Chapter VI

The Evolution of DIPG 1992 and DIPG 2000

The first DIPG announced in June 1992[545] was probably the first set of regulations announced by SEBI after the SEBI Act, 1992 was passed. The guidelines were issued in keeping with the powers of SEBI to make laws to regulate the capital markets.[546] The preamble to the guidelines state that these guidelines would apply to all issues to be made after the repealing of the CCI Act.

In the first phase the guidelines were revised through a series of twenty-seven circulars up to November 1999[547], when all the revisions were consolidated into a revised set of guidelines, now known as DIPG 2000. Many changes were also brought to the provisions as part of the consolidation. The consolidated guidelines have also continued to evolve through several amendments.

In Chapter V we critically examined the provisions of DIPG currently in vogue, applying the framework we developed in Chapter IV. In this chapter we trace the evolution of these provisions across time. The intention of this review is to identify important developments in the evolution of the guidelines. Identification of these regulatory landmarks is a prerequisite to an understanding of the impact that these regulations have had on market outcomes.

The review of regulations across time has been limited to those parts of the regulation that affect issuers. The current regulations discussed in the previous chapter review the regulations governing intermediaries

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[545] Issued vide GL/IP No. 1 / SEBI/PMD 92-93, dated June 11, 1992
[546] S 11 (1) of SEBI Act 1992
[547] The last of these, Circular No XXVII, was dated 26-11-1999

as well. However, in this chapter we do not trace the evolution of changes in those regulations regulating intermediaries so as to keep the research at tractable levels. A complete empirical investigation of the impact of regulation on market outcomes would need to take into account the evolution of the regulation of market intermediaries.

As in the case of current regulations, we limit our review to the regulation of public offerings of shares and convertibles issues. We do not review the provisions relating to the regulation of rights issues or issues of straight debt.

The review in this chapter also draws upon the framework developed in Chapter IV. As in the review of the current regulations in Chapter V, we classify the provisions for review under the following four heads.

- 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 needed 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.
- 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.

The following differences in the contents covered under each of these classifications are noteworthy though. We do not review the regulations governing the various intermediaries because they have been covered substantially in the previous chapter. We discuss provisions relating to pricing and price discovery as part of access criteria as initially they were an essential part of the mechanism to regulate the access to the capital market. We also highlight some of the additional devices resorted to align interests between owner managers and external shareholders. Finally, we review some of the mechanisms that seemed to have been intended to protect the interests of the external shareholder, especially the small or the retail shareholder.

The review is based on circulars of SEBI governing primary market activities. These have been taken from a number of published sources which have been included in the bibliography. A few circulars issued starting soon after the announcement of DIPG 1992 up to the consolidation of DIPG in 2000 and a few circulars after the consolidation in 2000 have been downloaded from the SEBI website. We review three versions of the post 2000 guidelines as they evolved as part of this survey. A more systematic documentation from SEBI would certainly help a more rigorous and complete survey. For eg., we are unable to track or comment on some of the changes in the regulations that have taken place between the regulations as they prevailed in 1999 and the consolidated version in 2000. We believe that SEBI can contribute to a better understanding of its activity of developing regulations by providing researchers easier access to documentation relating to its functioning which is already in the public domain.

We trace the evolution up to the point leading to the current state of the regulation.

The amendments or modifications to the guidelines include changes meant to rectify some of the drafting issues as well as substantive changes intended to address regulatory gaps and lacunae in the earlier versions. We focus on substantive changes and do not discuss announcements by way of drafting refinements or clarifications.

Finally, it must be pointed out that many aspects of the issue process that are sought to be regulated by these guidelines may already have been regulated, prior to the advent of SEBI, by administrative orders from the Dept of Stock Exchanges to the various SEs. Our survey of these provisions starts from the days of SEBI, given the overall objectives of this research endeavour.

Note :

1. All references to clarification numbers in the footnotes are to clarifications to DIPG 1992 and DIPG 2000 issued by SEBI, unless stated otherwise.
2. The analysis in this section uses the past tense while detailing various provisions. This is so because many, if not most, of these provisions have been modified or dropped altogether. Some of these provisions may remain in force as they were originally specified or modified. For the sake of consistency even those provisions that are still in force have been mentioned here in the past tense. The previous chapter discusses the provisions as they apply currently and hence the provisions there have stated in the present tense.
3. As in the previous chapter, details of provisions are part of the main discussion only to the extent necessary for providing a sense of the

drift in their evolution. Otherwise, details of provisions are provided in the footnote. Similarly, we have not reproduced or discussed numerical illustrations that are a part of the guidelines unless they are a part of the substantive aspect of the regulations.

4. References to Circulars are as they were provided in the sources from which the circulars were obtained. SEBI's convention for numbering circulars has varied over time. It is presumed that wherever we have relied upon references to circulars in other sources, the circular numbers provided in the respective sources are as they were in the original circulars from SEBI.

6.1 Access Criteria

The initial guidelines allowed all types of companies to issue securities in the public securities markets. SEBI was to vet the offer document in all the cases.[548] The requirement of vetting was withdrawn much later. Instead, the responsibility for ensuring adequacy and accuracy of disclosure appears to have been shifted to a Category I merchant banker who was mandatorily required for managing any public issue. The distinction between various types of companies appears to have been in terms of the price at which they were allowed to issue securities. Companies which wanted to issue equity shares or securities convertible into equity shares fell into two broad categories: (i) Those that could issue equity shares at par and / or securities that would convert into equity shares at par and (ii) those that could issue equity shares at a premium and / or securities that could convert into equity shares at a premium. This clarification did not apply to companies making a rights issue or an issue of debt instruments. We discuss these provisions relating to pricing separately.

However, it was not until October 1995[549] that the notion of eligibility for offering of securities for public subscription was introduced for the first time.[550] The notion of eligibility to make an offering of securities was extended to all companies across the board in 1996[551] through a fundamental change in the guidelines governing public issues. The

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[548] Clause A (a) of DIPG 1992
[549] [Clarification No XII dated 29-1995, w.e.f. 1-10-1995.]
[550] This was an eligibility criterion for finance companies which states that only those finance companies with a minimum track record of two years of operations or who have been granted registration as a non-banking finance company by the Reserve Bank Of India or as an intermediary by SEBI [Clause 2 of Clarification No XII dated 29-9-1995] or a housing finance company eligible for refinance by the National Housing Bank [Clause (c) of Part C of Clarification No XIV dated 17-4-1996] may make a public offering.
[551] Part A of Clarification No XV dated 17-4-1996

guidelines made a distinction between listed and unlisted companies in formulating the eligibility criteria.

6.1.1 Market Access Criteria for Unlisted Companies making IPOs

Pursuant to these amendments, unlisted companies making the first, issuance of equity or securities convertible into equity[552] was permitted only in the case of companies with a three year dividend record. Manufacturing companies were exempted from the requirement of dividend track record if their project had been appraised by a public financial institution (PFI)[553] or a commercial bank and the appraising agency had agreed to provide financial participation to the extent of 5%[554] (increased subsequently to 10%[555]) of the project cost by way of loan or equity financing. Thus the guidelines provided for a mechanism for the issuer to signal credibility by meeting the investment standards of a PFI.

The requirement of dividends was tightened further. The provision was subsequently extended to all companies, whether engaged in manufacturing or not.[556] Banking companies which were accorded approval by RBI on or before April 16, 1996 and public sector banks were exempted from these provisions.[557] Further, in the case of public sector banks, the requirement of track record for free pricing was reduced to two years.[558] Finally, pricing of shares by banks, both

[552] Clauses 1 and 2 of Part A of Clarification No XV dated 17-4-1996
[553] As notified under Section 4A of Companies Act, 1956, generally including state financial corporations, industrial development corporations and any such corporation approved for the purpose of S 36(1)(viii) of Income Tax Act, 1961 vide Clause (b) of Part A of Clarification No XVI dated 17-7-1996
[554] Vide Clause 2(b) of Clarification No XV dated 17-4-1996
[555] Clause (c) of Part A of Clarification No XVI dated 17-7-1996
[556] Vide Clause (a) of Part A of Clarification No XVI dated 17-7-1996
[557] [Clause (d) of Part A of Clarification No XVI dated 17-4-1997 vide RMB DIP Series Circular No 4 (96-97) dated 17-4-1997]
[558] Part B of Clarification No XVI dated 17-7-1996

public as well as private sector, was subject to approval from RBI.[559] As part of their oversight of banks the RBI regulates the capital structure of banks, their financial health in terms of capital adequacy and so on. The exemption of banks initially from the provisions governing pricing and the subsequent requirement of RBI approval may have been to avoid regulatory overlap and resultant confusion. Companies proposing to list on the OTCEI and offers for sale registered with OTCEI for a bought out deal were also exempt. [560] The OTCEI listing rules mandate the appointment of market maker in securities being brought into the market. The market maker, among other things, was required to maintain an inventory of the issuer's securities and offer two way quotes for the same. The exemption may have been in view of the availability of a market (liquidity) for those investors who wished to disinvest. This exemption may be viewed as an instance of rules of engagement of a SE being viewed as an alternative to a regulatory protection to investors. Not many companies chose to issue securities on the OTCEI. Thus we do not have the benefit of observing the market outcome of this exemption. However, it does raise the question of whether the regulations may have sought to build more effective institutional mechanisms based on the SEs rather than impose pricing restrictions on issuance activity, as it seems to have sought to initially.

In a further significant change to these guidelines[561], the following eligibility criteria replaced the criteria detailed above. [i] Track record of distributable profits in terms of S 205 of the Companies Act,1956 for at least three out of immediately preceding five years[562] and [ii] Pre issue

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[559] Part B of Clarification No XXII dated 5-6-1998 vide RMB (DIP Series) Circular No 1 (1998-99) dated 5-6-1998.
[560] [Part A of Clarification No XVIII dated 17-4-1997 vide RMB DIP Series Circular No 4 (96-97) dated 17-4-1997]
[561] Part A of Clarification No XXIV dated 18-5-1999
[562] Track record was defined later in detail as [i] three audited accounts comprising not less than 36 months [ii] in the case of companies engaged in more than one industry which claimed

networth of not less than Rs one crore in three out of the preceding five years, with the minimum networth being met during the immediately preceding two years. The circular announcing these changes attributed them to representations that unlisted companies desirous of accessing the public market may have chosen not to pay dividend so as to [i] plough profit back for the benefit of the company and [ii] that dividends would have benefited mainly the promoters who held most of the company's equity.[563] These requirements for unlisted companies were also to apply to those listed companies whose post issue networth would be in excess of five times the pre-issue networth.[564] This was consistent with the earlier treatment of issues from listed companies. (The revision referred to above referred to all issue of securities seeking to list on any stock exchange, whereas the provision that it sought to amend referred to IPOs. The said amendment did not deal with issuance of securities by a listed company, which was dealt with separately in the earlier circular [Circular No XV]. That must have created some ambiguity as to whether these amendments would apply to listed securities, in addition to the earlier provisions governing offerings of securities from listed companies. This was finally resolved only in the consolidated DIPG.)

