The provisions are summarised below.⁴⁰⁵

picture. The market may not have been able to anticipate this development at that time and factor it in the price.

⁴⁰³ It is possible to argue that the promoters underprice the public offering just to give themselves a sweet deal. That would be counterproductive, given that there is a limit to the extent to which they may participate preferentially in a public offering.

⁴⁰⁴ Rule 19(2)(b) of Securities Contract Regulation Rules, 1956, now provides that at least 10% of each class of securities offered by a company should be offered to the public for subscription through advertisement in newspapers for a period of two days and the other conditions specified therein to be satisfied as part of the listing requirements. These provisions have been further reiterated vide Reg 8.3.1 and 8.3.2 of DIPG 2000 and Clause 40A of Listing Agreement which deals with share ownership patterns for continued listing. The DIPG goes to the extent of prescribing that an IPO may not be made if the minimum number of prospective allottees is less than one thousand. [Reg 2.2.2 A of DIPG 2000]

⁴⁰⁵ The guidelines require that the number of shares allotted to applicants in each category of application size (in terms of number of shares) shall be in proportion to the total number of shares applied for *in that category* and the extent of oversubscription. (Reg 7.6.1.1 of DIPG 2000). The regulation lays down the details of the procedure to be followed in the allotment process. One of the interesting features of the guidelines in this regard is the idea of reservation for "Retail Individual Investors", defined as those who apply for shares upto Rs 100,000 [Definition xxiv (a). (Reg 7.6.1.2 of DIPG 2000)] Retail individual investors are entitled to get the higher of the minimum of 50% of the net offer of securities to the public or the proportion of the net offer that they would be entitled to as a category under the proportionate allotment formula. Further, the LMB has to ensure that the allotment is finalised in a "fair and proper manner" in accordance with the guidelines. (Reg 7.6.1 of DIPG 2000) In order to certify the fairness in the allotment process the drawal of lots in the case of oversubscription shall be conducted in the presence of a representative of the designated stock exchange and the basis of allotment has to be signed as correct by the Executive

The regulations have tried to address the issue of distribution of issues at four different level ways, namely, (i) the allocation of issues to specific categories of investors in the form of firm allotments and reservations, (ii) allocating a minimum portion of the offer to the public for certain categories of investors such as retail investors who apply for not more than an identified upper limit (in terms of number of shares or amount of investment), (iii) specifying the mechanism for dealing with situations such as over-subscription and spillovers; and (iv) specifically providing for discretion to MBs to decide on allotments in certain situations such as the allotment in the placement category or to Qualified Institutional Buyers in book built issues.

Director or the Managing Director, as the case may be, of the Designated Stock Exchange, the public representative, the LMB and the Registrar.

As noted earlier, the guidelines specify a minimum "net offer to the public" of 10% or 25%, as the case may be. The net offer to the public is the part of the issue through the prospectus to which institutional and retail investors may apply. Beyond the minimum net offer to the public, subject to the provisions of the guidelines, the issuer is free to make reservations and / or firm allotments to various categories of persons as provided for in the guidelines (Reg 8.3.4 of DIPG 2000). These may be of two types: Firm allotments and reservations. The guidelines define "reservations" as "reservation on competitive basis wherein allotment of shares is made in proportion to the shares applied for by the concerned reserved categories." (Explanation 1 to Reg 8.3.4 of DIPG 2000). Firm allotments may be contrasted with reservations in that the allotments in this category may not be on a competitive basis. Reservations are currently allowed to (i) permanent employees (including working directors) of the company and in the case of a new company the permanent employees of the promoting companies (excluding employees of financial institutions where the said institutions are the promoters themselves), subject to a maximum of 10% of the proposed total issue amount [Explanation 5 to Reg 8.3.4 of DIPG 2000] (ii) Shareholders of the promoting companies in the case of a new company and shareholders of group companies in the case of existing companies, subject to a maximum of 10% of the proposed total issue amount [Explanation 6 to Reg 8.3.4 of DIPG 2000] (iii) Indian mutual funds (iv) Foreign Institutional Investors (including non resident Indians and overseas corporate bodies), (v) Indian and multilateral development institutions and (vi) Scheduled Banks. (Explanation 2 to Reg 8.3.4 of DIPG 2000) Reservations on competitive basis were also allowed to shareholders holding shares worth Rs 50,000 (as valued at the price on the day previous to the record date) in the case of public issues by listed companies. [Explanation 2A to Reg 8.3.4 of DIPG 2000]. The allotment to the public category has to be on proportionate basis. The rationale for firm allotment to retail investors is unclear and does not appear to be consistent with the overall rationale behind firm allotments and reservations. Firm allotments are allowed to pretty much the same shareholder categories excluding category (ii) above and permanent employees of the promoter companies but including commercial banks. (Explanation 3 to Reg 8.3.4 of DIPG 2000) LMBs are allowed firm allotments subject to a ceiling of 5%. [Explanation 4 to Reg 8.3.4 of DIPG 2000]

All these provisions are important in their own right because each of them serves a different purpose as we shall see. Some of them are simply of a welfare nature as in the case of the reservation for small retail investors. The discretion in allotment in book built issues, on the other hand, can be used as a tool to incentivise influential investors to produce information.

In the past, in India, reservations and firm allotments were considered to be means of securing firm commitments while marketing the issue. They were also means to allotting large blocks of securities to “friendly” investor groups. Limiting ownership of shares to investor groups who were friendly to the promoters must have been all the more important, given the mandated minimum public ownership of 60% which then declined to 40% and then 25% or 10%, as the case may be.⁴⁰⁶ Owner managers would have liked the shares in the public offer to be either widely distributed or to be held by investor groups that did not pose a threat to owner managers’ control over the company; else the promoters may have been exposed to the risk of large blocks of shares being accumulated by potential acquirors.⁴⁰⁷ If owner managers chose the latter, the policy objective of wider distribution of shareholding would not have been met. The maximum limits were therefore necessary to ensure that reservations and firm allotments did not defeat the purpose of a broad-based share ownership.⁴⁰⁸

Further, the access criteria noted earlier appear to see merit in encouraging institutional ownership of securities. The advantage of having large blocks of institutional shareholding in terms of monitoring

⁴⁰⁶ Rule 19(2)(b) of SCR Rules, 1957.

⁴⁰⁷ Incumbent owners had other legal devices to fall back upon in such cases. These legal devices included the right of the Board of Directors to refuse transfer of shareholding under certain circumstances. The availability of those devices questions the tenability of the explanation above.

⁴⁰⁸ Historically the government may have pursued distributive, rather than efficiency considerations in line with the overall developmental philosophy.

the performance of the company has also been noted earlier. Having said that, the current provisions relating to firm allotments and reservations, represent a vast improvement over the previous regime of detailed categorywise limits and sub-limits. These provisions have replaced the elaborate schedule of categorywise maximum permissible firm allotments and reservations of the past.

5.4.5 Basis for Pricing, Pricing Related Disclosures and Price Discovery Mechanisms

Public offerings may be priced at predetermined prices [hereinafter called fixed price offerings] or at prices arrived at after assessing the price that the market is willing to pay [referred to as book built issues, hereafter.] As noted earlier, issuers may freely price issues under both methods, subject to certain regulations that are meant to ensure that the interests of outside shareholders, incumbent as well as incoming, are protected from abuse by owner managers.

The basis for the issue price or floor / band, where the issuer uses a price band, may be disclosed and justified in terms of specified accounting indicators and along the format in Schedule XV of DIPG 2000.⁴⁰⁹

⁴⁰⁹ Reg 6.8.4.11. The accounting indicators / ratios are [i] earnings per share (EPS) for the past three years, adjusted for changes in capital (ii) pre-issue price – earnings ratio [P/E] [iii] average return on networth in the past three years (iv) minimum return on increased networth to maintain pre-issue EPS (v) Net Asset Value per share based on last balance sheet (vi) NAV per share after issue and comparison with the issue price (vii) Comparison of the accounting ratios of the issuer as mentioned above with the industry average and with the accounting ratios of the peer group, defined as "companies of comparable size in the same industry". Source of information on industry average and accounting ratios of peer group to be provided (vii) Face value of shares and the ratio between face value and issue price / floor price / price band.

In calculating the ratios above adjustments have to be made for expansion in capital that may arise on exercise of conversion options, warrants and so on.

The basis for reckoning the three year period has not been specified.

The guidelines do not specify how the price may be justified in terms of the ratios suggested. Nor do they prescribe a range in which the price may move in relation to these values. The LMB however may not proceed with the issue in case the ratios do not justify the price. It is also not clear though under what circumstances the LMB may or may not proceed with the issue.

The Price / Earnings Ratio (hereinafter called the "P/E ratio") may be used to link the price of the proposed issue to trends in valuation in the market.⁴¹⁰

The basis proposed for justification of issue price raises several issues. First of all it is not clear whether the justification for price is limited to the indicators and methods prescribed in the guidelines or other methods and indicators may also be used. Considering that the purpose of these guidelines is to ensure that lay investors are not misled by the issuer, it is likely that the regulator may not favour the use of other measures, even if they be in addition to the ones prescribed in these provisions.

The use of accounting measures for valuation of securities has often been challenged in financial economics.⁴¹¹ There is some recent evidence though that industry specific multiples may provide better estimates of value in the case of IPOs provided by Moonchul Kim and Jay Ritter.⁴¹² Even among practitioners, the P/E ratio may not be a universally used accounting measure; instead alternate measures such as Price / Earnings Before Interest Depreciation Tax and Amortisation

⁴¹⁰ The inverse of the P/E ratio, the E/P ratio also provides an estimate of the cost of equity capital for the firm, under certain circumstances.

⁴¹¹ For a more detailed but fundamental overview of the valuation of equity shares and firms see Chapter IV of Brealey and Myers (2003), *supra* note 150

⁴¹² Moonchul Kim and Jay R. Ritter, "Valuing IPOs," 53 *Journal of Financial Economics*, 409-37 (1999).

[P/EBIDTA] are used.⁴¹³ Similarly the format in Schedule XV of DIPG 2000 uses weighted average in calculating the average earnings per share and return on networth. The Schedule does not indicate the basis of weighting that has been used. Finally, the idea of “companies of comparable size in the same industry” is useful for estimating the value of a company, especially where the securities of the issuer do not have a trading history in the (securities) markets. The challenge however is in finding companies that fit the definition. This is bound to be especially so when companies from a new or emerging sector enter the public market.

However, justification for issue price in terms of projected earnings is prohibited.⁴¹⁴ The prohibition of the use of projected earnings is consistent with the position of the guidelines precluding the issue of financial projections.⁴¹⁵

In the case of book built issues the red herring prospectus has to state that the final price would be determined on the basis of the demand from investors.⁴¹⁶ A detailed discussion of pricing and disclosure related to book built issues is covered in the section on book building that follows.

5.4.5.1 Book building⁴¹⁷

Perhaps one of the most significant developments in recent times relating to the public offering activity is that of book building as a mechanism of price discovery. In brief, the activity involves assessing

⁴¹³ The choice of such measures depends on the nature of the business. See English [2002] for a discussion on alternate measures.

⁴¹⁴ Proviso to Reg 6.8.4.11 (a) (ix) of DIPG 2000

⁴¹⁵ Reg 6.9.2.2 (a) (ii)

⁴¹⁶ Reg 6.8.4.11 (c) of DIPG 2000.