It must be pointed out that after the changes introduced above, companies had to satisfy the access criteria to *even access the*

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to be information technology companies, track record was defined with respect to profits emanating from information technology business / activity and [iii] in the case of partnership firms and unlisted companies formed out of a division of an existing company the profits of the partnership firm or the division would qualify to be considered as track record if [a] the accounts were compliant with requirements and format of Schedule VI of the Indian Companies Act, 1956 and the standards laid down by the Institute of Chartered Accountants of India in respect of companies and [b] are certified by a Chartered Accountant to be compliant with Schedule VI and by a Merchant Banker to be compliant with the ICAI standards. [Part B of Clarification No XXVI dated 15-10-1999]

[563]Networth has been defined as value of paid up equity capital and free reserves (excluding reserves created out of revaluation) reduced by the aggregate value of accumulated losses intangible assets and deferred expenditure not written off, including miscellaneous expenses written off. (Clarification No XXIV in RMB (DIP Series) Circular No 1 (1999-2000) dated 18-5-1999)

[564] Proviso to Clause 2.3.1 of DIPG 2000 as of March 2000

market; but pricing was still subject to the regulatory conditions in force at that time. Pricing of securities was made truly market driven in 1999 when SEBI announced that an unlisted company eligible to make a public issue and desirous of getting its securities listed on a SE was free to price its equity shares or convertible securities, subject to compliance with disclosure norms.[565]

A subsequent modification added the requirement of net tangible assets.[566] The access criteria have remained at these requirements since then.

The guidelines had a provision that tried to prevent listed companies from misinforming investors about their involvement in the IT sector for raising capital on attractive valuations. [These provisions are discussed below.] Originally the provisions were applicable to listed companies. It is worth pointing out that around the time of this amendment companies in the IT sector had become popular as investment opportunities in the capital market, riding on the IT boom in India and elsewhere in the world and the demonstrated success of pioneering Indian IT firms such as Infosys Technologies Ltd., and Wipro Technologies Ltd. These provisions were now extended, albeit in a somewhat less rigorous form, to companies making an IPO.[567] [The period of name change was reduced to one year instead of three years as originally stipulated in the case of listed companies above.] So also the stipulation regarding expansion in the post issue equity capital was also extended to IPOs.[568] In order to reveal to the

[565] Part C of Clarification No XXV in RMB (DIP Series) Circular No 2, (1999-2000) dated 11-10-1999 w.e.f 11-10-1999
[566] Vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003. The requirement was that the issuer would have net tangible assets of Rs 3 crores at least in each of the three preceding full three years. Of this, 50% or more would be held as non monetary assets or as monetary assets with firm commitments to deploy the same in business or projects.
[567] Vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003
[568] Vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003

prospective investor the true extent of their involvement in the IT industry the DIPG was modified.[569] The modification required that companies which wanted to project themselves as technology companies derived not less than 50% of their business from information technology businesses. This requirement was modified into a more generic requirement[570] that companies which underwent a change of name had to derive at least 50% of the revenues from the businesses that their names suggested they were in. On the face of it, the revised requirement as of August 14, 2003 is less stringent than its predecessor. What motivated the change in regulation is difficult to comprehend. The occurrence of such companies re-labelling themselves as IT companies may have become fewer in number as the interest in the technology sector declined to more rational levels. Equally, the difficulty, if not the futility in administering the previous section must have been realized by the regulator, giving way to a requirement that was less difficult to monitor. (To start with, it must have been a daunting challenge to define what constituted an "information technology" business, given the ubiquitousness of the technology.) As with so many other instances, the question arises as to whether the regulator should arbitrate on an issue that is essentially for investors to decide. Or, should the regulator have merely stopped at requiring the issuer to disclose changes in activities and their financial implications,[571] thus equipping the investor with the information to decide for her / himself?

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[569] Track record in terms of distributable profits of the company were to be measured as profits from IT business or activities in the case of companies in "IT sector" or companies raising capital for IT sector businesses or companies whose names suggest that they are engaged in IT activities. The regulation also went on to define when companies might be considered to have names that suggested that they were engaged in "information technology activities / businesses" and an elaborate listing of what constituted "information technology". Vide Clause 2, Part B of Clarification No XXVI in RMB (DIP Series) Circular No 3, [1999-2000] dated 15-10-1999.

[570] Vide SEBI/CFD/DIL/DIP/Circular No 11 dated August 14, 2003

[571] Regulation 6.18.(iv)(e) requires disclosure of change in activities of the issuer which may have impacted the profit and loss of the issuer in the past five years and quantification of the same wherever possible.

Similarly, new entrants who were earlier constituted as partnership firms, as well as divisions spun off from companies, were allowed to access the public equity market as long as their accounts complied with the performance criteria for IPOs. The same modification also added the criterion of a minimum of a thousand prospective allottees.[572]

The currently available alternatives of institutional participation and compulsory market making were added to the alternate routes for making an IPO for a company that did not meet the criteria above.[573] For reasons that are not apparent the same modification also required that the allotment to QIBs in the alternative route of book building be 50%, instead of the original 60%. [For details see the previous chapter on Current Regulations.]

Companies making an IPO, like companies making any public or rights issue of securities were required to tie up 75% of the means of financing besides the funds proposed to be raised through the public offering.

The shift from the dividend to the profitability track record was a significant and laudable step in many ways. First of all, it is a good example of the responsiveness of SEBI to the concerns of the issuer community. Secondly, many profitable companies that wish to minimize dependence on outside capital would conserve their cash flows to plough back rather than pay it off as dividends. Those companies and their shareholders would have been unduly penalized by the criterion of dividend paying track record. Many companies in

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[572] Reg 2.2.2A of DIPG 2000
[573] Vide SEBI/CFD/DIL/DIP/Circular No 11 dated August 14, 2003

the IT industry that made their IPOs in the late nineties would not have been able to do so without this amendment.

6.1.2 Market Access Criteria for Listed Companies

Listed companies whose post issue networth expanded to more than five times their pre issue networth were required to meet the conditions prescribed for an unlisted company.[574] In a subsequent amendment listed companies whose post issue networth expanded as above were allowed to make book built issue with not less than 60% of the issue being allotted to Qualified Institutional Buyers [QIBs].[575] This option was further modified to bring the requirements in the case of listed companies whose post issue networth expanded as above in line with the requirements in the case of unlisted companies which did not meet the eligibility criteria for making a public issue.[576] The requirements in respect of listed companies have remained at that position until now.

If the listed company changed its name to reflect its activities in the information technology sector, during the three years prior to filing of offer document with SEBI, the information technology part of the business had to satisfy the criteria applicable to unlisted companies.[577] In effect, the regulations required that if the company wanted to enjoy the popularity of an IT company in the capital market it had to qualify for market access as it might have qualified, if it had been a free standing IT company.[578] This requirement was lightened up by limiting

[574] Proviso to Clause 2.3.1 of Consolidated DIPG as of March 2000
[575] Clause 2.3.2 of DIPG 2000 as of
[576] Clause 2.3.2 introduced vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003
[577] Clause 2 of Part B of Clarification No XXVI dated 15-10-1999
[578] To make this requirement even more effective, Part C of the clarification referred to above required that companies who claimed to be in the IT sector would have to recast their financial statements so as to disclose profits from the IT business activities.

the period of name change so as to attract these provisions to one year preceding date of filing the offer document.[579]

These requirements applied to listed companies if the equity capital after the proposed issue would be more than five times the paid up equity capital prior to the issue.[580] This was further tightened by making the pre issue and post issue networth as the reference point instead of the paid up equity capital.[581] The distinction may have been based on the consideration that there would be enough information and trading history in the public domain in the case of listed companies that the criteria used in the case of IPOs was not warranted. However, the regulators may have been aware of a tendency in the market place to merge unlisted companies with dormant listed companies to get around the restrictions on unlisted companies on pricing (in the initial regime) and on market access (in the revised regime). The provision above that treats issues from listed companies which experience a relatively large increase in equity base may have been an endeavour to plug this possibility.[582] However, the requirement regarding calculating the effective increase in the equity was further tightened to include all issues during the preceding year including the proposed issue [as opposed to the proposed issue that was the stipulation previously].[583]

The evolution of the provisions relating to issue of securities by listed companies appears to have gone through a great deal of avoidable

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579 Vide DIP (Compendium) Circular No 3 dated 4-8-2000

580 Clause 3 of Part A of Clarification No XV dated 17-4-1996

581 The change first appeared in the Consolidated Guidelines.

582 Typically such mergers take place to use the merged [listed] entity as a vehicle for raising a large amount of public capital. Most dormant companies may have relatively low paid up equity capital, having been listed at times when the minimum requirement of paid up equity capital for listing was relatively low. Thus when these merged companies went for a public offering they would experience a large increase in equity capital after the issue. The proposed provision would thus have been an effective deterrent against such a practice.

583 Vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003

confusion and back and forth. It is inconceivable that some of these changes were the result of oversight or poor drafting at the time of the initial announcements. An alternate explanation might be that SEBI was trying to fine tune the regulations in favour of listed companies. A more pragmatic and simple alternative may have been just to maintain that listed companies which sought to expand their equity through a large issuance of securities to the public be treated on par with IPOs. For example, the attempt to include all issues within a year for the purpose of reckoning of expansion in equity appears to be an instance of over-engineering. It would appear unlikely that a company might make more than issue of equity within a year given the cost of the process. Further, such a company would possibly not have an interesting enough investment proposition to offer for public subscription.

6.1.3 Listing without offering securities

Avenues for listing securities and accessing the public securities market were expanded when the guidelines allowed unlisted infrastructure companies to list their non convertible debenture securities [NCDS] by[584]. This option was later extended to all unlisted companies.[585] Being pure debt instruments the regulation of these issuances is not of interest to us, except to the extent that these are applicable to offerings of debt securities that are convertible into equity.[586] Further, the guidelines allow unlisted companies to make an

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[584] Reg 8.2 of DIPG 2000

[585] Vide RMB (Compendium) Series Circular No 3 (2001-2002) dated January 11, 2002. This circular replaced the original Reg 8.2 with a new Reg 8.2 that extended the option to non-infrastructure companies as well.

[586] These conditions are [i] The issue will carry a rating that is not below investment grade [two ratings in the case of issue sizes of Rs 100 crores or more] [ii] At least 20% of the project cost to be financed through equity funds from the promoter [iii] Continuing disclosures applicable as per listing agreement [iv] Changes in terms of issue, capital structure and shareholding pattern subject to prior approval by NCDS holders in a general meeting [f] No partly paid up shares / other securities at the time of filing draft document with SEBI

initial public offering of Debt Securities Convertible to Equity [DSCE].[587] Apart from the provisions mentioned in the case of NCDS, the issue of DSCE is subject to the following other conditions.[588] The additional conditions ensure that the listed status is not used to circumvent the criteria governing an IPO.

The provisions relating to an initial offer of debt securities appear to have been targeted at municipal corporations and other government agencies that would have needed to access the public securities market without getting their equity shares listed. These provisions were then extended to private corporations that had no plans to get their equities listed. The regulations contain adequate safeguards to ensure that these provisions are not used by companies to get around the requirements [589]for listing of equity or convertible securities or those provisions relating to the issuance of debt securities[590].

Interestingly, there have been no issuances of NCDS or DSCE under the provisions of these guidelines.