⁴¹⁷ Chapter XI of DIPG lays down the procedural details regarding book building

investors' interest in the offering on the basis of a red herring prospectus.⁴¹⁸ There are two broad options for book building: One, where 75% of the issue which would have been allotted to institutional investors as part of reservations may be allotted through a book built price discovery mechanism and the other where 100% of the issue is allotted through a book-built price discovery. The former which we will refer to as the "75% Book Building Option", is thus a price discovery mechanism for the private placement part of a public issue. In contrast, we refer to the latter as the "100% Book Building Option". The latter is the more popular route. The latter again provides two sub-options: One where the price for the entire 100% of the issue is discovered through the book building process and the other where the price is discovered through book building for 75% of the issue and the remaining issue is allotted at the price fixed for the 75%. Of these two again, data shows that the latter is the more popular.

The most popular method noted above involves allotting not more than 50% of the offer to Qualified Institutional Buyers, not less than 35% to retail institutional investors and the remaining 15% to non institutional, non-retail investors such as high networth individuals, corporates and so on. (Retail individual investors are those whose application size is not more than Rs 100000). The price is often finalized on the basis of the "book" that is built for the offering from institutional investors. Non institutional investors have the option to invest at the cut off price determined for institutional investors or bid their own prices. The information issues and some of the procedural issues that book building faces in the light of the extant legal framework are likely to assume centrestage in discussions on institutions in the public offerings market, relegating many of the other existing aspects to irrelevance.

⁴¹⁸ See 5.6.1 below for a discussion on red herring prospectus.

Given the popularity of the 100% book built route we lay a greater emphasis in these discussions on the variants of the “100% book building option”.

5.4.5.1.1 75% Book Building Option

The 75% book building is available to all companies who are eligible to make a public issue, as an alternative to making a firm allotment. That portion of the offer has to be indicated as “placement portion” category and the portion on offer to the public, which shall not be less than 25% of public issue will be referred to as the “net offer to the public”. The disclosure requirement in this method of offer is the same as that in a fixed price offer, except that the price at which the offer is being made will not be indicated in the offer document. However, the price for the placement portion and the offer to the public shall be the same.⁴¹⁹ The guidelines outline the steps in conducting the book building exercise and the allotment process.⁴²⁰

⁴¹⁹ Reg 11.1 A (xiii) of DIPG 2000

⁴²⁰ The discussion that follows is based on Chapter XI of DIPG 2000.

Disclosure Requirements

The book building process has to be managed by one of the LMBs to be nominated as the book runner. The copy of the draft prospectus with the price band within which securities are being offered has to be circulated by the book runner to the institutional buyers who are eligible for firm allotment and to the underwriters, inviting offers for subscription. Within two days of the price being determined as below, the prospectus with the price, the number of securities and the amount of the issue is to be filed with the RoC.

Order aggregation and documentation

The book runner and underwriter are responsible for maintaining a record of the institutional investors' interest in terms of number of securities and prices. The underwriters aggregate the offers they receive and communicate them to the book runner. The book runner and other intermediaries are required to maintain records of the book building process and SEBI shall have the right to inspect those records.

Price Determination

The book runner and the issuer may decide the price at which the securities are to be offered to the public based on the order information.

Underwriting

The net offer to the public has to be mandatorily underwritten in this book building route. The reason presumably is that after the elicitation of interest from institutional investors the issue cannot be allowed to fail for lack of interest from the public. As soon as the price is fixed the issuer enters into an underwriting agreement, indicating the number of securities and the price at which the underwriter shall subscribe to the securities. The book runner has an option to require the underwriter to pay all the underwriting commitment monies in advance.

Application and Collection of Monies

The application monies are to be received into two separate accounts for the private placement and the public issue portions. The application forms and monies for the private placement portion is to be received one day prior to the opening of the issue to the public. If there is oversubscription in the private placement portion the interest from this portion may be transferred to the public offer portion and vice versa.

Allotment and Listing

Allotments for the private placement portion may be made within two days from the closure of the issue. However the "deemed date of allotment" for both the categories shall be considered to be the same to ensure that both categories of equity shares are pari passu with each other in all respects. In case the underwriters to the public portions have paid in their commitments in advance the private placement portion may be listed from the eleventh day of the closure of the issue. Allotment under the public category shall be as per the guidelines as noted earlier and shall be eligible to be listed.

Issue Management Agencies and Book Building Process

The issuer has to appoint one or more eligible merchant bankers as book runners, but the LMB has to act as the Lead Book Runner. In case there are more than one LMBs, the names of all those LMBs who have submitted DD certificates has to be mentioned as contact points for investors in case of complaints about the issue. Inter se allocation responsibilities among the LMBs may be assigned through an agreement, through which the rights, responsibilities and obligations of each of the LMBs has to be delineated and only the names of those LMBs who have signed the agreement may be mentioned among the issue managers in the offer document. The minimum requirements of such an agreement have been spelt out in Schedule II of the guidelines. One MB may be designated as the co-ordinator with SEBI.

The primary responsibility of building the book shall be that of the Lead Book Runner [LBR]. Book runners may appoint licensed underwriters as syndicate members. The two in turn may appoint brokers of SEs registered with SEBI for accepting bids, application and placing orders with the companies, having ensured their financial capacity to honour commitments arising out of defaulting clients and investors. These brokers may also act as bidding /collection centers. The brokers are to be compensated for these services by the issuer and not by the client. This should ensure that the brokers serve the issuer's interests as a distribution mechanism and not that of the investor.

The book runners have to maintain a final book of demand showing the result of the allocation process. Records of the book building prices are to be maintained by the book runners and other associated intermediaries. These records are liable to inspection by SEBI.

Disclosure Requirements

A draft prospectus has to be filed with SEBI, without details of price or number of securities but mentioning the total amount to be raised. SEBI may suggest modifications within twenty one days of receipt of the draft prospectus and the LMB is responsible for ensuring that the modifications / final observations are incorporated in the prospectus. The red herring prospectus has to disclose either the floor price of the securities or a price band, along with the range within which the price may move. The LBR has to ensure that the price band is not more than 20% of the floor of the band, and that the band may be revised by a maximum of

20% on either side (subject to the revised cap not being more than 120% of the revised floor). Such revisions are to be widely disseminated through the SEs, media, relevant websites and terminals of the syndicate members. Further, in case of such a revision, the bidding period shall be extended by a period of three days, subject to a maximum bidding duration of thirteen days. [The provisions relating to the bidding process mention this maximum bidding period in the case of a revision in price as ten working days. The requirement of thirteen working days here appears to be due to oversight in making the change in this provision. We believe this might be the case because the requirement of ten working days was introduced in modification to the earlier requirement of thirteen working days as noted under that provision. Further, the requirement in the bidding process is that of working days and not elapsed or calendar days. We believe that might be the requirement in the above instance too and the omission of the word "working" is just an oversight.] The red herring prospectus has to mention how the shortfall, if any, in financing arising out of the revision in price is proposed to be met. The issuer has to affirm that the allotment will not be made unless the shortfall has been tied up.

The last requirement above appears to contradict the earlier requirement that the amount proposed to be raised through the issue has to be mentioned in the draft prospectus. The implication of this is that the issuer commits itself to financing a defined amount of the investment in the project through the public offering. Further, the impact of the movement in the offer price will be absorbed by the incumbent shareholders of the company in the form of a higher dilution that they will face as the number of securities to be issued increases as the price per share declines to raise a fixed sum of money. The guidelines do not suggest that the amount of capital proposed to be raised through the issue can be altered. The provision in discussion here seems to suggest that such revision in the amount of capital to be raised is permissible under the guidelines.

In the case of listed companies the issuer may disclose the floor price or band one day before the issue and mention in the prospectus that newspapers, journals or websites where these announcements may be made and suggest the investors to follow the secondary market prices until then. The final prospectus containing the price and number of securities to be issued has to be filed with RoC, as per these guidelines.

In book built issues, apart from the standard disclosures in a regular issue, the following additional disclosures are also required to be made (i) Particulars of syndicate members, brokers, registrars, bankers to the issue (ii) accounting ratios which are the basis for arriving at the issue price (calculated after providing for likely dilution), namely, pre issue EPS for the last three years, P/E pre-issue, average return on networth in the past three years, net asset value per share based on last balance sheet, comparison of these ratios for the firm with that of industry peers and (iii) the proposed manner of allocation among respective categories of investors in the event of undersubscription in certain categories, where the undersubscribed amounts may be made available to excess interest in other categories.

Underwriting and Meeting Shortfalls

Shortfall to the issue in the case of an under-subscription has to be made good by the book runners. This commitment has to be incorporated in the inter se allocation of responsibility. Further, the entire issue in the case of the 100% book-building route and the 75% that is proposed to be book built in the alternate route have to be compulsorily underwritten by syndicate members and / or book runners. These are to be in the form of back to back agreements between syndicate members and book runners and book runners and issuers. Thus the ultimate responsibility for meeting devolvement obligations to the issuer rests with the book runner.

Bidding Procedure / Process

Bids shall be open for not less than three working days and not more than seven working days, extendable to ten working days in case of a revision in the price band as noted earlier. The bids have to be advertised, giving details of opening and closing dates, names and addresses of syndicate members as well as bidding terminals for accepting bids, method and process of bidding. Bidding is to be permitted only if an electronically linked transparent bidding facility is

available. At the minimum, bidding centers have to be available at all cities where SEs are located for 100% book building and in the case of 75% book built issues the minimum number of centers is the same as mandatory collection centers prescribed for fixed price issues. Bidding centers are bound by the norms governing collection centers. Bids are allowed only through brokers who will have the right to "vet" the bids. In case the securities are offered to the public through the online system of SEs, every broker who is approached by investors is bound to accept the order. Investors may revise their bids provided that QIBs are not allowed to withdraw their bids after the closure of bidding.

To ensure uniformity in bidding and accuracy, the standard bidding form is required to contain information about the investor, price and number of securities bid for. The bidding form is to be serially numbered at the bidding centers and date and time stamped either through a system or through an automatic numbering machine. The bid form is to be in duplicate, one each for the syndicate member and the investor, countersigned by both parties.

The resulting demand is to be shown graphically at the end of each day for the information of syndicate members as well as investors. SEBI requires the order book to be updated every hour. The consolidated order book is to be made available to the public by the stock exchanges concerned. In practice, merchant bankers express difficulty in maintaining hourly updates. Part of the difficulty arises from the dependence of the BRLM in getting the bids from the syndicate members, which also affects to some extent the accuracy of the order book as displayed by the stock exchange.

The identities of the QIBs are not to be disclosed however. The Lead Book Runner and the exchange which is conducting the bids are the only two agencies that have access to complete bid information at the level of the individual bids. Members of the syndicate who procure the applications have access to the details of the bid procured by them. The anonymity of bids has two possible advantages. One, it preserves the confidentiality of the bidders, a feature that is valued by bidders. It also limits the information cascade effect suggested noted in and Benveniste and Wilhelm [1997].

The allocation of shares to QIBs is at the discretion of the investment banker. In practice investment bankers seem to value earliness and quality as positive considerations and exaggeration of bids as the most serious negative characteristic. Investment bankers also try to bundle to investors issues that are in high demand as well as issues that are not hotly in demand. Regularity in participation in bids of various issues is an important attribute that is rewarded with allocation. The primary determinants of quality are the commitment of the QIB as demonstrated in terms of the exposure to India and their likelihood of holding to the investment for the long term. "Flippers" and institutions such as hedge funds who are likely to book early or quick profits are thus low in the allocation priority.

In the case where 25% of the issue is to be allotted at the price arrived at using the book building route, is to open within fifteen days from the closure of bidding and the offer for subscription shall remain open for at least three working days. Prior to the opening, material has to be dispatched for application and the necessary advertisements have to be issued. Those investors who receive intimation of their entitlement under the book built portion while the retail portion of the issue is open may also apply. Other retail individual investors who have not bid in the book building and / or those who have not received intimation of entitlement may also apply when the retail portion is open.