6.1.4 Denial of Market Access

Companies which had been prohibited from accessing the capital market by an order of SEBI were disallowed from making issues. This

[587] Reg 8.2.3 of DIPG 2000
[588] [i] Subsequent issue of equity or convertibles will be subject to complying with the conditions governing to IPOs. The provisions relating to outstanding warrants under Reg 2.6 of DIPG 2000 shall not be applicable if the floor price for conversion of these debt securities are determined and disclosed in the offer document [ii] Promoters' equity may be listed along with the listing of equity arising from conversion of the debt securities [iii] Promoters' equity may be listed if shares allotted to the public comply with 19(2)(b) of SCR Rules, 1957 [iv] Price band of 20% allowed for interest as well as share price; price / interest rate may be firmed at a later date before filing offer document with the RoC [v] Share price / interest rate may be determined using book building, subject to provisions of Chapter XI of DIPG 2000.
[589] Reg 2.2 of DIPG 2000
[590] Chapter X of DIPG 2000

specific denial of market access was introduced in 2000.[591] The denial remains in force even now.

6.2 Pricing

The guidelines categorised issuers into three types in terms of the price at which they may issue capital. First, new companies were those that had not completed twelve months of commercial operations and whose audited operating results were not available. They were allowed to issue capital only at par.[592] Secondly, existing unlisted companies which did not have a three year track record of consistent profitability were allowed to issue capital to the public also at par, subject to a minimum issue of 20% of the total expanded capital.[593] This requirement is puzzling considering that the minimum offer to the public required under Rule 19(2)(b) of SCRR at that time was 40% of the post issue equity capital. The SCRR requirement more than addressed the regulatory objective being pursued by SEBI. A third category of companies, namely listed as well as unlisted companies with a three year track record of profitability and companies which did not meet the track record criterion but 50% of whose equity was held by profitable companies as promoters were allowed to price their equity issues at a premium.[594] This category of companies was allowed to determine the price in consultation with the lead manager. Additionally, for new companies it was subject to "specific disclosures", including Net Asset Value [NAV] as per the latest balance sheet and justification for issue price. The pricing decision was thus handed over to the market, subject to conditions.[595]

[591] Clause 2.1.3 of DIPG 2000
[592] Clause A (a) of DIPG 1992
[593] Clause (C) of Sec B of Clarification II dated 16-7-1992
[594] Unlisted companies was clarified to include existing private companies, closely held companies and other existing unlisted companies going in for a public issue for the first time. [Clause (b) of Section B of Clarification No II dated 16-7-1992]
[595] [Clause (iv) of Section B of DIPG 1992.]

A few exemptions from these provisions restricting free pricing are mentioned below.[596] Rights issues were perhaps exempted because the scope for redistribution of wealth among different categories of shareholders due to a price advantage to one set of shareholders is limited.[597] The reason for exempting issues on the OTCEI may be the same considerations mentioned earlier under the discussion on access criteria, namely that the market making mechanism in OTCEI was

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[596] Rights issues by existing private companies as well as rights issues by listed companies without an option to renounce were exempted from these provisions. Further exemptions to these categorisations were made in the case of companies that sought listing on the OTCEI and (in October 1995) in the case of companies which would list on markets with screen based trading.

Pricing in accordance with the provisions of the OTCEI was also allowed in the case of issues that consisted of shares which had been bought by a sponsor and were being offered for sale by the sponsor. Additionally the sponsor had to be a market maker for three years, providing two-way quotes alongwith another market maker to be brought in by the sponsor. After the offer, the promoters of the company had to hold at least 25% of the total issued capital, which had to be locked in for a five-year period from the date of the sponsor taking up the shares. [Clause (c) of Section B of Clarification II dated 16-7-1992]

A new category of offerings was recognised in October 1995 from unlisted companies with less than two years of commercial operation and whose post issue capital would be between Rs 3 crores and Rs 5 crores. These offerings would qualify to list *only* on those SEs which had screen based trading facilities. The issuer was to appoint at least one market maker each on all the SEs where the securities were proposed to be listed, subject to certain minimum performance conditions to be met by the market maker. [Clarification No XII dated 29-9-1995, w.e.f. 1-10-1995.] Each market maker in this case was required to

- Offer a continuous two way quote for a minimum period of 18 months from the date on which the securities were admitted for listing
- Buy and sell quotes offered by the market maker were to be with a minimum depth of 3 marketable lots
- Bid-ask spread shall not at any time exceed 10%
- Minimum inventory of 5% of post issue capital to be maintained market maker as on date of allotment

Further, the issuer was to appoint an additional market maker for a period of twelve months from the date of allotment on the same performance terms as that for the main market maker.

The circular is silent on the pricing of these offerings. It would be reasonable to presume that the exemption offered earlier to issues on the OTCEI would apply to these issues as well.

Other than offer a marketing advantage to the monumental failure that the OTCEI was, this exemption did not appear to have any discernible rationale. The exemption was finally withdrawn in 2003, not having made any perceptible difference to the fortunes of the OTCEI.Vide SEBI/CFD/DIL/DIP/Circular No 11 dated August 14, 2003.

[597] To the extent that under-priced rights may be traded in the secondary market at a premium, an opportunity for an one time windfall gain for shareholders may be envisaged. But then that opportunity is available to all shareholders equitably and hence the need to regulate the same does not arise.

seen as a mitigant against many of the risks that investing in companies with a limited operating history was exposed to.

Many of the amendments to the regulation relating to this category attempted to fine tune the definitions of these criteria[598]. The guidelines provided for issuance of new financial instruments, subject to disclosures adequate for investors to arrive at investment decisions.

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[598]The category of companies included (i) Companies which were already listed and (ii) Unlisted companies with a three year track record of consistent profitability, clarified as two completed years of twelve months each and one of not less than six months (Clause B of Clarif I dated 17-6-1992) offering not less than 20% of the issued capital [Clause B (ii) of DIPG 1992 and Clause II (b) of Clarification No III dated 13-8-1992] (clarified as a record of profit after interest, depreciation and tax in three out of the most recent five years including the most recent two years [Clause (a) of Section B of Clarification No II dated 16-7-1992]. The profitability track record of a company, which was previously a partnership firm, had to be certified by a chartered accountant to be in line with the requirements of the Companies Act and that the accounting standards of the Institute of Chartered Accountants of India (ICAI) have been followed. Similar conditions were to apply to an issuer, which was previously a division of another company [Para 2 of Section B of Clarification VI dated 23-12-1992]. The track record of the division being spun out had to be certified through an auditors' certificate [Clarification No XIV dated 1-3-1996]. The LMB had to further confirm that the accounts were in accordance with the standards laid down by the ICAI. [As laid down in Schedule VI of Companies Act, 1956]. In the case of public sector banks the profitability record requirement was subsequently reduced to two years [Clarification No XVI dated 17-7-1996 w.e.f. 18-7-1996]; and,
New companies, [Section A of DIPG 1992] as well as existing companies which did not have a three year track record of consistent profitability [Clause C of Section B in Clarification I dated 17-6-1992] which were promoted by companies which have a profitability track record of five years (clarified later to be track record of consistent record of profit after interest, depreciation and tax in five out of most recent seven years, including profitability in two most recent years [Clause (c), Section A of Clarification No II dated 16-7-1992], applicable to each of the promoting private sector companies [Clause 2 b of Clarification II dated 16-7-1992] and not less than 50% of the equity is held by the promoters and the promoters' equity is priced at the same level as the public issue are allowed to freely price their issue of capital. However all issue price is to be uniform for all investors [Clause A of Clarification I dated 17-6-1992]. In case the additional contribution from the promoters is by way of FCDs / PCDs which are to be converted after eighteen months the equity has to be priced at par, irrespective of the terms of conversion of the debentures; if the conversion is to take place in less than eighteen months the promoters could convert at the same price at which the public subscribers are entitled to convert [Clause 2 (a) Section A of Clarification No II dated 17-6-1992]. If the maturity of the debentures was less than eighteen months and was not secured by a charge on the assets it was to comply with the Companies (Acceptance of Deposit) Rules, 1975. [This appears to be somewhat puzzling because promoters who converted later might have appeared to be able to acquire shares for a lower price (at par) as opposed to promoters who convert earlier. Thus to fulfill the 50% equity requirement promoters had an incentive to delay the conversion of the PCDs / FCDs. The three year track record was subsequently clarified to be two completed years of twelve months each and one year of not less than six months [Clause B of Clarification No. I dated 17-6-1992].

The list of eligible categories of issuers was expanded to include listed and unlisted companies, with and without foreign shareholding of 51% or more, wishing to expand foreign shareholding. This provision was later abused and the abuse had to be plugged through the provisions relating to private placement. Preferential allotments were thereafter limited to joint issues along with rights issues with a view to consolidating or increasing their stake in the company. The guidelines did not specify or define eligible categories of shareholders though.[599] Public offerings by way of offers for sale [OFS] were also permitted.[600]

Wherever the issuer was allowed to price the shares freely, the draft offer document was required to provide the net asset value of the shares. Additionally, a justification for the price in the case of issues by listed companies and companies which satisfied the performance track record conditions was also required. These prices could not be adjusted as an incentive to firm allottees through discounts, commissions or such other payments by the promoters or body corporates.[601]

Differential pricing was allowed in the case of a composites issue (a combination of rights issue and a public offering), between the rights shareholders and other investors who were offered as part of the public issue. This option was later clarified to be limited to listed companies[602]. Participation by the promoters in a public offering beyond the higher of 20% of post issue capital and 20% of the proposed issue would attract provisions of the pricing guidelines relating to preferential issues.[603]

[599] Clause 2.0 of Clarification No VIII dated 11-10-1993
[600] [Clause (d) of Section B of Clarification No II dated 16-7-1992]
[601] Part B Clarification No XV dated 17-4-1996
[602] Clause E, Clarification No V dated 4-11-1992
[603] 4.10.1 [c] of Consolidated DIPG 2000

Issuance of shares prior to the public issue at a price lower than the public issue was sought to be discouraged by requiring these shares to be locked in. The evolution of these provisions and their eventual withdrawal are discussed separately under provisions relating to lock-in.

The provisions relating to the pricing of securities remained remarkably stable since the important change in 1999 that introduced free pricing for all companies that qualified to make an offering of securities.

6.2.1 Observations on regulation of pricing

The evolution of regulations relating to pricing reflects a significant departure in the philosophy underlying regulation of IPOs. It would appear that SEBI initially seems to have been of the opinion that access to market might be controlled by regulating the price at which issues were made. Two arguments may be advanced in favour of this approach. One, the regulator may have believed that an issuer would be deterred from making a par issue if the issuer felt that it deserved a higher price. Secondly, in case the issuer did not meet the criteria, on average, the investing public would be compensated by the low offer price for the higher risk inherent in investing in such companies. The sheer number of issues that entered the market with par issues, including the number of companies that were not new but were "existing" companies[604] suggests that the requirement did not deter companies with on-going operations from making an issue. That fact by itself does not quite establish that companies accessed the market with par issues even if they believed their securities warranted a higher price. Although they were companies with some kind of an operating

[604] These classifications are as per the classification in the database of public issues available in the Annual Review of the Primary Market published by Prime. Please see Chapter VII for the analysis.

history their owners / owner-managers may have gone ahead with a par issue because they believed that par pricing was a fair pricing for the company's shares, given the business / financial prospects for the company. It does however suggest that there may have been in the group of existing companies a set of issuers who may have liked to charge a premium on their offer. On the issue of compensation by way of lower offer price there is no study currently available that suggests anything about the connection between the long run performance of companies and par versus premium pricing. The evidence from most of the research on IPOs in India which we reviewed in the previous chapter suggests that the extent of underpricing in the case of premium issues was significantly lower than that in the case of par issues.

A second possibility is that the regulator may have used the process of vetting offer documents to ensure that only issues that satisfied some minimum criteria of quality entered the market. To examine whether this process ensured that only issuers who satisfied some minimum criteria entered the market it would be necessary to examine (i) whether the vetting process weeded out poor quality issues, howsoever quality may have been defined; and / or (ii) whether the vetting process facilitated a better assessment of the quality of the issues on offer by ensuring better and greater levels of disclosure. A direct assessment of the contribution of the process of vetting to the improvement of the quality of issues, if any, would require information on the vetting process and its effect on the quality of issues. The data for this analysis is currently not available and examining that issue is thus beyond the scope of this thesis. (Also see the discussion on vetting of offer documents later in this section.)

Similarly, the rationale for the fine tuning of some of the criteria such as the exemption from the criteria for pricing those issues at a premium where the promoters were companies that satisfied the profitability track record and where they held at least 50% of the equity capital of the issuer company is questionable. The track record of profitability of the promoters would not in itself have been a sufficient indicator of the managerial capability of the promoter group since the guidelines do not stipulate any yardstick of profitability, leaving the ground open for marginally profitable promoting companies to take advantage of these guidelines. It was possible that even the nominal profit numbers were not from genuine business profits and were the result of creative accounting. Even more basically the track record was not required from the same industry. Thus it is difficult to accept that a track record of success in the textile industry would have been a predictor of success in running an automobile or software business. It was at best a better background to have than having no demonstrated record of successfully managing a business. The importance of relevance of background must have been evident from the number of examples of failed diversifications by companies or business families which had successfully run their core business, even at the time of writing these guidelines. Their 50% holding in the issuer company would have demonstrated a high level of financial stake for the promoter. Taken together, whether these criteria would have mitigated the risks of a start-up business in which the promoters may or may not have had a prior experience is a moot point. In other words, the objective of mitigating for the public investor the risks of investing in a start-up company, which would appear to have been the principal objective of these provisions, may not be considered to have been effectively accomplished these provisions. Another possible explanation for this exemption might be that when a profitable company starts a new enterprise it is possible to suggest that the new enterprise ought to have been a part of the promoting company itself. That way, the shareholders of the promoting company would have benefited from the wealth generated by the project. By spinning the same out into a new company the same is being shared with a new set of shareholders who were not part of the original enterprise. (We examined a similar argument while discussing preferential allotment to the shareholders of the promoting companies.) The deal would have thus become even more unfair to shareholders of the promoting company when the shares of the new enterprise were offered to the new shareholders, at a price which was quite likely lower than its intrinsic worth. This was quite likely if the shares of the new company had been offered at par. The provision would have thus addressed the concerns of the shareholders of promoting companies and not so much that of those subscribing to the public offering. It is possible to argue that this provision may even have provided an incentive to the shareholders of the promoting companies to behave opportunistically. Such an argument would run as follows. The shareholders of the promoting company, especially the owner managers who are insiders, are likely to have had a better idea of the true value of the shares of the new company. Given that knowledge, if the shares of the new company are worth more than the offer price they are bound to retain the project in the promoting company or companies, as the case may be. They are likely to offer the shares only if they are sure that the offer is overpriced, taking advantage of the information asymmetry. This argument assumes that the promoters would be able to finance the project in the new company without recourse to the public equity markets, which is not an unrealistic assumption, given the profitability of the promoting companies. This further assumes the public offer is not motivated by the other benefits of an IPO, mentioned in Chapter IV.

Having said that, given the emerging character of the Indian industrial economy and the rapid rate at which many industrial groups expanded their activities, the need for capital would well have been a legitimate motivation for many such issues. That does not take away the fact that as start-ups these businesses were riskier than established companies. The question of whether they deserved to raise share capital at a premium thus remains to be answered. Further, it would be interesting to know what kind of companies, if any, took advantage of this exemption and for what reasons? Did the regulation serve the intended purpose? These are empirical questions that are beyond the scope of this thesis.

6.3 Information and Disclosure Related Issues

We discuss provisions relating to information and disclosure under two broad heads, namely, (i) Processes relating to compliance with disclosure requirements and (ii) Details of Disclosure Requirements, per se.

6.3.1 Processes relating to disclosure

The guidelines required that SEBI would vet the draft prospectus in the case of IPOs by new as well as existing companies in order to "ensure adequacy of disclosures".[605] In the case of an existing listed company making a further public offering, i.e. an FPO, the guidelines require that the "draft prospectus or offer documents"[606] shall contain the net asset value of the company, a justification for the price of the issue and high

[605] Section A, Clause B (ii) and Clause C (c) (i) of DIPG 1992. The reference to ensure adequacy of disclosures is provided for only in Clause B (ii), but that appears to be more of a drafting issue since from a regulator's perspective the disclosure concerns relating to a new company cannot be different from that of an existing unlisted company.

[606] It must be mentioned that the term "offer document" had not been defined by SEBI in the DIPG or other rules and regulations relating to the primary market or public offerings. The Companies Act, 1956 did not have this term either.

and low price of the shares for the last two years.[607] The latter requirement was in addition to those of the Companies Act, 1956. Considering that listed companies were allowed to price their securities freely, this additional requirement of information was inadequate to justify the higher price. The subsequent enhancement in disclosure requirements is an acknowledgement of the need for higher levels of disclosure in the case of an FPO.

The guidelines did not specify what the scope of the vetting process was to be. Did the vetting examine issues of fact as well as compliance with the disclosure requirements? Or, was it to be confined to mere compliance with disclosure requirements? In the absence of disclosure standards laid down by SEBI it would be reasonable to presume that the requirements of the Companies Act[608] were the benchmarks against which the adequacy of disclosures may been verified. Finally, did SEBI have the right to stop a company from proceeding with a proposed issue if the vetting process indicated that the prospectus did not provide the requisite level of disclosure, howsoever that may have been defined? These are some of the more important questions that arise from a preliminary examination of the requirements of the DIPG with regard to disclosures.

The policy rationale behind vetting was mentioned in an indirect fashion by SEBI while proposing the withdrawal of vetting in the case of rights issues which were not accompanied by public issue within a period of three months before or after the issue. "Since a rights issue essentially affects the existing shareholders of a company unlike a public issue, it has been decided that as a first step that rights issues which are not accompanied by public issues three months prior or

[607] Clause C (c) of DIPG 1992
[608] Schedules I and II of the Companies A Schedules I and II Act, 1956

subsequent to the date of the rights issue will not be required to be vetted by SEBI."[609] It is not clear as to why the requirement of vetting should not have been withdrawn in the case of rights issues which had public issues proximate in time, given that the public issues would anyway have been subject to the disclosure requirements of a public offering and the occurrence of a public offering did not alter the fact that the rights issue was offered to the existing shareholders of the company. Leaving that puzzle aside, the statement seems to allude that when it came to offering of securities to a constituency of investors who were not already shareholders in the company, SEBI perceived the need to vet the offer documents.

The requirement of vetting of documents was withdrawn in a phased manner with removal of the same for rights issues in 1995[610] and in 1996 for any issue of securities by a corporate eligible to issue securities, or a company that was planning to make an issue on OTCEI.[611] It has been noted already that minimum eligibility conditions for companies to make a public issue of securities were introduced by SEBI in 1996. The requirement of an acknowledgement card was also correspondingly withdrawn.[612]

In the new regime SEBI would issue a set of observations on the draft offer document. The validity of the SEBI observation letter was for 365 days from the 22nd day of date of filing offer document with SEBI, subject however to the condition that the audited as well as unaudited

[609] Clarification No X dated 23-5-1995
[610] Clarification No X dated 23-5-1995 applicable to offer documents filed with SEBI after July 1, 1995
[611] Clarification No XVI dated 9-12-1996
[612] The requirement of vetting offer documents in the case of debt instruments was also withdrawn at the same time, but the same is not discussed in this note in detail. Clarification No XVII dated 9-12-1996

statements contained therein are not older than six months from the issue opening date.[613]

The removal of vetting coincided with the scam in the primary markets that was brought to light in 1995 with the aborted issue of MS Shoes, popularly known as the "MS Shoes scandal".[614] Did the unearthing of the scam establish the impossibility of the task of vetting prospectus is an interesting question.

Vide a subsequent clarification[615] SEBI required that the draft prospectus filed with SEBI be made a public document, "in order to introduce enhanced transparency". LMBs were required to simultaneously file copies of the draft document with the stock exchanges where the issue was proposed to be listed. The period for which the document was to be made public was prescribed as 21 days from the date of filing the same with SEBI. Simultaneously the amendment also specified the manner in which the documents were to be made available.[616] Such documents were to include the offer documents in the case of companies which had made earlier offers.[617]

6.3.2 Details of Information Disclosure

The guidelines did not formally define disclosures until 1993. It is not clear whether the regulations expected that the issuer would comply with the requirements of the Companies Act, 1956. However, the Companies Act has required all issue of capital to be preceded by a prospectus or a letter of offer as the case may be.

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[613] Clarification VIII dated 11-10-1993
[614] There are many popular press accounts that cover the MS Shoes scam. SEBI's annual report for 1995-96 has a brief mention of the irregularity attempted by MS Shoes.
[615] Clause 5 of Clarification No XII dated 29-9-1995
[616] Clause 5.6.1of DIPG 2000
[617] Clause 5.6.2 of DIPG 2000 vide SEBI/CFD/DIL/DIP/19/2006/31/3 dated 31-3-2006

The first specific requirements of SEBI dealt with the following aspects of disclosures: [i] Appraisal of projects [ii] Particulars of "Other Income" [iii] Adverse events [iv] Capacity Utilisation [v] Material changes in key management personnel [vi] Disclosure on market prices for listed companies [vii] Disclosure on Investor Grievance and redressal systems and [viii] Risk factors[618]

The first major initiative by SEBI to define disclosure requirements as part of the DIPG in a manner that went beyond the requirements of the Companies Act was based on the report of the committee under the chairmanship of Shri YH Malegam (hereafter known as the Malegam Committee.) The report of the Malegam Committee and its recommendations are quite vast in scope and voluminous. A detailed discussion of the same is beyond the scope of this work. We focus instead on the key regulatory announcements of SEBI based on the report of the Malegam Committee. Our interest is in understanding how these announcements lent a disclosure-based character to the regulatory approach of SEBI following the recommendations of the Malegam Committee. These discussions are based on the clarification announced by SEBI to implement the disclosure regime recommended by the Malegam Committee. As the clarification acknowledged, some of the requirements would have needed guidance notes from the Institute of Chartered Accountants of India (ICAI). The standards available from the ICAI at that time addressed only the requirements under the Companies Act.