⁴²⁰ The guidelines require that both in the 100% as well as 75% book built issues not more than 50% of the offer be allotted to QIBs. In the former case, from the remaining 50% not less than 35% be allotted to retail individual investors and not less than 15% to non institutional investors. In the 75% book built issue, 25% out of the 75% is to be allotted to non institutional investors, the remaining to QIBs and the 25% is to be allotted to retail individual investors at a price arrived at by the book building route. In the case of the alternate access criteria provided under Clause 2.2.2 and 2.3.2 of DIPG 2000, not less than 50% of the net offer to the public is to be mandatorily allotted to QIBs, in both 100% as well as 75% book built issues. Similarly, in issues where a mandatory minimum allotment of 60% of the net offer to the public is required under Rule 19(2)(b) of SCR Act, allotment to retail individual investors and non institutional investors will be 30% and 10% respectively. Mutual funds are allowed to be allotted up to 5%

The 75% book building route was never popular. The reasons for this are not clear. It is quite possible that its lack of popularity may be due to the fact that the idea of book building was ahead of its time when this framework was announced. Another possible reason cited by practitioners is that the issue was practically conducted in two stages, comprising a book built and a fixed price component. The key implication of this is that the issue technically does not close until the completion of the fixed price portion. The listing of the issue thus gets delayed, posing a risk arising from the illiquidity for institutional investors who cannot trade until commencement of listing.

5.4.5.1.2 100% book building Option

The 100% book building route is available in two formats: (i) 100% of the net offer to the public through the book building process and (ii) 75% of the net offer to the public through the book building process and the 25% at the price determined through the book built for the 75%. The book building portion excludes allotments to those who may broadly be viewed as insiders to the company. The guidelines further specify the categories of investors and the maximum percentage of firm allotment.

of the QIB quota on a proportionate basis as well as participate in the balance available for QIBs. [The allotment pattern as above has been illustrated in Schedule XIX A.] Allotment to all categories is to be on a proportionate basis. The proportionate basis of allotment has been discussed earlier and the format for the same has been provided in Schedule XVIII.] The provisions for dealing spillovers and undersubscriptions has been discussed earlier and the same shall be dealt with as has been indicated in the prospectus by the issuer, subject to the condition that the mandatory minimum of 50% of QIBs will not be affected, where required. The allotment is to be made on receipt of the minimum subscription amount and within fifteen days of the closure of the issue failing which interest at the rate of 15% will be paid to investors and refunds are due from the broker within three days of the receipt of the basis of allocation.

The model time frame is suggested in Schedule XXI.

The guidelines lay down the issue management process in great detail. The guidelines relating to this route of book building are quite elaborate and have evolved to a great degree. This is so presumably because of their popularity and the issues that emerged as issues were made under this framework.

5.4.5.1.2.1 Allotment / Allocation

The guidelines provide specific limits on the distribution of the public offering among various categories of investors. Broadly, the guidelines categorise investors into three categories, viz, (i) Qualified Institutional Buyers (QIBs), (ii) Retail individual investors, defined as those investors who apply for shares worth Rs 100,000 or less and (iii) Non-institutional investors comprising investors who apply for worth shares more than Rs 100,000 but who are not QIBs. These might typically include high networth individuals, other corporate investors or investment partnerships who do not qualify to be classified as QIB. These limits are intended to directly influence the distribution of post issue shareholding. The larger policy objective underlying the intended distribution is not stated anywhere. It is presumed that for political reasons the regulator may want to ensure a stake for the retail investor. Some of the other provisions are also intended to achieve this purpose. The most noteworthy of these requirements is that the limit on retail individual investors is a minimum as is the limit on non institutional investors. The allotment to QIBs would thus appear to be a residual allocation, subject to a maximum.

The 100% book building framework has been enormously popular. At the core of these regulations is a framework for managing the flow of information and a contractual framework that will help manage the bidding – subscription – allotment – payment process.

However, a good deal of information exchange takes place outside the issue management framework. The process of testing investor appetite for the offering is achieved through the pre-marketing meetings between the investment banker and prospective investors and during the marketing roadshows. During these interactions information interchange between the investment banker and the investor of the kind envisaged in the model developed by Lawrence Benveniste and Paul Spindt⁴²¹ takes place. The non revocability of bids must have been introduced presumably to discourage frivolous bidding as well as to ensure that non serious bids are not invited to create a false sense of investor interest in the issue.⁴²²

One of the ways in which the 100% book building route manages to preserve the informational integrity of the pricing process is by allowing the allotment and listing to take place quickly for all categories of investors.⁴²³

Long issue times, as were witnessed in the days of the fixed price issues, led to uncertainties in the market for the investor. These uncertainties arose from changes in market conditions and therefore prospects for the issue. Second, long issue times have also been seen to be enabling manipulative practices with activities such as the grey market. Third, a long lag between application for the shares and listing increases the investors' risk in terms of adverse movement in the price of the share due to changes in the market or due to firm or industry specific factors. Long lead times with uncertainty over

⁴²¹ Benveniste and Spindt (1989), supra note 264

⁴²² This explanation has been confirmed in the personal conversations between the author and Indian investment banking professionals.

⁴²³ Strictly speaking, reduction in issue time also requires development of other supporting infrastructure such as dematerialized trading. But the process of electronic bidding, speedy estimation of subscription interest and quick advice of allotment (using contemporary information technology) are perhaps the most important enablers for reduction in issue time.

allotment increase the cost of acquisition of shares at IPO for large institutional investors.

Practitioners that this researcher conferred with have questioned the practical utility of setting aside not less than 50% of the book built issue for non institutional investors and retail investors. They have expressed the view that reservation to retail individual investors have led to high issue management costs, given the large volume of transactions and small holdings that characterize this segment of investors.⁴²⁴ Further, they argue that investors in this category do not help much in the price discovery process since most of the time they bid at the cut off arrived at from the institutional segment. Non institutional investors seem to be an assorted group including such unlikely investor categories such as corporate treasurers who seem to work with the nearly firm belief that every IPO is a source of assured positive returns. While there are no empirical studies confirming this aspect, investment bankers that this researcher spoke to claim based on their own, as well as on the basis of unpublished studies, that the largest extent of "flipping" occurs among these categories of investors.⁴²⁵

Interestingly, by requiring that not less than 50% of the net offer to the public be mandatorily offered to QIBs as an alternate market access criterion in the case of companies that do not meet the track record or other criteria of merit under the guidelines, the provisions apparently

⁴²⁴ Most of the retail applications crowd in as the issue is about to close since retail investors wait to observe the extent of excess subscription so that they can adjust the size of their bid to improve their prospects of receiving an allotment as well as estimate the returns they are likely to earn on the investment in the IPO (most applications in this category are considered to be highly leveraged and so the return on the investment can be sensitive to the extent of over-subscription and proportion of allotment and from the cost of borrowed funds; thus the quality of the return estimates can improve closer to the book closure as the extent of oversubscription becomes clearer).

⁴²⁵ The investment bankers cite these and other reasons for challenging the wisdom behind the special privilege to non institutional and retail investors.

recognize the certification and / or the governance role that these investors may play in such companies. By subscribing to IPOs at the "cut off" price arrived at largely (if not entirely) on the basis of bids from QIBs non institutional investors (both retail as well as non-retail) essentially enjoy a free ride. Although this is a claim that has not been substantiated empirically in the Indian context, this tendency squares with the public good character of securities prices that has been noted by Sanford Grossman and Joseph Stiglitz.⁴²⁶ The recent scams in the IPO market, where a large part of the allotment to retail individual investors was allegedly cornered by a set of market operators, also casts a question mark over the welfare benefits realized from these reservations.⁴²⁷ At the minimum there appears to be a case for re-examining the allotment to non-retail, non-institutional investors, assuming that the retail investor is a political holy cow in Indian securities regulation.

The book-building guidelines provide a model timeframe.

5.5 Roles and regulation of intermediaries

The general approach to the regulation of intermediaries has been by way of a mandatory registration and licensing requirement.⁴²⁸ If an

⁴²⁶Sanford J.Grossman and Joseph E. Stiglitz, "On the Impossibility of Informationally Efficient Markets." 70 American Economic Review 393-408 (1980).

⁴²⁷These scams were widely reported in the press and seem to have occurred in the case of a number of IPOs. For a coverage of some of the incidents see for eg., Raghuvir Srinivasan, "Lessons from Yes Bank IPO scam." The Hindu Businessline December 25, 2005 and Sebi now unearths IDFC IPO scam, The Chandigarh Tribune dated January 14, 2006 (Online edition). For a detailed exposition of the mechanics please see Rachna Monga, "The Anatomy of an IPO Scam", Businessworld 25, 40-46 (2006). (Issue dated April 17, 2006).

⁴²⁸SEBI has formulated rules and regulations governing the functioning of MBs, Registrars to Issue and Share Transfer Agent and Bankers to the Issue. The rules have been announced under S 29 of SEBI Act 1992 while the regulations have been formulated under S 30. The rules typically require registration, conditions for grant of certificate and period of validity of the certificate. The regulations spell out the procedure for application for certificate, grant of certificate, payment of fees, general obligations and responsibilities of the participant such as compliance with code of conduct, maintenance of books, their professional responsibilities and

intermediary does not comply with the applicable rules and regulations SEBI can impose a number of penal measures, including revocation of license. The licensing process requires certain fitness criteria such as capital adequacy in the case of merchant bankers and adequacy of infrastructure in the case of RTIs. The process of renewal enables SEBI to ensure that the intermediary concerned continues to meet the fitness criteria.

We examine the role of intermediaries along the following aspects, as participants in the issue process: (i) Their business as envisaged in the regulation (ii) The incentives for the various intermediaries to discharge their roles effectively (iii) Production of information prior to, during and after the issue process (iv) Validation and certification of information; and (v) Their role in ensuring the orderly functioning of the market for public offering and investor welfare and

In the process we examine whether and how the regulation of intermediaries fits into a web of regulatory connections that together constitute the regulation of market for public offering, as opposed to a single composite piece of regulation encompassing the entire issue process.

5.5.1 Roles and Responsibilities of Merchant Banker (MB)

One of the key figures in the public offering of securities is the merchant banker. The regulations define the MB as an intermediary engaged in various aspects of issue management and specify

roles, procedure for inspection, audit requirements, procedure for action in case of default, liability and so on. As noted in detail earlier, SEBI has formulated this combination of rules and regulations governing MBs (1993), RTIs and STAs (1993), Underwriters (1993), Debenture Trustees (1993), Stock Brokers and Sub-brokers (1992), Bankers to an Issue (1994), Mutual Funds (1996), Custodians of Securities (1996), Portfolio Managers (1993), Depositories and Participants (1996), Venture Capital Funds (1996). For the regulations issued in 1996 SEBI does not appear to have a separate set of rules as in the other cases.

qualifying criteria.^{429,430} The regulations provide for the registration of MBs, renewal of registrations and penalties in the event of non compliance.⁴³¹ Thus the regulations provide a comprehensive framework for determining the right to participate in the market on a continued basis as a well graded system of incentives (penalties), depending upon the level of infraction.

⁴²⁹ In order to ensure a minimum quality of participants, the MB is required to be a body corporate, other than a non banking finance company (NBFC) (as defined in S45IA of Reserve Bank of India Act, 1934) with minimum prescribed infrastructure and at least two professionals who have the experience and prescribed qualification to conduct MB business. Apart from the applicant being a "fit and proper" person, (as to who is a "fit and proper person" see SEBI (Criteria for Fit and Proper Person) Regulations 2004), the MB cannot be connected with persons who have already been refused registration by SEBI, or have partners or directors involved in litigations connected with the securities market or convicted of moral turpitude or found guilty of economic offences.

The MB also needs to meet the following minimum capital adequacy requirements. Minimum of Rs 1 crore for Category I, Rs 50 lakhs for Category II and Rs 25 lakhs for Category III MBs). This categorization was subsequently withdrawn in 1997.