The major disclosure requirements arising from the Malegam Committee report and the amendments thereto are as below. We highlight those requirements that are in addition to the requirements of

[618] Part 1 of Clarification No VIII dated 11-10-1993

the Companies Act. We discuss them under the following heads: [i] Information relating to historical financials[619] [ii] Information relating to

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[619] Historical Financials

Breakup of revenue into products manufactured and products traded, showing separately infrequently traded products. (Clause 4 of Clarification No XIII dated 12-10-1995 Clarification No VIII dated 11-10-1993 w.e.f. 1-12-1993.) If "other income" constituted 10% or more of the total income details of that income such as source, recurring / non-recurring nature had to be provided. The basis of disclosure was thereafter modified to cases where the income net of expenses constituted in excess of 20% of net profit before tax. [Clause 1.2 of Clarification No XIV dated 1-3-1996, w.e.f 4-3-1996]

Disclosure requirements relating to historical financials were further strengthened in 1996[vide Clarification No XIV dated 1-3-1996]. One of the principal changes was to recognise the qualifications by auditors in historical financials and, where possible, to quantify the impact of the same. Such quantification included adjustments / rectification for all incorrect accounting practices, restatement of material adjustments in arriving at the profits of the previous years, restating the profits or losses of earlier years based on old accounting policies if there had been changes in the accounting policy and the profit or loss before as well as after considering extra-ordinary items has to be shown separately.

All significant accounting policies followed in the preparation of the financial statements.

Changes with a quantitative assessment of their impact wherever possible, of a material nature such as discontinuance of lines of business or loss of markets.

The issuer as well as any other listed company in the group which has become a "BIFR company" or was under winding up or had a negative networth was to provide information regarding adverse factors affecting the business, whether the company has incurred a loss in the preceding year, whether it had become a sick company under Sick Industrial Companies (Special Provisions) Act, 1985 or is under winding up. In case the company had incurred a loss during the preceding period it has to provide details of profit or loss for the preceding three years [Clause 5(k) of Clarification No XIV dated 1-3-1996]

Details of tax shelters available to the company and their impact on the post tax profit of the company as per a proforma provided in Annex B [Clause 6 of Clarification No XIV dated 1-3-1996]

Details of capitalization of debt and networth and debt / equity ratios before and after the issue was made and details of changes, if any, in the share capital between the last financial statements and the date of the offer document and a note explaining the same. [Clause 11 of Clarification No XIV dated 1-3-1996]

Details of Group Companies, Affiliation and Intra Group Transactions

The following information relating to the five largest listed companies promoted by the promoters: Date of incorporation, nature of activities, equity capital, reserves excluding revaluation reserves, sales, profit after tax, earnings per share, net asset value.

Details of intra group business transactions such as sales or purchase between companies in the promoter group exceeding 10% of the total sales or purchases of the issuer. It further called for disclosure of "material items of income or expenditure arising out of transactions in the promoter group". [Clause 9 of Part A of Clarification No XIV dated 1-3-1996] The latter requirement appears difficult to interpret operationally since no definitions of "promoter group" (does it include for eg., proprietorship and partnership concerns or only limited companies), or "material items" has been defined in the provisions.

the projects[620] [iii] Information relating to ownership structure and changes in the same[621] [iv] Information relating to share price and

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Assets and liabilities adjusted for revaluation reserves Clause 5 of Clarification No XIII dated 12-10-1995

The manner in which or consideration for which shares were allotted to the promoters (such as whether they were by way of bonus shares or for some other consideration other than cash) prior to the public issue have to be disclosed in the prospectus.

The following ratios were required to be disclosed for each of the periods for which financial information was provided: [i] EPS [ii] Return on Net Worth [iii] NAV per share

[620] Project Related Disclosures

Details of project expenditure incurred upto two months prior to the later of filing of the prospectus with SEBI or with RoC, the means of financing and year-wise break up of future expenditure. [Clause 2 of Clarification No XIII dated 12-10-1995]. (It is presumed draft prospectus is what was intended.)

Details of bridge loan or any other project financing to be repaid from issue proceeds. [Clause 3 of Clarification No XIII dated 12-10-1995]

Details of new projects and major expansion projects such as technology, market, competition, managerial competence and capacity build-up.

Projections of future profits were permitted only in the case of a new company or in the case of expansion in excess of 100% of capacity by existing companies. The projections had to appraised by a financial institution or commercial bank which had committed to finance a part of the project. [Clause 7 (d) of Clarification No XIII dated 12-10-1995] Projections based on appraisal by sponsors on OTCEI who also undertook market making activity in those shares were also allowed later on. [Clarification No XVIII dated 17-4-1997 w.e.f 15-4-1997] The projections had to be limited to the later of two years from the commencement of commercial production or three years from the date of closure of issue. The major assumptions on which the projections were based had to be specified. [Clause 7 of Clarification No XIII dated 12-10-1995]

In case the company did not provide projections as above it was allowed to provide a forecast of the estimated profits for the year ending immediately before the offer document and the year ending immediately after the date of the offer document. The assumptions underlying the same and the arithmetic underlying the calculations had to be supported by an auditor's certificate. A company which had not commenced commercial production was not allowed to provide these forecasts. [Clause 10 of Clarification No XIV dated 1-3-1996]

Details of persons with whom technical and financial arrangements had been entered into such as place of registration, year of incorporation, issued share capital, turnover of the last financial year of operation and "general information regarding such person relevant to the issuer". [Clause 12 of Clarification No XIII dated 12-10-1995]

[621] Ownership Structure and Changes, Promoters' Transactions in Securities

Details of promoters' shareholdings and transactions in shares (including the maximum and minimum price and the dates of the transactions in the six months prior to filing the prospectus till the filing of the prospectus with the RoC. The provision defined promoter and promoter group for this purpose. Financial institutions and mutual funds were not to be defined as promoters merely by virtue of holding 10% equity in the company.—Taxmann p11.55) (The definition has been discussed earlier under Promoters' Contribution and Lock-in - Clause 9 of Clarification No XIII dated 12-10-1995) transactions in the same within the promoter group around the time of the issue[622] [v] Risk[623] [vi] Offer Price[624] and [vi] Others[625]

This was further refined by a requirement that the company would undertake to report to SEBI within 24 hours details of transactions in shares by promoter or the promoter group and the immediate relatives of the promoters during the period between the filing of the offer documents with the RoC or the SE, as the case may be and the date of closure of the issue. [Clause 5.3.5.1 introduced as part of the consolidation of DIPG in 2000] It is not clear as to why the commitment period for this undertaking started with the filing of the document with the RoC and not with the filing of the Red Herring with SEBI which was even prior to the filing of the document with the RoC. The last provision above raises several questions. The provision did not appear to have defined who constituted "immediate relatives". This could of course have been resolved by referring to the definition provided in the Companies Act. The exact point at which the transaction could be said to have occurred had not been defined in the provision. Further, the provision also did not state whether this requirement applied only to listed companies or both to listed as well as unlisted companies. Technically speaking such transactions could take place between the promoter and other investors even if the issuer was an unlisted company which was about to make an IPO. The primary concern about whether the promoters were cashing out of the company, leading to a possible incentive alignment problem between the promoters or owner managers and the public shareholder would have been equally relevant for unlisted companies as well. Finally, it was not clear as to why the window for monitoring such transactions should have started with the filing of the prospectus with the RoC. An easy way out for promoters who wished to circumvent this requirement would have been to sell their shares just ahead of filing the prospectus with the RoC. Details of these sales were not required to be reported anywhere under the Companies Act or SEBI guidelines.

Details regarding major shareholders and changes in shareholding composition such as names of ten largest shareholders and their shareholding as on the date of filing the prospectus (including shares allottable on exercise of warrant or any conversion rights) and the same two years earlier and ten days prior to the filing of the prospectus with the RoC.

If the company had made a public issue within two years prior to the proposed issue the shareholding details above have to be broken down into whether shares had been acquired by subscription in the public issue and shares acquired on a firm allotment or private placement basis. [Clause 15 of Clarification No XIII dated 12-10-1995] The company was also to provide an undertaking to SEBI that transactions in the shares of the company by the promoter and the promoter group and the "immediate relatives of the promoters" during the period between the filing of the prospectus with the RoC and the closure of the issue would be reported to the SE within twenty four hours of the transactions. (Clarification XIII dated 12-10-1995 w.e.f. 1-11-1995)

[622] Share Price Related Information

Details of high, low and average share prices of past three years, similar monthly data and volume of shares traded for the six months preceding the filing of the prospectus, market price immediately after date of resolution approving was approved. [Clause 10 of Clarification No XIII dated 12-10-1995]

In case the company had made a public or a rights issue in the preceding three years, the issue price of the security, current market price and particulars of change in capital structure, if any, since the date of issue and a statement regarding the progress of implementation of the project in comparison with the cost and implementation schedule were to be included in the offer document.

[623] Risks and Management Views

Internal and external risk factors and management perception of the same were to be discussed alongside the risk factors. [Clause 11 of Clarification No XIII dated 12-10-1995]

The directors were to make a statement regarding developments, if any, since the date of the last financial statements in the prospectus and the impact of the same in the next twelve months on the profitability, value of its assets, or inability to pay liability. [Clause 8 of Clarification No XIII dated 12-10-1995]

Further, the prospectus had to carry an analysis and discussion by the management (referred to as Management Discussion and Analysis or MDA, hereafter) of the financial conditions and results of the operations, as reflected in the financial statements containing (i) a comparison of the significant items of income and expenditure across the most recent three periods going back from the most recent period for which there are financial statements. [Clause No 13 (a) of Clarification No XIII dated 12-10-1995]

[623] The MDA also needed to provide information regarding [i] unusual or infrequent events or transactions [ii] significant economic changes that affect or are likely to affect income from on-going operations [iii] known trends or uncertainties that have had or are expected to have material adverse impact on sales, revenue or income from continuing operations [iv] future changes in relationship between costs and revenues in case events such as future increase in labour or material costs or prices that were to cause a material change were known [v] the extent to which material increases in net sales or revenue were due to increased sales volume, introduction of new products or services or increased sales prices [vi] total turnover of each major industry segment in which the company operated [vii] status of any publicly announced new products or business segment [viii] seasonality of business [ix] significant dependence on single / few suppliers / customers and [x] competitive conditions Clause 13 (b) of Clarification No XIII dated 12-10-1995.

The regulations required certain boiler plates regarding risk factors in the issue. "This being the first issue of the company, there has been no formal market for the securities of the company. The issue price [has been determined and justified by the lead manager and the issuer company as stated under justification of premium paragraph – in case of premium issue] should not be taken to be indicative of the market price of the equity shares after the shares are listed. No assurance can be given regarding an active or sustained trading in the shares of the company nor regarding the price at which the equity shares will be traded after listing." [Ref: RMB (GI Series) Circular No 6 (96-97) dated 16-8-1996.]

[624] Offer Price

SEBI concluded that "there is considerable time gap between the approval granted by the general body / Board of Directors of the company and the actual date of the issue and very often on account of subsequent development in the capital market the price indicated in the offer document does not reflect the true position." In response to this issue SEBI resolved that "issuers be allowed to fix the issue price in consultation with the lead manager, as near as possible the opening of the issue / filing of the offer documents with the Registrar of Companies / Stock Exchanges instead of specifying the issue price in the offer documents submitted to the SEBI for vetting."

Accordingly, SEBI allowed the draft offer document to carry a price band of 20% between floor and cap, with suitable explanatory notes indicating the financial implications if the price were to be fixed at various ranges within the price band. The actual price was to be determined at the time of filing the final prospectus with the RoC or offer document with the SE. The offer price or band was not to be mentioned in the offer document or letter of offer filed with SEBI, as the case may be, in the case of a rights offering or public offering from a listed company. (Clause 3.5.4 and 3.5.5 of DIPG 2000, introduced vide SEBI/CFD/DIL/DIP/19/2006/31/3 dated 31-3-2006.) The final price had to be within the price band indicated in the offer document. (RMB (DIP Series) Circular No 1 (94-95), dated 6-4-1994). In case the Board of Directors was authorised to finalise the price within the band the company had to provide a minimum notice of 48 hours to the SE for the meeting where the resolution was to be passed. [Clause No 5, Section C of Clarification No XIII dated 12-10-1995 w.e.f. 1-11-1995] The final offer document was required to contain only one offer price. [Vide SEBI/CFD/DIL/DIP/19/2006/31/3 dated 31-3-2006]

These requirements were further strengthened in March 1996, in less than six months of their first announcement. The second set of provisions required information that was more analytical in nature and that was meant to further assist the investor in forming a view on the quality of / prospects for the investment opportunity under consideration. Thus the issuer was required to provide information that was to analyse the impact of audit qualifications and such other contingencies that might have impacted the level of financials reported, justification for the price in terms of actual [historical] indicators such as EPS and NAV, adjusted for potential dilution in equity, impact of tax shelters, details of other income, intra group transactions, details of accounting policies and so on.

The requirements in these two circulars marked a significant improvement in the disclosure requirements that were in force until then.

It further provided for the details to be provided in the abridged prospectus and the letter of offer. Most of the time, the abridged prospectus has been the only source of information to investors in a public issue, especially the retail or non-institutional investor. It was

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The following information was required to be provided as basis for issue price. [i] EPS for last three years as adjusted for changes in capital [ii] P/E pre issue and comparison thereof with industry P/E where available (giving source from which industry P/E has been taken) [iii] average return on net worth in the last three years [iv] minimum return on increased net worth to maintain pre-issue EPS [v] NAV per share based on last balance sheet and NAV after issue and comparison thereof with the issue price. All the ratios above had to take into account expansion in equity capital base on account of outstanding conversion or other options to acquire equity in the company, assuming that the options will be exercised. Projected earnings however was not to be used as a justification for the issue price in the offer document.

[625] Others

A statement that the issuer accepted no responsibility for statements made other than those in the prospectus, advertisement or any other material issued at the instance of the issuer and that anyone placing on any other source of information was doing so at his own risk. (Clause 16 of Clarification No XIII dated 12-10-1995).

thus important for the regulation to ensure that the non-institutional investor received at least the minimum necessary information from the abridged prospectus.

6.3.3 Collateral Disclosures: Advertisements

A code of conduct governing issue related advertisements was introduced in 1993.[626] These provisions applied to a whole host of communication vehicles listed in the guidelines[627]. The provisions of this code as originally introduced are paraphrased below.[628]. Barring

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[626] Clarification No IX dated 11-10-1993. The discussion on advertisements in this section is based on this clarification, as modified.

[627] The guidelines specifically mentioned notices brochures, pamphlets, circulars, show cards, catalogues, hoardings, placards, posters, insertions in newspaper, pictures, films, radio / television programmes or through any electronic media and would include the cover page of offer documents

[628] Issue advertisements were required to be "truthful, fair and clear" and not contain any statement which is "untrue or misleading". [Clause 1.1a]. Advertisements were considered misleading if [a] statements made about the performance of the company's performance or activities gave an exaggerated picture of the same in the absence of explanatory or qualifying statements or [b] it provided an inaccurate portrayal which implied that past gains or income will be repeated in the future. [Clause 1.1 b] The language was to be clear, concise and understandable and to avoid extensive use of technical, legal terminology or complex language and excessive details which would detract the investor. This was necessary considering that the investor may not be well versed in legal or financial matters. [Clause 1.1 c] Not to contain promise of or guarantee an appreciation or rapid profits [Clause 1.1 d] Advertisements in newspapers, brochures, magazines, pamphlets containing highlights also had to mention risk factors in the same print size and mention the names of the lead managers and registrars to the issue. [Clause 1.1 f] Corporate advertisements between the opening and the closing of any public issue were to be limited to product advertisements and were not to make any reference to the performance of the company directly or indirectly during the period. [Clause 1.1g] This period was extended to start from date of acknowledgement card issued by SEBI. [Clause 2 (ii) of Section C of Clarification No XIII dated 13-10-1995.] This was relaxed to allow corporates to issue corporate advertisements after 21 days from the date of filing the offer document with SEBI till the date of closure of the issue, provided the advertisement contained all the risk factors as are required to be mentioned in the document. The advertisement was also not to contain any reference directly or indirectly to the performance of the issuer during the said period. [Clause 3 of Section C of Clarification No XVII dated 9-12-1996.] While the issue is open advertisements may merely state the issue is open and not make any announcements about the level of subscription. Announcement of the closure of the issue may be made only on the last closing date. If the issue is fully subscribed before the last closing date, such announcement may be made only after the issue is fully subscribed and that on the closing date. [Clause 1.1 h] The onus of ensuring the 90% subscription was transferred to the LMB who in turn had to receive a certificate from the RTI. [Clause 2 (iii) of Clause (c) of Clarification No XIII dated 12-10-1995]. Use of models, celebrities, fictional characters, landmarks, caricatures or the likes, slogans, expletives or non-factual and unsubstantiated titles were to be used in issue advertisements or offer documents. [Clause 1.1 j and 1.1 k] However, an important departure on a related matter was that the guidelines permitted the branding of securities, although the branding was limited to describing the nature and not the quality of the security. [Clause 5.15 introduced vide EBI/CFD/DIL/DIP/ Circular No 11 dated 14-8-2003.] Although a welcome development for issuers it is not apparent how the

some changes the regulation relating to advertisements remained nearly the same from the time they were first announced in 1993. Advertisements were required to carry extracts from the prospectus in full.[629] An advertisement announcing the issue was allowed soon after receiving final observations, if any, from SEBI.[630] There were restrictions on product and corporate advertisements during the period commencing 21 days after the filing of the draft offer document with SEBI. For eg., corporate advertisements during this period had to carry risk factors underlying the investment in the securities being offered to the public. Product related advertisements during the period were not allowed to carry any direct or indirect reference to the performance of the issuer.[631]

6.3.4 Review of the evolution of disclosure requirements

Disclosure requirements have evolved to a great degree during the period. The disclosure requirements had very few requirements that were specific to public companies, beyond what was required under the Companies Act, 1956. The current requirements have sought to require issuers to provide investors with the information that might be considered essential for making an informed investment decision. (A

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regulator could have possibly drawn and enforced a fine line of distinction between the two types of branding. If an advertisement carried any financial data it was to contain data for the past three years and include details of sales, gross profit, net profit, share capital, reserves, earnings per share, dividends and book values. [Clause 1.1 k]. No incentives apart from the permissible underwriting commission and brokerage were to be offered through any advertisements to anyone marketing the issue. [Clause 1.1 l]. Issue advertisements on television in the form of crawlers or any other form were not allowed. [Clause 1.1 (m) added vide Part C of Clarification No XXIV dated 18-5-1999 vide RMB (DIP Series) Circular No 1 (1999-2000) dated 18-5-1999.] The Lead Manager was responsible for the compliance with the code and for that purpose the Lead Manager was to comply with the following: [i] To obtain an undertaking from the issuer as part of the Memorandum Of Understanding that the company would not release directly or indirectly during any conference or at any other time any material or information which is not contained in the offer documents. [Clause 1.2a]. To ensure that the issuer obtained approval in respect of all issue advertisements and publicity materials from the Lead Manager responsible for marketing the issue and ensure availability of copies of all issue related materials with the Lead Manager till the issue allotment is completed.

[629] Clarification No XIII dated 12-10-1995 w.e.f 1-11-1995

[630] Clause 5.6A of DIPG 2000, vide SEBI/CFD/DIL/DIP/14/2005/25/1 dated 25-2-2005. The details of this provision are part of the discussion on current regulation.

[631] Clarification No XVII dated 9-12-1996, with immediate effect.

more critical evaluation of the current disclosure regime is provided in the discussion on the current regulatory framework in Chapter V.) The foundation for the current regime was laid by the Malegam report; but as may be observed from the current regulations this foundation has been built upon considerably in the consolidated guidelines of 2000 and the revisions thereto in 2003. What motivated the changes in these guidelines and how effective have they been in ensuring the entry of good quality issuers in the market and whether they have resulted in greater efficiency in pricing is an empirical issue that will be interesting from a policy perspective. While developing the framework for analyzing these provisions we have noted the doubt cast on the same in the context of the US SEC.

6.4 Aligning Interests of Owner Managers and External Shareholders

As in the previous chapter we discuss 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 is such that the promoters and external providers of capital have converging interests; and (iii) Pricing of share allotments and (iv) Distribution of shareholding.

6.4.1 Ensuring an enduring stake for the promoters

6.4.1.1 Financial Commitment

Promoters were required to bring in at least 25% of the total issued equity capital up to Rs 100 crore, 20% for issues above Rs 100 crore and one third of the convertible portion of PCDs and FCDs.

Promoters' contribution was defined as contribution by promoters, directors, friends, relatives and associates.[632],[633] The guidelines specified and modified from time to time the manner in which the minimum promoters' contribution could be raised.[634] We have already pointed that companies which did not meet the criterion of track record had to allot not less than 50% of their equity to promoting companies.

One such modification related to the relaxation in the minimum size per application, the rationale for which is debatable. There could have been, for eg., a legitimate apprehension that a low minimum size per application could have allowed, if not encouraged, the promoter group to farm out the promoters' contribution to a large and disparate group of investors and thus provided the circumstances for the creation of an informal market prior to the IPO, intentionally or otherwise, with its attendant effects. At the time of introducing the DIPG and the clarifications thereto SEBI had not attempted to define the notion of a promoter.[635] In the absence of such a definition one could have fallen back on the company law definition of a "promoter" as a person who was involved in the formation of the company and bringing it into existence till its management and operations were handed over to the Board of Directors. In the context of family managed businesses in

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[632] Section L, Clarification I, dated 17-6-1992

[633] This requirement applied to each class of securities where more than one class of securities was issued. [Clause 3 (i) of Clarification No VIII dated 11-10-1993].

[634] Issue of convertible instruments to the public or other instruments which entitled the public to an option to subscribe to the equity at a premium were to be treated as equity issued immediately at the time of the public offer, for the purpose of calculating promoters' contribution, lock-in and such other requirements related to the conditions for the issue of securities in the original guidelines. [Clause A of the original guidelines and Clause 1 of Clarification No VII dated 10-8-1993.] The contributions were to be brought in by those who were promoters, directors, friends, relatives and associates and were to be brought in before the issue was made, subject to a minimum subscription by each applicant of Rs one lakh. [Clause (a) of Section L of DIPG 1992] The minimum subscription per application was subsequently reduced to Rs 25000 in the case of friends and relatives, business associates such as dealers and distributors. The minimum contribution was to remain at Rs 100,000 as before in the case of corporates or firms who were not business associates like dealers [Clause 2.7 of Clarification No VII dated 10-8-1993].