⁴³⁰ Category I: Those authorised to act in the capacity of lead manager / co-manager / advisor or consultant to an issue, portfolio manager and underwriter to an issue as mandatorily required, subsequently modified allowing the MB to act as an underwriter even if MB is not a lead manager to the issue.

Category II: Those authorised to act in the capacity of co-manager / advisor or consultant to an issue or portfolio manager, and subsequently permitted to act as underwriters to an issue⁴³⁰; and

Category III: Those authorised to act only in the capacity of advisor or consultant to an issue.

The minimum network for these categories was fixed at Rs 1 crore, Rs 50 lakhs and Rs 20 lakhs respectively.

MBs were limited to outstanding underwriting exposures of five times their network at any point in time.⁴³⁰

⁴³¹ To ensure compliance with the various guidelines, defaults by MBs were divided into four types, namely, General Defaults, Minor Defaults, Major Defaults and Serious Defaults. Each of these categories of defaults was to carry a set of penalty points, ranging from one point for a general default to four for serious defaults. On reaching a maximum of eight penalty points the MB would attract action from SEBI under clause 4(m) of the guidelines and clause 12 of the terms of authorisation. Before awarding penalty points SEBI would provide a notice to the MB concerned of the proposed levy of penalty and allow the MB a time of fifteen days to provide an explanation as to why such action may not be taken against the MB. SEBI may award penalty points for each offence. There are four maximum permissible levels of penalty points. Upon reaching a limit, SEBI may impose a limit. SEBI has the further right to take action against MBs for serious non compliances such as carrying out business detrimental to public interests, conviction in economic offences, not meeting network criteria and so on. (Circular No MB / 2 / 91dated 18-3-1991)

However, this is sought to be achieved through regulating the conduct of a key intermediary, the merchant banker who is made an essential part of the issue management process by SEBI. One possible explanation for this approach is that SEBI did not have any regulatory control over issuers at the time of the drafting of the original DIPG. Issuers who are companies or other body corporates are governed by the Companies Act, 1956 or other relevant statutes governing their functioning (as for eg., in the case of banks or utility companies.) SEBI therefore may have thought of making the investment banker an integral part of the process and design a set of incentives for MBs to comply with the regulations.

As a market participant, the MB is governed by the SEBI (Merchant Bankers) Regulations, 1992 and SEBI (Merchant Bankers) Rules 1992.⁴³² The precise responsibilities are mentioned at various points in the DIPG 2000. Not surprisingly therefore many of the specific aspects of the role to be performed by the MB, mentioned in the DIPG, also appear in the circulars or instructions issued to the MBs under the regulations governing MBs.

Broadly speaking, the LMB's role may be seen as comprising three components, namely, production of information, certification and ensuring compliance.

The regulations place the responsibility for the issuer complying with the regulations almost entirely on the MB. To enable the MB to play that role the guidelines require that every issue of securities has to be

⁴³² Interestingly, many aspects of the issue process, apart from pricing and the types of securities, have been regulated by the Gol even prior to the creation of or the subsequent empowerment of SEBI. For eg., the practice of issuing advertisements claiming oversubscription of issues even prior to the closure of public issues was sought to be prohibited by Gol. Similarly issuer companies were required to ensure that refund orders and allotment letters were despatched only by registered post and that the refund order was marked account payee. These are two instances of the many facets that Gol tried to regulate.

lead managed by a Lead Merchant Banker (LMB). Further, every company is required to enter into a Memorandum of Understanding with the LMB before making a public or a rights offer of securities.^{433,434}

The regulations try to ensure that there are no conflicts of interest between the functioning of the various issue related intermediaries and the issuer. The issue cannot be lead managed for eg., by a merchant banker who is considered a promoter, associate or director of the issuer as defined in the regulations.⁴³⁵ Similarly, the LMB cannot be a registrar to an issue where it is handling post issue responsibilities. The interests of the LMBs and the issuer are further sought to be aligned by requiring the latter to accept underwriting commitments of Rs 25 lakhs or 5% of the issue, whichever is less.⁴³⁶ Another requirement is that the outstanding underwriting commitments of the LMB shall not however exceed twenty times its networth at any point in time.⁴³⁷

5.5.1.2 Incentives

⁴³³ Reg 5.3 of DIPG 2000

⁴³⁴ The minimum requirements of the MoU which is to lay down the mutual rights, liabilities and obligations of the LMB, has been spelt out in Schedule I to the DIPG. The schedule essentially binds the company to provide the information and extend the co-operation required for the LMB to discharge their responsibilities under the DIPG, including the conduct of due diligence. Other commercial terms of the issue management relationship may be added to the basic minimum draft required by SEBI. A copy of the MoU is to be submitted to SEBI along with the draft offer documents.

A code of conduct makes MBs accountable to issuers, investors and the markets at large. Responsibilities under the code of conduct include (i) That investors are provided with true and adequate information (ii) That adequate steps are taken for fair allotment of securities / refund of application money without delay (iii) That investor complaints are adequately dealt with. MBs are prohibited from creation of false market, price rigging, manipulation, passing on of price sensitive information or any action, which is unethical or unfair to investors.

⁴³⁵ Reg 5.4.1.1 of DIPG 2000. The exception to this is the case of merchant bankers holding securities as market makers for an OTCEI issue where the OTCEI requires the holding of some minimum inventory as part of the market making responsibility.

⁴³⁶ Reg 5.5.3. The clause is unclear as to whether this obligation is to be fulfilled jointly from all the LMBs or severally by all the individual LMBs.

⁴³⁷ Reg 5.5.4

Non-compliance could lead to award of penalty points in a graded fashion, depending upon the gravity of the breach, suspension⁴³⁸ or, even worse, cancellation⁴³⁹ of registration. In order to facilitate more effective supervision, those MBs that are not a bank or a financial institution are prohibited from carrying on business other than that in securities market after June 30, 1998. Thus the responsibility of the LMB stretches all the way to ensuring that the securities are offered, allotted and listed in compliance with the regulations.

5.5.1.3 Production and Certification of Information

Apart from verifying the contents of the offer document through a process of due diligence, the LMB has to issue certificates to SEBI about the accuracy of the disclosures as well as the incorporation of SEBI's comments on the draft.⁴⁴⁰ The LMB is sought to be made

⁴³⁸ in the case of violation of code of conduct, breach of capital adequacy, non-redressal of investor complaints, manipulation, price rigging and cornering of shares.

⁴³⁹ in the case of fraud or the MB being convicted for criminal offence or repeated default.

⁴⁴⁰ While the DIPG requires that all issuance of securities needs to be managed by a registered MB, the MB rules and regulations require the MB to issue a certificate verifying the contents of the prospectus and reasonableness of the views expressed therein to be submitted to SEBI at least two weeks prior to the opening of the issue for subscription. (as per Form C of the SEBI (Merchant Bankers) Regulation, 1992) Further, the LMB is also charged with the duty of ensuring that modifications or suggestions made by SEBI are incorporated in the draft prospectus or letter of offer. [Clause 5.3.3.2 (ia) of DIPG 2000]

The LMB is responsible for filing the draft offer document simultaneously with SEBI and the SEs where the securities are proposed to be listed. (Reg 2.1.1 and Reg 5.6.2 of DIPG 2000) The offer document filed with SEBI is to be made public for a period of 21 days from the date of filing and the MB is responsible for making the same available on various media such as the MB's website. At the end of the 21 day period the LMB has to report back to SEBI the complaints received on the prospectus and the manner in which the complaints were dealt with (Reg 5.8 of DIPG 2000).

The LMB is required to conduct "due diligence" to ensure the veracity and accuracy of the disclosures in the draft offer document and other necessary compliance (Reg 5.1 of DIPG 2000 and Reg 5.3.3 of DIPG 2000). The term "due diligence" itself has not been mentioned anywhere in the guidelines or in Indian Company Law. This "liability" of the merchant banker is expected to continue after the issue process is completed.

Apart from ensuring that the offer documents are in conformity with the DIP Guidelines, the LMB has to ensure that the format of the prospectus conforms to the format prescribed by the Department of Company Affairs, Ministry of Law Justice and Company Affairs. (Vide GSR 614(E), dated October 3, 1991 and Clause 3.1, RMB (GI Series) Circular No 2 (93-94) dated 26-5-1993. The Offer documents are to be made public on the internet. (SEBI (Primary Market Department) Press Release No 112/97 dated 9-10-1997). There are certain aspects of company law administration, compliance with which is sought to be enforced through MBs. For eg., MBs are required to ensure that issuers do not include statements regarding delayed listing of securities which are in contravention of S 73 of the Companies Act, 1956. Similarly

accountable for the certification of the information through a disclaimer in the offer document, which draws reference to the Due Diligence Certificate that the LMB provides to SEBI. The disclaimer also places a direct onus on the LMB for having verified the eligibility of the various intermediaries participating in the management of the issue.⁴⁴¹ The disclaimer has two aspects that are of legal significance. First, it absolves SEBI of any liability to the investor on account of the disclosures made in the offer document. Second, it establishes a liability on the LMB towards the investor for the accuracy of the disclosures. It remains to be seen though whether the liability thus established will be legally tenable.

The certification role is not limited to the information that is required to be disclosed but extends to ensuring that intermediaries such as registrars and share transfer agents, bankers to the issue, underwriters⁴⁴² and authorized collection agents (where necessary) have the license and the organisational and financial capacity as required under respective regulations to discharge their functions in the management of the issue.^{443,444}

The regulations expect the LMB to serve as the primary source of information on the progress and performance of an issue through mandatory periodic reports as well as updates during the intervening periods on important developments pertaining to the issue.⁴⁴⁵

the MB has to ensure that issuers have appointed qualified company secretaries before filing of documents with the RoC.⁴⁴⁰ [Letter dated 17-2-1993 from Department of Company Affairs to SEBI]. The LMB has to ensure that the underwriter has the financial capacity to discharge his financial obligation [Reg 5.5 of DIPG 2000] and to invoke agreements and obligations for mobilizing the devolved amount of the issue in the event of a default by the underwriter [Reg 5.5.1 of DIPG 2000]

⁴⁴¹ Clause 6.3.3 of DIPG 2000

⁴⁴² Reg 5.5 of DIPG 2000

⁴⁴³ Reg 5.10.1 and Reg 5.10.3 of DIPG 2000

⁴⁴⁴ Reg 5.4.3

⁴⁴⁵ RMB (GI Series) Circular No 3(1995-96) dated 26-7-1995

Once the issue process is underway, the LMB has to ensure that the offer documents and other issue related documents are dispatched to various SEs, brokers and other as agreed upon.⁴⁴⁶ There are also detailed instructions to the LMB relating to the number of copies of prospectus to be distributed and the date by which it has to be distributed and so on.⁴⁴⁷

Through the provisions above, the regulations impose on the MB the onus of the quality, extent and timing of disclosure. The certificate from the MB goes considerably beyond confirming compliance with the reporting format. It is expected to address the contents of the prospectus as well.

⁴⁴⁶ Reg 5.7.1 of DIPG 2000. It is presumed that the reference in the provision is to the agreement between the issuer and the LMB.