[635] Corporate Law had a notion of a "promoter"; but the SEBI laws never explicitly referred to this definition in the guidelines.

India the promoters end up managing the operations of the business as majority or as the largest shareholders of the company. [Also see discussion on agency related issues in Chapter IV]. Although be it with the benefit of hindsight, it could be argued that SEBI recognised this role for the promoter in defining promoter subsequently as "the person or persons who are in overall control of the company".[636] By allowing promoters, thus defined, to farm out the minimum promoters' contribution the regulations also provided a mechanism to the promoters to meet the minimum contribution requirements without investing their own financial capital in the business. Issuers were required to provide to SEBI a list of persons who constituted the promoter group and their individual shareholding. Thus the objective of alignment of financial interests intended by these provisions may have been possibly diluted, if not defeated altogether by the reduction in the minimum size.

The guidelines provided several clarifications which attempted to ensure that promoters did not circumvent the intention of aligning the interests of owner-managers and external shareholders, as may be seen from the numerous modifications.[637] In particular, the concern

[636] Explanation (1a) of Clarification No XIII dated 12-10-1995

[637] Profitable promoter companies seeking to bring in additional equity capital to meet the minimum 50% equity ownership of a company that proposes to make a premium issue were to subscribe at issue price [Section B of Clarification No V dated 4-11-1992]. In calculating the contribution in the case of an existing private or closely held or other unlisted company, equity issued at par in the twelve months prior to the public issue, other than by way of bonus shares, were to be taken into account. In case such shares were to be reckoned as the minimum promoters' contribution the public issue could not be made at a premium [Clause L (a) of Clarification No V dated 4-11-1992]. A similar provision applied to the public issue of PCDs and FCDs which were to be converted into equity at a premium [Section B of Clarification No V dated 4-11-1992]. The prospectus had to disclose the consideration (such as bonus shares or for any other consideration other than cash) for which shares had been issued to the promoters prior to the public issue. [Clause 10.2 of Clarification No VIII dated 11-10-1993, w.e.f 1-12-1993]. A literal interpretation of this provision would suggest that equity issues to promoters at a marginal premium instead of at par as above would allow the company to go ahead with an issue at premium. The spirit of the provision however appears to have been to ensure that promoters brought in the minimum contribution at the same price as the offer to the public if the contribution is being brought in at the same time (within a period of twelve months from) as the public issue. This latter interpretation would be consistent with the objective of the minimum promoters' contribution, namely, to align the financial interests of the promoter and that of the external shareholder.

seemed to centre on promoters trying to issue themselves shares at a price lower than public issue or, even worse, allotting themselves free shares through a pre-issue bonus and so on. Were these in response to abuses attempted by issuers or were they in response to clarifications sought by prospective issuers is a question worth studying, in order to get a better understanding of how regulations formulation has evolved in this area. But the detailed nature of the modifications in this regard indicate the tremendous difficulty in trying to evolve a regime for aligning interests through this route.

6.4.1.2 Restricting Liquidity

The second element of the interest alignment device was locking in the promoters' contribution, rendering the minimum promoters' contribution illiquid. Lock in provisions relate to securities held by promoters as well as other investors. Our interest is primarily on those provisions that govern the securities held by or allotted to the promoters.

Broadly, the provisions relating to lock in seemed to view the shares that deserved to be locked in as consisting of five categories: [i] Minimum promoters' holding to be locked in [ii] Securities held by promoters, but ineligible for promoters' contribution [iii] Securities allotted to promoters in excess of the mandated minimum [iv] Securities allotted prior to the proposed issue and [v] Securities allotted as part of a firm allotment. The regulations stipulated lock-in provisions relating to all of these. We trace the evolution of these provisions below.

6.4.1.2.1 Minimum promoters' holding to be locked in

The minimum securities mandated to be held by the promoters were to be locked in for a minimum period of time, five years to begin with. [The economic rationale behind minimum promoters' contribution and locking in the same has been discussed in one of the previous chapters.] As with the minimum contribution, the lock-in provisions underwent several modifications intending to plug the possibility of promoters circumventing the spirit while complying with the spirit of the regulations.[638]

6.4.1.2.2 Securities allotted to promoters in excess of the mandated minimum

Allotments in excess of the stipulated minimum promoters' contribution were not always welcome, it would appear.[639] The provisions are not clear as to whether this applies to all public offerings, IPOs as well as FPOs. This was specifically extended to allotment in excess of the stipulated minimum contribution in the case of unlisted companies as well[640]. However, in the case of a listed company, if the excess

[638] The promoters' contribution was to be locked in for a period of five years, to the extent of 50%, 25% or 20% as the case may be. [Clause (b) of Section L of DIPG 1992 and Clause C of Section L of Clarification II dated 17-6-1992], modified subsequently to three years [Clauses 2 and 3 of Part 3 of Clarification No XIX dated 14-5-1997] from the later of the date of commencement of production and allotment [Clause L(b) of DIPG 1992]. However, the shares could be pledged with banks and financial institutions as additional security for loans where such pledge had been stipulated as part of the terms of sanction of the loan and if the offer document had a disclosure to this effect [Section L of Clarification No VI dated 23-12-1992]. Inter se transfer of share among promoters was allowed among promoters subsequently, although the lock-in was to continue to apply to the promoters' block as a whole. In case the promoters had been holding the minimum percentage prior to the public issue and did not contribute any additional capital as part of the public issue the lock-in of such prior shareholding was to be five years less the period for which the shares had been held prior to the public issue. In any case such shares held prior to the public issue were to be held for a minimum period of two years from the later of the date of allotment in the public issue or the commencement of commercial production in the case of a manufacturing company [Clause II (g) of Clarification No III dated 13-8-1992]. Lock in commenced in the shares of a non-manufacturing company from the date of allotment [Clause II (h) of Clarification III dated 13-8-1992].

[639] Any contribution to the shareholding in the proposed issue in excess of the minimum requirement was to be treated as firm allotment and be subjected to a three year lock-in [Clause II (i) of Clarification No III dated 13-8-1992]. In the case of convertible debentures the lock-in was to be from the date of the allotment of debentures [Clause L (e) of Clarification No II dated 16-7-1992].

[640] Clause 4.12.1 and 4.12.2 of DIPG 2000.

allotment was made in an issue which was priced at the level prescribed by the guidelines on preferential allotment it was not to be locked in as above.[641] The lock-in on excess subscription was reduced to a period of one year subsequently.[642]

6.4.1.2.3 Securities allotted as part of a firm allotment.

All firm allotments, preferential allotments to shareholders of promoter companies and collaborators made as part of the public issue were to be locked in for a three-year period.[643] as well as securities subscribed to by promoters as part of a firm allotment [644] A similar lock-in was extended to securities subscribed to by the promoters to meet a shortfall in firm allotment subscriptions.[645] However, the lock in of three years on firm allotments to promoters did not appear in the consolidated guidelines of DIPG 2000.[646] Instead there was a provision which locked in shares allotted prior to the public issue at a price below the issue price[647], which we discuss separately. The provision locking in firm allotments however reappeared later as a modification to the provision on lock-in of pre-issue allotments.[648] This lock-in commenced from the later of the date of allotment and commencement of commercial operation.

The latest provision above did not distinguish between firm allotments to promoters and non-promoter allottees. It was also consistent with the lock-in on all shares held prior to the public issue, for one year from

[641] Proviso to Clause 4.12.2 of DIPG 2000
[642] Vide SEBI DIP (Compendium) Circular No 3 dated 4-8-2000
[643] Clause L (c) of DIPG 1992
[644] Clause 4.14A of DIPG 2000 introduced vide RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000
[645] Clause 8.5 (e) of DIPG 2000
[646] Refer to the DIPG 2000 as of March 2000

[647] Clause 4.14.3 and Clause 4.14A of DIPG 2000 as of March 2000
[648] Clause 4.14A of DIPG 2000 modified and substituted vide DIP (Compendium) Circular No 3 dated 4-8-2000

the date of allotment. The effect of both these provisions was to restrict the liquidity on shares allotted just prior to the public issue for a year after allotment, no matter whether they were priced at the same level as the public or whether they had been allotted to promoter or non-promoter investors. It was a simpler provision to implement, without an in built bias for or against any set(s) of investors, unlike earlier versions of the same.[649] It restricted liquidity on all incumbent shareholding prior to the public offering and thus pre-empted opportunistic selling by pre-public offering shareholders.

Where promoters received firm allotments, while picking up the shares unsubscribed[650] due to the withdrawal of an application by a firm allottee of shares[651] the guidelines suggested a three year lock-in on the shares thus subscribed. On the face of it appeared to be an instance of a promoter being penalized for making good the shortfall arising from the withdrawal of an investor. One possible explanation may be that this was meant to be a deterrent against promoters misusing default against firm allotments, or even engineering such defaults, as an excuse to garner shares in their names. Even if such a concern were to be valid, it is not clear as to why these shares should have been treated differently from the shares subscribed to by the promoters for making good the shortfall in firm allotments[652]. If that were to be so, the applicable lock-in period ought to have been one year as in the case of lock in of firm allotments under Reg 4.12.2.

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[649] Given these aspects, the difference in the date of commencement of the lock in period appears to be an unwarranted extra twist. It is possible to argue that firm allotments were likely to be more recent, on average, than all shares held prior to the public issue; hence the need for a more stringent date of commencement of lock-in. The argument may not have had much practical significance as it affected only those issues where date of commencement of commercial production was likely to be later than date of allotment, which would have been true only in the case of some start-ups.
[650] Vide Clause 8.5(e) of DIPG 2000
[651] Clause 8.5(f) of DIPG 2000
[652] Under Reg 4.12.2 of DIPG 2000

6.4.1.2.4 Securities held by promoters, but ineligible for promoters' contribution

Securities ineligible for promoters' contribution[653] were locked in for a three year period from the date of allotment of the proposed issue of capital.[654] In an important easing of the restrictions, the lock in on securities issued against revaluation reserves, bonus issues against revaluation of assets and all securities issued at a price less than that of the public issue were removed.[655] On the face of it, this might appear to be an innocuous modification. The magnitude of the benefits becomes apparent when one considers the instances of promoters acquiring shares at effectively negligible prices when the companies were issuing stock to the public at fancy valuations. The easing of this provision may have substantially diluted the objective of alignment of interests. Another view on this matter might suggest that these changes to share capital prior to the public offerings were merely accounting details and the materially relevant consideration ought to have been the valuation of the company and the price per share derived from the same. As long as investors were provided with enough information to estimate / assess the price, they could be expected to arrive at rational and informed investment decisions. The limitation to that argument arises from the large number of retail individual investors who participated in public offerings. To ensure that those investors did not miss these details and the impact of the same on the offering price, the guidelines needed to require appropriate disclosure of such issue of shares to the promoter and the impact of the same on the cost of acquisition of the promoters' shareholding.