⁴⁴⁷ The LMB has to "ensure that wider, proper and equitable distribution of public issue material takes place." Often, clarifications from SEBI relating to the administration of the issue, such as that applications by separate schemes from mutual funds (under reservations for mutual funds) would be treated as distinct applications and not as multiple applications from the same fund, are routed through the LMB. (RMB (GI Series) Circular No 1 (94-95) dated 20-4-1994)

5.5.1.3 Issue Logistics

The responsibilities of the LMB in the post issue phase have been spelt out in great detail⁴⁴⁸ and cover practically all the facets of the post issue activity to ensure that the issue allotment process is conducted and completed in a fair, transparent and timely manner so as to maintain investor confidence in the market. In particular, this part of the guidelines lays considerable emphasis on investor servicing and the redressal of investor grievances.⁴⁴⁹ The guidelines prescribe the

⁴⁴⁸The LMB is generally responsible for the distribution of the material relating to the issue (in particular application form accompanied by abridged prospectus)(Reg 5.13 of DIPG 2000), ensuring that the issuer has entered into the necessary arrangements for dematerialisation of the securities and finally, obtaining an in-principle approval to list the securities within fifteen days of the filing of the draft offer document with the SEs. (Reg 7.7.7 of DIPG 2000)

As noted earlier, the LMB's role continues in the post issue phase as well. The LMB has to announce the closure of the issue at the earliest closing date only upon being sure of the issue having been fully subscribed, else the issue has to be kept open for the requisite number of days. The LMB is required to furnish a series of post issue monitoring reports (Reg 7.2 of DIPG 2000), co-ordinate with intermediaries such as registrars throughout the post-issue stage, depute its officials to monitor the flow of applications and funds (Reg 7.4.1 (i) of DIPG 2000), oversee the allotment and despatch of securities or refund order process without giving rise to investor grievances (Reg 7.3 of DIPG 2000) and report to SEBI instances of non-compliance, if any (Reg 7.4.1 (ii) of DIPG 2000), ensure that underwriters honour their commitments against devolvments, if any, within sixty days from the date of closure of the issue and report instances of failure to honour such commitments to SEBI. (Reg 7.4.1.2 (b) and (c) of DIPG 2000). The format for reporting such defaults has been provided in Schedule XVII of DIPG 2000). The LMB has to ensure that the issue proceeds are maintained in a separate account as per the requirements of the Companies Act (S 73(3) of Companies Act, 1956) and are released by the bank after listing permission has been obtained from all the SEs where the shares are supposed to be listed as per the offer document (Reg 7.4.1.3 of DIPG 2000) and secure release of 1% security deposit. The LMB has to ensure that the securities are allotted in a "fair and proper manner", in line with the relevant guidelines (Reg 7.6.1 of DIPG 2000) and that the despatch of certificates or refund orders (by registered post or certificate of posting as applicable (Reg 7.7.4 of DIPG 2000) or demat credit completed and allotment and listing documents are submitted to the SEs within two days of the finalisation of basis of allotment (Reg 7.7.1 of DIPG 2000), steps for commencement of listing and trading are completed within seven days of the finalisation of basis of allotment (Reg 7.7.2 of DIPG 2000) and ensure payment of interest in cases of delayed dispatch of allotment letters or securities (Reg 7.7.3 of DIPG 2000).

The LMB will further procure for SEBI a certificate from the company secretary of the issuer or chartered accountants that all the refund orders / security certificates for the previous issues were dispatched within the prescribed time and manner and that the securities were listed on the stock exchanges as specified in the offer documents. (Reg 5.3.4 of DIPG 2000)

⁴⁴⁹ For eg., the Rule 4(C) on conditions of grant / renewal of certificate of registration of merchant bankers requires MBs to take adequate steps for redressal of investor grievances within one month of receipt of the complaint. So also Reg 36 (iii) says that a MB who fails to resolve investors' complaints or give a satisfactory explanation to the Board in respect of the

minimum number of collection centres for issues and provide for authorized collection agents and their roles⁴⁵⁰. The LMB has to ensure that the dispatch of share certificates and / or refund orders, as the case may be, cancelled stock invests⁴⁵¹ and demat credit against allotted securities are all completed and allotment and listing documents submitted to the SEs within two working days of the finalisation of the basis of allotment.⁴⁵² Further, the LMB responsible for post issue obligations has to ensure that all steps for completion of necessary formalities for listing and commencement of trading at all SEs are taken within seven days of finalisation of basis of allotment⁴⁵³, for dispatch of refund orders, allotment letters, share certificates, as the case may be, as prescribed⁴⁵⁴ and for release of an advertisement within ten days of "completion of various activities".⁴⁵⁵ The responsibility of the post issue LMB continues till the activities identified above are completed.⁴⁵⁶

The LMB is also responsible for looking into the subscription levels and the enforcement of underwriting, where necessary. If the issue is to be closed before the earliest closing date, which in any case cannot be less than the minimum period required prescribed under the

same may face imposition of penalty or suspension of registration. Reg 25 of SEBI (Merchant Banker's) Regulations requires the LMB to continue to be associated with the issue till the subscribers have received the share or debentures certificates or the refunds, as the case may be. Reg 18(2) of the said guidelines requires that the rights, liabilities and obligations in the MoU between the issuer and the MB ought to cover the allotment and refund processes as well.

⁴⁵⁰ Reg 5.10 of DIPG 2000

⁴⁵¹ Since deleted vide SEBI Circular No SEBI/CFD/DIL/DIP/14/2005/25/1 dated January 25, 2005

⁴⁵² Reg 7.7.1 introduced vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000.

⁴⁵³ Reg 7.7.2 of DIPG 2000 introduced vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000.

⁴⁵⁴ Reg 7.7.4 prescribes the procedure

⁴⁵⁵ Reg 7.7.4 of DIPG 2000 prescribes the time limit and Reg 7.7.5 specifies details to be provided in the advertisement. The regulations do not specify what these "various activities" are. However, viewed in the context it may be presumed that these comprise allotment of securities, communication of the details of the same to the SEs, despatch of related documents to individual investors and completing formalities for listing of the securities on all the SEs where the securities are supposed to be listed.

⁴⁵⁶ Reg 7.7.7 of DIPG 2000

Companies Act, 1956,⁴⁵⁷ the LMB has to ensure that the issue has been fully subscribed before announcing closure. In case there is no information on the level of subscription, the issue has to be kept open for the "required number of days" to take care of the underwriters' interests and to avoid disputes about meeting devolvement obligations. In the event of a devolvement the LMB responsible for underwriting arrangements has to invoke the underwriting agreement,⁴⁵⁸ ensure that underwriters honour their commitments within sixty days from the date of closure of the issue and report to the Board details of failure on the part of underwriters to meet their devolvement obligations.⁴⁵⁹

The LMB has to ensure that a SEBI nominated public representative is associated with the process of the finalisation of allotment.⁴⁶⁰ The LMB is required to ensure that in each class of securities being offered to the public the minimum number of shares that will make the issue eligible for being listed⁴⁶¹ are offered to the public.⁴⁶²

5.5.2 Registrars to the Issue and Share Transfer Agents

5.5.2.1 Role of RTI

The regulations governing registrars to the issue (RTIs)⁴⁶³ define an RTI as a person appointed to (i) collect applications from investors in

⁴⁵⁷ Under Section 72(1)(a) of Companies Act, 1956

⁴⁵⁸ Reg 5.3.2.2 of DIPG 2000

⁴⁵⁹ Clause 7.4.1.2 of DIPG 2000. The format for the report has been provided in Schedule XVII of DIPG 2000.

⁴⁶⁰ A public representative is required in case of par issues if they are oversubscribed by more than five times and in the case of premium issues if there is an oversubscription of more than two times. (RMB (GI Series) Circular No 2 (94-95) dated 24-6-1994) modifying Clause E of (RMB (GI Series) Circular No 1 (92-93) dated 1-3-1993)

⁴⁶¹ Under Rule 19(2)(b) of SCR Rules, 1956

⁴⁶² RMB (GI Series) Circular No 7, (93-94), dated 20-1-1994

⁴⁶³ The SEBI (Registrars to and Issue and Share Transfer Agent) Regulations, 1998 and The SEBI (Registrars to and Issue and Share Transfer Agent) Rules, 1998

respect of an issue (ii) keep a proper record of applications and monies received from investors and paid to sellers of securities (iii) assisting the issuer in (a) determining the basis of allotment of securities (b) finalising list of persons entitled to allotment, and (c) processing and despatching allotment letters, refund orders or certificates and other related documents in respect of the same.⁴⁶⁴ Our discussion in this paper is largely confined to the role of the RTI since the STA's role relates largely to post issue trading in the secondary market.⁴⁶⁵

From the definition of the RTI it may be seen that the RTI plays an important part in the conduct of the issue proceedings. The failure of this intermediary may result in incorrect or delayed allotments, delayed receipt of refunds or even loss of funds in transit. All of these are important failures of the market, especially when there are large institutional investors deploying large sums of capital in the market. The RTI needs to have robust systems that can handle large volumes of applications, allotments and refund amounts from several locations across the world. RTIs can also collude with issuers and manage the allotment process in ways that benefit the issuer or LMB. The consequences of the failure of the RTI have been experienced recently in the Indian public offerings market.⁴⁶⁶ It is yet to be established

⁴⁶⁴ The regulations further divide RTIs into Category I RTIs which are required to maintain a minimum capital adequacy of Rs 6 lakhs while Category II RTIs which are required to maintain Rs 3 lakhs.

⁴⁶⁵ A Share Transfer Agent (STA) has been defined as (i) a person who on behalf of any body corporate, maintains the records of holders of securities issued by such body corporates and deals with all matters connected with the transfer and redemption of its securities; and (ii) department or division (by whatever name called) of a body corporate performing activities referred to in sub clause (i) above at any time the total number of securities exceed one lakh.

Technically speaking the STA's conduct can affect outcomes in the primary market. For eg., the transfer of shares in the after market could be delayed by the STA as a connivance in a mechanism of price rigging, which in turn could affect the integrity and public confidence in the primary markets. In a paper based trading system the STA could come up with a number of reasons, many of them technically tenable but invoked for delaying transfer. Situations like these require the regulation of the conduct of the STI. However, we confine our discussion to the RTI since the scope of this paper is limited to the issuance and listing of securities.

⁴⁶⁶ See the reference below to the recent scams in the Indian IPO market

whether these recent failures were systemic or on account of malfeasance on the part of the RTIs or other players or both.⁴⁶⁷ The important lesson that these failures brought out is the criticality of the RTI's role in maintaining the confidence of the investor in the integrity of the market as well as in pursuit of policy objectives by the regulator.

We discuss below the regulation governing RTIs.

5.5.2.2 Participation Rights and Incentives

Only registered RTIs are allowed to provide the service in the case of public issues.⁴⁶⁸ The RTI's relationship with the issuer is governed by a formal agreement, the minimum requirements of which have been spelt out in the model agreement.^{469,470}

RTIs must have the necessary infrastructure to ensure that the allotment is done in a fair, transparent and efficient manner. Barring marginal differences,⁴⁷¹ RTIs are subject to a set of incentives quite similar to that of MBs.

⁴⁶⁷ One version of the reasons for failure hold the RTIs and BTIs responsible. See for example the articles by Raghuvir Srinivasan and the report in the Tribune Chandigarh on the IPO scams, supra note 420.

⁴⁶⁸ Rule 3 of SEBI (Registrars to and Issue and Share Transfer Agent) Rules, 1993

⁴⁶⁹ Rule 4 (1)(b) of SEBI (Registrars to and Issue and Share Transfer Agent) Rules, 1993

⁴⁷⁰ The model agreement contains specific provisions that deal with records and documents to be maintained by the RTI and operational checks and balances. (Rule 4(1)(b) of SEBI (Registrars to Issue and Share Transfer Agent) Rules, 1998) identifies mandatory activities that cannot be outsourced (Para 4 of the Model Agreement between RTI and Issuer), a whole lot of operational details such as announcement of offices, retention of applications, documents till completion of allotment, maintenance of stationery and so on (Model Agreement between RTI and Issuer).

⁴⁷¹ RTIs/ STAs are subject to eligibility requirements and a code of conduct similar to that for MBs. Additionally, the code of conduct for RTIs also requires them not to engage in unfair competition which will be harmful to other RTIs or competitively disadvantage them. So also the definition of "associate" in the conflict of interest clause is more encompassing under these regulations than that in the case of MBs. An associate has been defined as an entity where (i) Direct / indirect control of not less than 10% of the voting power of one is held by the other (ii) He / any of his relative is a director of RTA / body corporate, as the case may be. Interestingly this definition is broader in its applicability and raises the question of why it ought to be so. Apart from non-compliance with registration conditions and relevant regulations, RTIs are also liable for contravention of SCR Act and SCR Rules. The specific provisions of the SCR Act and Rules that apply to the role of the RTI have not been spelt out.

The provisions regulate the operations of the RTI's business in a fairly detailed manner as well as lay down standards of codes of conduct. The requirement that prohibits "unfair competition" appears to reflect SEBI's concern that RTIs do not engage in methods that will deter pursuit of fair practices by the industry in order to garner business. Finally, the regulations tie the functioning of RTIs into the provisions of SCRA and SCRR. If monitored carefully, these regulations could impose significant overall costs of regulation.⁴⁷² Overall, the regulations seem to get into a fair bit of detail to ensure the orderly functioning of this class of intermediaries, thus providing an indirect indication of their importance to the market.⁴⁷³

5.5.2.3 Information related provisions

RTIs produce a considerable volume of information related to the subscription (level, types of applicants and so on). This information may be useful to applicants who wish to apply later. However, the regulations ensure that the RTI or the issuer do not misuse this information to convey wrong impressions about the investor response to the issue.

⁴⁷² While SEBI carries out periodic inspection of RTIs, as it does of various other market intermediaries, details of the duration of these visits, the cost of compliance enforcement and the costs of compliance are not available. From time to time SEBI has imposed penalties and / or passed strictures on these intermediaries. In an interesting co-incidence, after the first wave of punitive action, following the announcement of these guidelines, the increase in these activities appears to follow the unearthing of a scam, leading one to wonder whether they are examples of the proverbial locking of the stables after the horses have fled. SEBI's annual reports provide a brief discussion on these inspection visits and punitive action.

⁴⁷³ An alternate view of this level of regulation of RTIs may be simply to suggest that there is an unevenness in the regulatory strategy across various classes of intermediaries, either by design or regulatory oversight. The former may in turn be further attributed to the lobbying power of certain intermediaries and hence be viewed as an instance of regulatory capture. These are substantial issues and would need considerable research effort to arrive at tenable conclusions.

5.5.2.4 Ensuring market integrity

Allotment has to be in line with the offer in the prospectus and in line with statutory requirements, if any (such as the requirement relating to the minimum allotment to retail investors or the treatment of spillovers from one category of investor to other categories where there is excess demand or application).

5.5.3 Underwriters

5.5.3.1 Role of Underwriter

The DIPG defines "underwriting as an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of the body corporate or the public do not subscribe to the securities offered to them."⁴⁷⁴ As with other intermediaries, SEBI has introduced guidelines which govern the functioning of underwriters.⁴⁷⁵ The underwriter's subscription is to be the extent of a shortfall in subscription from public and incumbent shareholders, in return for a fee.⁴⁷⁶ Underwriting assumes particular importance because of the requirement that in case the issue does not achieve a minimum subscription⁴⁷⁷, including capital brought in by underwriters,⁴⁷⁸ the issuer is bound to return the entire application

⁴⁷⁴ Clause 1.2.1 (xxviii) of definitions of DIPG 2000

⁴⁷⁵ SEBI (Underwriters) Rules, 1993

⁴⁷⁶ The role of an underwriter in the American markets and other financial markets that follow the American model is similar to that of an investment banker in the Indian context. The underwriter in this system either (i) arranges to market the securities on a best efforts basis in which case he merely does the marketing of the securities with no underlying financial exposure risk or (ii) buys the securities being offered at a fixed price and face the risk of having to pay for the same in case he does not manage to distribute all of the same at the minimum agreed upon price, thus carrying a financial exposure risk.

⁴⁷⁷ S 69 of Companies Act, 1956

⁴⁷⁸ Reg 5.3.2.2. of DIPG 2000. The underwriter has to bring in the capital to the extent of his share of the devolvement within sixty days of from the date of the closure of the issue [Reg 7.4.1.2 (b) of DIPG 2000]

money. Thus underwriting can help avoid serious financial uncertainties for the company and the investors therein. However underwriting is optional.⁴⁷⁹

5.5.3.2 Participation rights and Incentives

The LMB has to ensure that only those intermediaries who are licensed by SEBI and certified stock brokers and MBs may participate in the underwriting of public issues.⁴⁸⁰ Underwriters are required to have a minimum capital of Rs 20 lakhs under the SEBI regulations⁴⁸¹ or such additional / higher capital adequacy requirements stipulated by the SE of which they are a member. Further, the total underwriting exposure cannot exceed twenty times the networth of the underwriter.⁴⁸² Finally, the LMB has to satisfy himself about the ability of the underwriters to discharge their underwriting obligations and incorporate a statement to that effect in the offer document.⁴⁸³ The LMB is required to inform SEBI of underwriting devolvement.⁴⁸⁴ Underwriters are subject to the same requirements as other intermediaries relating to unfair competitive practices, exaggerated claims, divulging privileged information and so on.

5.5.3.3. Information Production and Validation

Underwriting arrangements may be considered to signal the quality of the issue.

⁴⁷⁹ Reg 8.11.1

⁴⁸⁰ Rule 3 of SEBI (Underwriters) Rules, 1993

⁴⁸¹ Regulation 6(d) of SEBI (Underwriters) Regulations, 1993. Regulation 7 goes on to state that in the case of a broker acting as an underwriter the capital adequacy norms of the SE where the broker is registered would apply and in the case of an MB the norms applicable to a MB under Regulation 7 of SEBI's Merchant Banker Regulations 1992 would apply.

⁴⁸² Rule 7 of SEBI (Underwriters) Rules, 1993

⁴⁸³ Reg 5.5 of DIPG 2000

⁴⁸⁴ Reg 7.4.1.2 (c) of DIPG 2000. The format for reporting to SEBI is in Schedule XVII.

From the point of view of an issuer, having an issue underwritten may be seen as a decision to buy an insurance based on the issuer's assessment of the conditions in the primary market. The cost of a failure to meet the 90% minimum subscription requirement may be viewed as a significant enough deterrent against which the decision to buy underwriting services may be weighed. In a sense, except in the case of mandatory requirement of underwriting, the underwriting arrangement may be seen to reflect the issuer's concern about the issue meeting with adequate investor interest.

From the point of view of the investor an underwriting may be seen to serve two purposes. The underwriter has a natural incentive to market the issue, failing which he carries an exposure risk. It is not coincidental that in the Indian context, most of the time the underwriting facility is provided by brokers and sub-brokers who are otherwise engaged in marketing securities in public issues.

Underwriting ensures that the issue will not fail for want of subscription and hence the financial cost of applying to a failed issue is avoided. More importantly, the fee paid to the underwriter is not sizeable enough to encourage moral hazard type risk taking. In case the issue is of such poor quality as to be unable to be marketed, barring unforeseen adverse developments in the financial markets, the underwriter would not extend his support to the issue since he would end up holding an investment that may affect his financial interests adversely at least in terms of short run liquidity if not in terms of the long run value of his portfolio. In extending underwriting support the underwriter thus signals to the market the belief that the issue is likely to be fully subscribed.

5.5.3.4 Ensuring Market Integrity

The key to ensuring that the underwriter is indeed bound by these economic considerations is to ensure that the underwriter does fulfill his contractual obligations in the event of a devolvement, such that he faces the risk of a negative ex post pay off in case he does not exercise commercial judgment in choosing issues for underwriting public issues.⁴⁸⁵

The empirical issue here is whether in the past underwriters have signalled the quality of the issue, as suggested above. One of the possibilities is that in the past underwriters have not demonstrated much of a discriminating ability and have accepted even poor quality issues when the markets are receptive to all kinds of offerings, as it appears to have happened in the mid nineties. The value of underwriting in that case is questionable. The question assumes significance for deciding whether underwriting has to be optional, as it is now, or whether it has to be made mandatory as it used to be in the past.

The enforcement of underwriting obligations has been fraught with difficulties historically due to underwriters accepting commitments in excess of their network, in the absence of regulations relating thereto, and in the absence of regulatory deterrents against willful default. The current regulations purport to address these issues.

⁴⁸⁵ Underwriters may face devolvement exposures if they do not exercise adequate effort in marketing the issue. At an individual underwriter's level, under the current underwriting rules there is an incentive to free ride since if other underwriters market the issue the underwriter who does not work hard at selling the issue will also enjoy the benefit of the issue having been fully subscribed. The details of this problem are beyond the scope of this discussion however.

The relationship between the issuer and the underwriter is required to be governed by an underwriting agreement. The contractual essence of the underwriting agreement has been pointed out to be time and the law therefore stipulates the time within which the obligations are to be fulfilled. In case the obligations are not fulfilled within the stipulated time the issuer / underwriter as the case may be, stands discharged of the obligations under the agreement.^{486, 487}

The steps to be undertaken by the LMB while enforcing the underwriting agreement have been discussed earlier in this chapter.⁴⁸⁸

Presumably, given the exposure risk for the underwriter, the underwriter is given some protection against incorrect information provided by the issuer. Not only does the underwriter have the right to examine the draft prospectus prior to signing the agreement as mentioned earlier, he need not be bound by the underwriting contract in case subsequent to the signing of the underwriting contract, the issuer has made disclosures that SEBI deems "material and essential" to the contract of underwriting. Further, the underwriter has the option to terminate the agreement at any time prior to the opening of the issue under exceptional circumstances.⁴⁸⁹

⁴⁸⁶ Clause 15 of Model Agreement to be entered into between underwriter and issuer. Rule 4(b) of the SEBI (Underwriters) Rules 1993 and Reg 14 of SEBI (Underwriters) Regulations, 1993 require the underwriter to enter into an agreement with the issuer. The Model Agreement is available at Annex A of SEBI Operational Guidelines / Instructions with Model Underwriting Agreement for Registered Underwriters vide SEBI-RUW Circular No 1 (93-94) dated 19-11-1993.

⁴⁸⁷ Some key elements of time stipulated under company law are that (i) The issue has to open no later than three months from the date of the agreement unless agreed to be extended in writing by the underwriter (ii) The subscription list has to be open for minimum of ten calendar days, unless the issue has been fully subscribed in less than that stipulated period (iii) Copies of application form and prospectus have to be made available not less than twenty one days before the opening of the public issue (iv) The copy of the prospectus approved by SEBI, after study by underwriter to be filed with the RoC in not less than thirty days. (v) Obligations upon devolvement to be paid up within thirty days after receipt of communication from the issuer.

⁴⁸⁸ Refer discussion Issue Logistics in Section 5.5.1.3 of the thesis.

⁴⁸⁹ These have been specified as (i) any of the representations / statements made by the company to the underwriter and / or in the application forms, negotiations, correspondence, the prospectus or in the underwriting agreement are, or are found to be incorrect; (ii) complete

5.5.4 Banker to an Issue

Public offerings call for a funds transfer system that can move large amounts of funds to the issuer's bank account, in varying remittance sizes, from across far flung geographies covering a large number of investor locations, swiftly and cost effectively, without the risk of loss of funds in transit. Thus bankers are an essential part of the public issue process.

5.5.4.1 Role of BTI

As intermediaries in the public issue the banker to an issue (BTI) is also subject to SEBI regulations.⁴⁹⁰ The regulations define a BTI as a "scheduled bank"⁴⁹¹ carrying on any or all of the following activities:⁴⁹² (i) Acceptance of application and application monies (ii) Acceptance of allotment or call monies (iii) Refund of application monies (iv) Payment of dividend or interest warrants.

The banker's role commences from the time the issue opens till the allotment process is completed. The importance of the BTI's role is in terms of (i) reducing the financial cost of applying to an issue through speedy handling of application monies and refunds (ii) ensuring the safety and integrity of the process of handling funds relating to the issue, in the absence of which investors may be reluctant to apply to an issue (iii) a quasi fiduciary role in ensuring that the application funds

breakdown or dislocation of business in major financial markets or war or, insurrection, civil commotion or sustained financial, political or industrial emergency or disturbance affecting the major financial markets or cities of Calcutta, Bombay, Madras or Delhi.

⁴⁹⁰ SEBI (Bankers to an Issue) Rules, 1994

⁴⁹¹ Rule 2(g) of SEBI (Bankers to an Issue) Rules, 1994 and Second schedule of the Reserve Bank of India Act, 1934 (2 of 1934) Scheduled banks, as distinct from co-operative, regional rural banks and land development banks, are the regular commercial banks under Indian banking law.

⁴⁹² Rule 2(b) of SEBI (Bankers to an Issue) Rules, 1994

are dealt with as required by the regulations and are not misused by the issuer or other intermediaries and (iv) lastly in producing timely and quality information relating to subscription to the issue.

5.5.4.2 Participation Rights and Incentives

As a scheduled bank, the BTI is also subject to the regulatory oversight of the RBI. The BTI is subject to dual regulation but the principal responsibility appears to rest with the RBI.⁴⁹³ Non-compliance could potentially lead to the bank losing the opportunity to function as a BTI. It is not clear however that the same affect will its routine banking business. Again, the authority to launch investigative and penal procedures in the case of a BTI lies with the RBI and not with SEBI.

5.5.4.3 Information Production and Validation

This information produced by the BTI is an important input to investors as it helps them to assess the prospects for the issue based on the collective response of other investors as reflected in the level of subscription. While the RTI receives information on the applications it has to be validated by the actual receipt of application monies.

⁴⁹³ For eg., while SEBI has the right to inspect the books as in the case of other intermediaries, (Rule 18 of SEBI (Bankers to an Issue) Rules), 1994 in the case of a BTI, SEBI has to request RBI to undertake the actual inspection (Rule 17 of SEBI (Bankers to an Issue) Rules). Similarly, if a bank is disallowed from undertaking the role of BTI by RBI as part of a penal action, the BTI's certificate may be considered as suspended or cancelled as the case may be. (Proviso to Rule 15 of SEBI (Bankers to an Issue) Rules). During the course of the inspection the obligations of the BTI are to RBI, (Rule 20 of SEBI (Bankers to an Issue) Rules) which will then communicate its findings to SEBI. (Rule 21 of SEBI (Bankers to an Issue) Rules) SEBI may then take action against the banker on the basis of the RBI findings. Two implications that may be relevant flow from these provisions. One, the rules leave the timing and the execution of the inspection to RBI's control. It raises the question of whether RBI has the internal expertise to conduct the inspection, given the complexities of the issue management process. Secondly, the RBI's concern is with the BTI as a constituent of the banking system. As a supervisor of the BTI's functioning, RBI's response to a capital market crisis may not reflect SEBI's concern about the market.

5.5.4.4 Ensuring Orderly Functioning of the Market

The rules require the BTI to enter into an agreement **with the issuer**.⁴⁹⁴ The agreement is required to provide for service standards such as the number of banks centers for collecting application monies, time limit for forwarding the monies as well as the applications to the RTI and for a daily statement indicating the number of applications and the application monies received. Further, the rules specify records to be maintained by the BTI.⁴⁹⁵ The BTI is also bound by a code of conduct that is by and large akin to the code of conduct for other intermediaries.

5.5.5 Brokers and sub-brokers

Though the primary functions of the stock brokers and sub-brokers relate to the secondary market, they also in market to their clients securities in a public issue. For procuring orders they are paid a brokerage commission which cannot exceed 2.50% of the value of the applications sourced by them.⁴⁹⁶ Brokers are also allowed to underwrite public issues,⁴⁹⁷ an aspect that has been discussed separately. However, their main business is executing trading orders in the secondary market, either on behalf of their customers or on their own account. The regulations governing brokers address mainly these activities, which we do not discuss in this paper. This aspect of the broker's role is governed by SEBI directly as well as the SE on which the brokers conduct their business.

⁴⁹⁴ Rule 14 (1) of SEBI (Bankers to an Issue) Rules, 1994

⁴⁹⁵ Rule 12 of SEBI (Bankers to an Issue) Rules, 1994

⁴⁹⁶ S 77(1) which commission is payable in an issue of securities (5% in the case of shares and 2.50% in the case of debentures). S 77(3) provides that nothing in S 77 shall affect the power of a company to pay such brokerage as it has heretofore been lawful for a company to pay.

⁴⁹⁷ In respect of which S 77 (1) would apply

5.6 Provisions of Company Law

In this section we survey the aspects of the process of issuance of securities that the Companies Act, 1956 seeks to govern most directly.⁴⁹⁸ We have noted earlier the position of the Companies Act on what constitutes a public offering of shares.

5.6.1 Access related provisions

While the law defines two kinds of share capital⁴⁹⁹ and limits the types of share capital that may be issued and the rights attached thereto,⁵⁰⁰ and the process of application and allotment of shares,⁵⁰¹ it does not specifically provide for the conditions under which and the manner in which a company may issue securities. A circulation of an offer of securities to more than fifty persons is deemed to be a public offer.⁵⁰² Thus the law casts a wide net to cover issuance of securities under the ambit of public offer.

5.6.2 Disclosure related

The contractual terms of the relationship between the various security holders inter se and between the management of the company and the other investors in the company are governed by the charter documents

⁴⁹⁸There might be a much larger set of provisions that affect issuance of securities in some way or the other. For eg., one of the key elements of securities regulation is disclosure of financial information. The company law governs the presentation of financial information by body corporates, both in terms of form and content.(S 211 of Companies Act, 1956 and Schedule VI). In this discussion, we have limited ourselves to those provisions that directly impact the process of issuance and those provisions that are primarily intended to govern the issuance of securities.

⁴⁹⁹ S 85 of Companies Act, 1956

⁵⁰⁰ S 86 of Companies Act, 1956 as amended by Amendment Act 2000

⁵⁰¹ Ss 69 to 75 of Companies Act, 1956 generally

⁵⁰² Proviso to S 67(3) of Companies Act, 1956 inserted by Amendment Act of 2000

of the company, namely the Memorandum of Association⁵⁰³ and Articles of Association of the company⁵⁰⁴ as well as the various provisions of the Act that deal with the governance of the company and the roles of the directors as well as other officers in charge of the management of the company.

The Companies Act however requires that “no one shall issue any form of application for shares in or debentures of a company, unless that form is accompanied by a memorandum containing the salient features of a prospectus, as may be prescribed, which complies with the provisions of this section.”⁵⁰⁵ By requiring that the terms of issue of securities by the company be captured in a prospectus and by regulating the issue of the prospectus, the company law regulates the process of issuance of securities. In the case of a private company which is converted into a public company or a public company that does not propose to make a public issue of securities or where the attempted public issue has failed, a statement in lieu of a prospectus may be filed with the Registrar.⁵⁰⁶

The law defines a prospectus as “any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in or debentures of a body corporate.”⁵⁰⁷ The law further provides for an abridged prospectus as a “memorandum that contains such salient features of a prospectus as may be prescribed.”⁵⁰⁸ This applies even in the case of an OFS, where the issuer would be subject to the same

⁵⁰³ S 12 and S 13 of Companies Act, 1956

⁵⁰⁴ S 26 of Companies Act, 1956

⁵⁰⁵ S 56(3) of Companies Act, 1956, amended by Amendment Act, 1988 w.e.f May 31, 1991

⁵⁰⁶ S 44 and S 70 of Companies Act, 1956

⁵⁰⁷ S 67(3) proviso 2(36) of Companies Act, 1956, amended by the Amendment Act of 1974

⁵⁰⁸ S 2(1) of Companies Act, 1956 inserted by the Amendment Act of 2000 w.e.f 13-12-2000

liability as in the case of a fresh issue of securities.⁵⁰⁹ The prospectus has been broadly defined to bring under its ambit any document intended to raise capital through issue of securities.

One of the items of information to be provided in the prospectus under law is the offer price. However, the pricing of securities issued by a company which does not have a trading history is a challenge in corporate finance. The information disclosed through the prospectus could be used to discover the price that investors are willing to pay for the securities on offer. The idea of a red herring prospectus has been introduced primarily for this purpose.

The red herring prospectus has all the information that a normal prospectus would have under law, except the offer price and the number of securities on offer. It has to be filed under Indian law at least three days before the opening of the issue. The law defines an information memorandum [IM] as a "process"⁵¹⁰ undertaken prior to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited and the price and terms of issue for such securities is assessed, by means of a notice, circular or advertisement."⁵¹¹ The IM and the red herring prospectus carry the same obligations as a regular prospectus.

The disclosure requirements relating to annual accounts and balance sheet,⁵¹² the provisions relating to the form and contents thereof⁵¹³ and the provisos relating to the dissemination of the same,⁵¹⁴ are important from a disclosure perspective, since they form the basis on which the

⁵⁰⁹ S 64(1) of Companies Act 1956

⁵¹⁰ The use of the term process appears to be a semantic inaccuracy. The reference in the definition is to a document.

⁵¹¹ S 2(19B) of Companies Act, 1956 inserted by the Amendment Act of 2000 w.e.f 13-12-2000

⁵¹² S 210 of Companies Act, 1956

⁵¹³ Ss 211, 212, 215, 216, 217

⁵¹⁴ Ss 218-220

historical information presented in the offer documents are prepared. We have noted earlier that in the case of partnerships that convert into companies before making a public issue as well as in the case of spin offs from companies the accounts for the period prior to the issue have to be as prescribed under the Companies Act while ensuring compliance with the access criteria. Authentication of annual accounts is provided for in the case of all body corporates.⁵¹⁵

5.6.3 Alignment of Interests between Shareholders and Managers

The law has extensive provisions relating to the governance of the corporation as well as the relationship between the shareholder and the management, which are beyond the scope of this paper.

Specifically in the case of listed companies, two recent developments are noteworthy. These are the developments relating to Clause 41 of the listing agreement relating to continuing disclosures and the developments relating to Clause 49, which deal with the corporate governance requirements. Companies that make a public offering are bound by these requirements. Hence we consider them relevant to the regulation of public offerings of shares and convertible instruments. A separate discussion on these aspects follows later.

5.6.4 Issue Process

The Companies Act does not specifically provide for intermediaries such as MBs, registrars or bankers to the issue. It appears that the mandating and the functioning of these have been left to SEBI, given that these are entities associated with the securities market and they are not an essential feature of the functioning of the corporate sector or

⁵¹⁵ Ss 224 to 233B

corporate form of organisations.⁵¹⁶ The law lays down the requirements to be followed in the allotment of shares,⁵¹⁷ issuing calls on share capital,⁵¹⁸ and provisions for issuing shares at a discount to face value.⁵¹⁹ The law⁵²⁰ provides for payment of underwriting commission, subject to a ceiling, although it does not define underwriting anywhere.⁵²¹ The law also provides for appointment of brokers.

The provisions of the law relate to the basic relationship between the company and its shareholders and the rights of the shareholder or debenture-holder or creditor against the company. Although the Act was conceived in the background of owner managers promoting companies, it focuses mainly on rudimentary information and other governance rights of the providers of capital against the company and the duties and responsibilities of the directors towards the shareholders as custodians of their (shareholders') interests. These laws have been built on the foundations of the Indian Contract Act, 1872. A large body of case laws and transactions involving several thousands of corporations across several decades has made the law robust in this regard. It needs to be augmented in many areas to address the effects of information asymmetry and agency conflicts that have been discussed earlier. SEBI's regulations fulfill this need to augment the company law insofar as listed companies are concerned.

⁵¹⁶ To the extent they are corporates their formation and governance are subject to the provisions of the Companies Act except specialized agencies like banks and development financial institutions.

⁵¹⁷ S 69 to S 75 of the Companies Act, 1956

⁵¹⁸ Ss 91 and 92 of Companies Act, 1956

⁵¹⁹ S 79 of Companies Act, 1956

⁵²⁰ S 76(3) of Companies Act, 1956

⁵²¹ However, court decisions have ruled that an "underwriter agrees to take those shares that have not been taken by the public (Lord Tomlin in *Australian Investment Trust Ltd v Strand and Pitt Street Properties Ltd* and that an underwriting may be allotted shares directly without waiting for further application cited in Avtar Singh, *Company Law*, Eastern Book Company, Lucknow, (2001).

In the case of unlisted companies, investors resort to private contracting.

5.7 Provisions of the SCR Act, 1956, SCR Rules, 1957 and Listing Agreement

The provisions of the SCRA and SCRR act in a direct and indirect way. Provisions that act directly are those provisions in the SCRA and SCRR that govern the issuance and listing processes and post-listing conduct of the issuer. Indirect influence is achieved through the listing agreement. A substantial part of the relationship between the issuer and the SE, prior to listing, during the process of listing and post listing conduct are all governed through the listing agreement. We noted in Chapter III that SEBI has the authority to influence the provisions of the listing agreement and that SEBI has already required the SEs to follow a standard listing agreement which has the minimum provisions that it considers essential.

5.7.1 Provisions of SCR Act, 1956 and SCR Rules, 1957

5.7.1.1 Access Related Provisions

The preamble to the SCR Act, 1956⁵²² defines it as an “Act to prevent undesirable transactions in securities by regulating the business of dealing therein”. Only those securities included in the definition in the SCRA may be traded on a stock exchange.

⁵²² The Act has been amended in 1995, 1999 and 2001. The reference here is to the act as amended.

In an earlier related work⁵²³ this researcher notes that the SCR Act and the Rules are one of the important levers by which SEBI regulates stock exchanges. Of these, issuance of securities is governed through (i) the restriction on the types of securities that may be traded on the stock exchanges and (ii) the authority to accord (or deny) permission to list and trade securities on a stock exchange. We have noted in Chapter III that the SCRA allows SEs to make bye laws which govern, *inter alia*, the listing of securities and further provides that the companies listed on a SE shall be governed by the conditions of the listing agreement with that exchange.⁵²⁴ SCRA also provides for appeal by a company to the Securities Appellate Tribunal (SAT)⁵²⁵ against the decision of a SE to refuse listing permission.

The SE may stipulate such other terms and conditions, as it may deem appropriate for listing. In addition the company has to satisfy the exchange that the articles of association of the company allow for transfer of shares.⁵²⁶ The company accepts as a condition precedent several obligations relating to share register administration and share transfer related obligations.⁵²⁷

5.7.1.2 Disclosure related

The SCR Rules, 1957 (SCRR) deal with the operationalisation of the provisions of the SCRA. From the point of view of a public offering of securities the SCRR specifies the procedure and the documents that have to be submitted alongwith the application form by a company seeking listing on a stock exchange. These documents / information

⁵²³ G.Sabarinathan, "Securities and Exchange Board of India and the Indian Capital Markets - A Survey of the Regulatory Provisions", Working Paper No 228, Indian Institute of Management Bangalore, 2003.

⁵²⁴ S 9(m) of SCR Act, 1956

⁵²⁵ S 22A of SCR Act, 1956

⁵²⁶ Rule 19(2) of SCR Rules, 1957

⁵²⁷ Rule 19(3) (a) of SCR Rules, 1957 and various sub-clauses thereof

go beyond the requirements of the prospectus under the Companies Act and the DIPG, presumably intended to help the SE decide on the suitability of the shares for listing.⁵²⁸

Further, it accepts an obligation to the SE to provide on-going information on a range of business and capital structure issues and corporate actions such as dividends⁵²⁹ and comply with any additional requirements that the SE may impose.^{530 531}

5.7.1.3 Distribution related

The most important of the rules perhaps relates to the minimum extent of dilution for a company to qualify for listing. A company is normally required to offer at least 25% of each class of securities to be issued to the public to qualify for listing.⁵³² However, this may be reduced to 10%, subject to certain conditions.⁵³³ These provisions originally were intended to pursue the government's distributional objectives. However, as we note in Chapters IV and V, issuers can use the allotment mechanism to signal their commitment to good governance by being monitored by institutional shareholders.

5.7.1.4 Incentives

⁵²⁸ Rule 19 of SCR Rules, 1957

⁵²⁹ Rule 19(3)(f) to Rule 19(3)(o) of SCR Rules, 1957

⁵³⁰ Rule 19(3)(t) of SCR Rules, 1957.

⁵³¹ Most interestingly, SEBI retains the right to waive or relax the requirement relating to these listing rules, indicating the sweeping over-riding powers that SEBI has in the administration of the listing rules, which it exercised for eg., in waiving infrastructure companies from these requirements. [Rule 19(7) of SCR Rules, 1957]

⁵³² Rule 19(2)(b) of SCR Rules, 1957

⁵³³ The conditions are that (i) a minimum of 20 lakh securities are to be offered to the public, excluding reservations, firm allotments and promoters' contribution (ii) the value of securities on offer at the offer price is not less than Rs 100 crores and (iii) the issue was made through the book building route with 60% of the issue being allotted to QIBs as required by SEBI. Any subscription to a list of development financial institutions and investment institutions identified in the explanation to Rule 19(2)(b) will not be considered as part of the 10% or 25% minimum above, as the case may be.

The SE may suspend or withdraw admission to dealings in the securities of a company either for breach or non-compliance with any of the conditions of admission to dealings or for any other reason.⁵³⁴ The company is entitled to a show cause notice in writing⁵³⁵ and a further right to appeal to SAT if the suspension is for more than three months.⁵³⁶ The SE on its own or under order from SAT may restore the scrip to listing.⁵³⁷

5.7.2 Provisions of the standard listing agreement

The listing agreement between the issuer and the stock exchange is a private contract. However, listing agreements have been standardized to a considerable degree by SEBI.⁵³⁸ The bulk of the provisions relate to the on-going conduct of the company in terms of disclosures and investor servicing issues (such as allotment, transfer of shares, dividend payment and closure of books).⁵³⁹

5.7.2.1 Access Criteria

The provisions of the listing agreement that are of direct relevance to a public issue are those relating to the requirement that a listing application has to be accompanied by an acknowledgement card for the issue from SEBI and a certificate of compliance with the provisions of the DIPG from the LMB.⁵⁴⁰ Companies already listed agree not to

⁵³⁴ Rule 19(5) of SCR Rules, 1957

⁵³⁵ First proviso to Rule 19(5) of SCR Rules, 1957

⁵³⁶ Second proviso to Rule 19(5) of SCR Rules, 1957. The right to appeal to SAT is under Section 15K of SEBI Act, 1992

⁵³⁷ Rule 19(6) of SCR Rules, 1957

⁵³⁸ S 3 of SCR Act, 1956 requires that the bye-laws require SEBI's approval whereas S 10 of the same Act provides that SEBI may amend the bye-laws of a SE, suo motu or at the request of the SE's governing Board.

⁵³⁹ These are important to the IPO process inasmuch as they impose a fixed cost to being listed on a SE and could therefore have a bearing on the decision making process. However, the focus of this paper is on the process of going public once the decision is made and the market access conditions to going public.

⁵⁴⁰ Clause 24 (d) of the Listing Agreement

issue any offer documents unless an acknowledgement card has been obtained from SEBI.⁵⁴¹ The other provision relates to the eligibility conditions for listing on various SEs, which have been left to the discretion of the SE.⁵⁴² Finally, the listing agreement lays down minimum conditions for share ownership distribution for continued listing of the shares on the SE.⁵⁴³ This condition essentially seeks to ensure that the shares are held among an adequately large number of shareholders, which in turn will contribute to the liquidity of the shares. This is understandable given that liquidity is one of the key concerns of the management of any SE.

5.7.2.2 Disclosure related

The disclosure related provisions mainly deal with continuing disclosures, post listing. The requirements at the time of application for listing build on those in the DIPG and the Companies Act, 1956 are paraphrased below.⁵⁴⁴

⁵⁴¹ Clause 24 (c) of Listing Agreement

⁵⁴² However as part of the approval process of bye-laws the eligibility conditions also require the approval of SEBI.

⁵⁴³ Clause 40A of the Listing Agreement. If the company does not maintain the minimum required of 10% or 25% as the case may be at the time of listing the promoters will have to tender an open offer under the Takeover Regulations. The company will not be able to make a preferential offer or buy securities back in case the share ownership will drop below the minimum as a result of the same. These restrictions do not apply to companies that have been registered with the Board for Industrial and Financial Reconstruction under the Sick Industrial Companies Act.

⁵⁴⁴ Under Rule 24 of the standard listing agreement,

- a) The Issuer agrees to make true, fair and adequate disclosure in the offer documents/draft prospectus/letter of offer in respect of any new or further issue of shares/ securities.
- b) The Issuer agrees that it shall not issue any prospectus/ offer document/ letter of offer for public subscription of any securities unless the said prospectus/ offer document/ letter
- c) of offer has been vetted by SEBI and an acknowledgement card obtained from SEBI through the lead manager.
- d) The Issuer further agrees that the Issuer shall submit to the exchange the following documents to enable it to admit/ list the said securities for dealing in NSE, such as -
- e) a copy of the acknowledgement card or letter indicating the observation on draft prospectus/ letter of offer/ offer documents by SEBI;and
- f) a certificate from a merchant banker acting as lead manager to the issue reporting positive compliance by the issuer of the guidelines on disclosure and investor protection issued by SEBI.

5.9 Conclusion

The survey views the public offering process as a complex sequence of events over an extended period of time. The decision to make an IPO is important from the point of view of the issuer company as well as that of the securities market and the industrial economy. It is therefore important to ensure that the market for IPOs remains vibrant and healthy.

This survey finds that a number of institutions have evolved to address the complex information and certification issues that arise during the course of the IPO process as well as to mitigate agency concerns and the risk of opportunistic behaviour by the issuer at various stages in the issue management and post allotment stages.

Regulations are necessary to ensure that the issuers as well as the various agencies associated with the issue do not cheat the investor. Given that the various agencies connected with an issue have to carry out the mandate of the issuer who pays for their services, investors need a mechanism that leaves more at stake than just the reputation of the participants involved. The regulatory framework provides those incentives.

The various intermediaries discussed in this survey are all important to the issue process. They will continue to remain important until the processes are changed dramatically either due to paradigm shifts in

g) in the event of non-submission of the documents as mentioned in sub-clause (d) above by the Issuer to the NSE or withdrawal of the acknowledgement card by SEBI at any time before grant of permission for listing/ admission to dealing of the securities, the securities shall not be eligible for listing/ dealing, as the case may be, and the company shall be liable to refund the subscription monies to the respective investors immediately.

regulation and / or due to changes in the technology of making public issues. Given this scenario, the regulations governing each of this category of players is important to the orderly functioning of the market for public offerings of securities, in particular that of equity shares and convertible instruments. In fact, an examination of the evolution of these regulations indicates that these regulations have attempted to address potential sources of failure in the market observed from the experience of offerings in the past.

Any study of the functioning of the market for public offerings in India will need to examine this tightly interlocked web of regulations.