[653] These included securities issued out of revaluation assets or capitalization of intangible assets [Clause 4.14.1], securities issued by way of bonus out of revaluation reserves [Clause 4.1.4.2] and in the case of unlisted companies shares allotted, during the preceding one year, at a price lower than the issue price. The regulations do not specify when the one year period commences for reckoning the said allotment.
[654] Vide
[655] Vide DIP (Compendium) Circular No 3 dated August 4, 2000

6.4.1.2.5 Securities allotted prior to the proposed issue

Allotments to promoters or any other shareholder at a price lower than the public offering price, during a year preceding the public issue, was to be locked in for a year from the date of allotment of the proposed issue of capital.[656] Interestingly, the guidelines had another provision that the entire pre-issue capital of the company was to be locked in for a period of six months from the date of trading of the shares on a regional stock exchange,[657] where shares had been allotted at a price lower than the issue price during a period of six months prior to the opening of the issue.[658] Allotments to promoters were locked in even if the allotment was made earlier than the six month period. The latter provision seems to overlap almost entirely with the former other than in respect of the exemption to certain categories of investors from this provision. Worse, the proviso to the latter proviso exempts shares allotted to non-promoter shareholders at prices lower than the public offering price more than six months prior to the proposed issue. It thus contradicted the requirements of the former provision. The intent here appears to have been that shares by way of firm allotments to investors other than VCs or employees should not be misused as a means to making a quick profit. The restraint was even more in the case of promoters who could be considered to be not just privileged to negotiate attractively priced equity allotments but also make use of their intention and inside information about the forthcoming public issue to get around the six month limit and allot themselves equity at a favourable price.

[656] Clause 4.14.3 of DIPG 2000
[657] Inserted vide RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000
[658] Allotment to venture capital investors and employees was exempt from this requirement.

The confusion was resolved with the new provision which said that the entire pre-issue share capital, other than that locked in as minimum promoters' contribution and barring certain other exceptions,[659] was to be locked in for a year from later of the date of allotment and the date of commencement of commercial production. The date of commencement of the lock-in was subsequently fixed as the date of allotment, making the provision marginally less restrictive for start-ups.[660] The connection between the lock in and the differential pricing was removed by dropping the two related provisions mentioned above. As in the case of firm allotments, the new provisions did away with the distinction between promoters and non-promoter investors. Such distinction appeared to be unwarranted, given that the promoters' commitment was additionally demonstrated by the mandatory lock in of the minimum contribution of 20%.

Apart from the requirement relating to the lock-in of the minimum promoters' contribution, there appear to have been numerous changes, the motivations for which appear confusing, sometimes even conflicting with the previous intentions as noted earlier. As long as allottees of securities, no matter which constituency they belong to, paid a fair price for any allotments during a reasonable period preceding the public issue and as long as the minimum promoters' contribution was locked in as per the current provisions it seems to be not so important as to whether they dispose of shares recently allotted to them or retain them. Equally, the concern about promoters disposing of their shareholding soon after the IPO should have been a matter of concern no matter when the allotments had been made.

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[659] The exceptions were [i] pre-issue share capital held by VCs and Foreign Venture Capital Investors, [ii] pre-issue capital that had been held at least for a year and that was being offered for sale and [iii] shares allotted to non promoter employees under an ESOP scheme compliant with the Employees Stock Option Scheme and Employees Stock Purchase Scheme Guidelines, 1999. Further, shares lent to the Stabilisation Agent under the Green Shoe Option Scheme [Clause 8A.7, were exempt for the period for which they were lent by the promoters.
[660] Vide SEBI/CFD/DIL/DIP/19/2006/31/3 dated 31-3-2006

After all, the normal concerns about pre IPO shareholders selling shares in the after markets, soon after an IPO, are essentially as follows. They could destabilize the price in the after-market either by providing too large a supply of securities and / or by signaling not too positive an outlook for the company. These concerns could be effectively addressed through restricting the sale of securities by all shareholders across the board, no matter when the allotments were made or the prices at which the allotments were made. Such restrictions could be for a reasonable period, such as a year, so as not to take away the incentive for pure financial investors to participate in pre IPO placements, which we noted in the previous chapter serve some important purposes. An even handed and simple provision along those lines would have been easier to comprehend for all and less costly to administer.

It was not until 1996 that the requirement of minimum promoters' contribution was withdrawn in the case of listed companies which had been listed for three years and which had a record of dividend payment in three out of the five preceding years and in the case of companies which did not have an identifiable promoter.[661] As a precursor, the requirements of promoters' contribution were withdrawn in the case of rights issues made by "companies which are professionally managed".[662] In both the cases the promoters were required to disclose their existing shareholding and the extent to which they were participating in the proposed issue.

However, in what appears to have been an instance of oversight in the formulation of regulations, the requirement of 50% of minimum

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[661] Clause 3 of Part III of Clarification No XIV dated 1-3-1996, effective 4-3-1996. The promoters will have to continue to disclose the extent to which they are participating in the public or rights issue.
[662] Clause 2.3 (d) of Clarification No VIII dated 11-10-1993, w.e.f. 1-12-1993

promoters' contribution in the case of companies seeking to make an issue at a premium when they did not qualify to do so under the requirements of the pricing regulations was withdrawn only in 2000. A similar requirement relating to issue of securities at a premium by infrastructure companies was also withdrawn.[663]

The guidelines initially permitted transfer of shares among promoters inter se, subject to the continued applicability of these provisions in the hands of the transferee[664] and subject to compliance with SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, as applicable[665]. So also pledge of locked in securities was permitted.[666] Transfer was further permitted among non-promoter shareholders, subject to the requirement the transferees also owned locked in shares and further subject to the condition that the transferred shares would continue to be locked in for the originally stipulated period.[667] It is not clear why these latter transfers were permitted only to those shareholders who were also owners of locked in shares, given that any category of shareholders (unlike a specific category such as promoters) could have been owning locked in shares and that transferred shares were further subject to continued lock-in as per the original terms of allotment.

The guidelines also specified the terms of conversion of debentures that were subscribed to by the promoters as part of the promoters' contribution.[668] However, the provision offered an incentive to

[663] Vide Circular dated February 16, 2000
[664] Clause 4.16 of DIPG 2000 introduced vide....
[665] RMB (Compendium) Series 2003-2004 Circular No 9, dated May 2, 2003.
[666] Section L of Clarification No VI dated 23-12-1992
[667] 4.16(1)(b) introduced vide RMB (Compendium) Series 2003-2004 Circular No 9, dated May 2, 2003.
[668] If the promoters' contribution was brought in by way of PCDs or FCDs, the conversion was allowed at par if first tranche of conversion of the debentures issued to the public was convertible after 18 months and at the same price as the public debentureholders where the conversion was to take place in less than 18 months [Clause (e) of Section L of Clarification II dated 16-7-1992]. It would appear from the above that the guidelines clearly favoured

promoters to bring in their contribution as debentures, especially where getting equity allotted for the sake of control may not have been a consideration in the minds of the promoters of the issuing company. These companies may have had incumbent shareholders who may or may not have participated in the public issue. Allowing promoters to subscribe to the issue of debentures raised one basic question of fairness: The incumbent shareholders may have had their share of the cashflows ploughed in without any returns for a given project whereas the promoters bring a part of their contribution as interest bearing debentures. Admittedly the promoters also forsake their share of the cash flows as incumbent shareholders but by allowing them to participate in an interest bearing instrument the guidelines allowed them to run ahead of incumbent shareholders even if it was in consideration for bringing in fresh capital. Fundamentally, allowing owner managers to bring in interest bearing debt that ran ahead of shareholders appeared would have created avoidable conflicts. Which is why term lending financial institutions have always requires that these funds were brought in as interest free loans to be converted into equity. Similarly in contemporary international project finance the debt from owners or project sponsors is subordinate to debt from all "outside" lenders in terms of interest or principal payments. (See Peter Nevitt's book for structuring of project financing transactions.[669]) The

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debenture holders over equity shareholders since the start and end date for lock in of equity [Clause L (e) of Clarification No II dated 16-7-1992]) was more stringent than in the case of allotment of debentures. Further, while calculating the 50% promoters' contribution only those shares that had been allotted twelve months prior to the IPO were to be first taken into account. In case the promoters brought in their contribution towards the 50% in the form of equity twelve months prior to the IPO and those shares had been allotted at par the company was to issue equity to the public at par [Clarification No V dated 4-11-1992. The reference to the "proposed public issue" from which the twelve month period had to be worked out did not state clearly what was the relevant date signified by "proposed public issue". One possibility is that it referred to the proposed date of allotment since the issue here appears to be whether the promoters' contribution was coming in close to the allotment to the public. Since the elapse time between the filing of the offer document and the allotment in the public issue may have been as high as seventy days at the least, often even higher, it was important to specify the precise reference point.] Possibly the assumption here is that subscription to debentures would mostly come from the investing public.

[669] Peter Nevitt, "Project Financing" 7th ed., Euromoney Publications, London (2000).

guidelines contained stipulations regarding the timing of infusion of promoters' funds. We discuss this under provisions relating to Investor Protection.

In respect of further issues, if there were no promoters, the contribution was to come from directors, friends, relatives and associates.[670] In the case of professionally managed companies, this requirement was to apply to "persons in charge of the management of the affairs of the company".[671] How realistic must this provision have been is somewhat debatable. For eg., would it have been feasible for professional directors of companies to be able to raise this capital? Equally, it must have been difficult to define "persons in charge of the management of the affairs of the company".

In the case of issue of convertible instruments, promoters could bring in their contribution at the weighted average of the price of conversion at which the public debentureholders converted into equity. The idea appears to have been to ensure that the price at which the promoters convert was the same as that of the public.[672]

Of all the provisions in the guidelines the ones relating to minimum promoters' contribution and the lock in of the same appear to reflect the infancy of the regulatory regime. They also seem to reflect a mindset that was prevalent in development banks and term lending institutions at that time. (Even the figure 20% appears to be the same as the minimum percentage promoters' contribution prevalent at that time, mentioned by Prasanna Chandra.[673] The basic problem with the

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[670] Clause L of Clarification I to DIPG 1992, dated 17-6-1992
[671] Clause d of Section L of Clarification I dated 17-6-1992
[672] Clarification IV dated 21-9-1992
[673] Prasanna Chandra, Projects: Planning, Analysis, Selection, Financing, Implementation and Review, Tata McGraw Hill Ltd., New Delhi (2006).

reliance on the approach of the term lending institutions is that their approach is that of a lender, which is often at conflict with that of an equity shareholder as noted in Chapters IV and V. We have also noted several inconsistencies earlier in the provisions governing lock-ins. All this effort was directed without any clear understanding of whether a high promoters' contribution mitigated agency risk. The literature at that time did not seem to suggest that it might have mitigated any agency conflict. Experience from the sickness in the loan portfolio of term lending institutions suggests that a good deal of the delinquency may have been attributable to poor or bad management. The relief from these provisions could not have come any sooner than they did, although as we note parts of the extant provisions are inconsistent with the overall objective and there is scope for further simplification.

6.4.2 Restrictions on Capital Structure

The guidelines placed restrictions on the capital structure of the company in three broad ways, namely (i) on issue of bonus shares (ii) on issue of warrants and options to subscribe to equity share capital to groups of shareholders, prior to the public issue and (iii) on terms of conversion of debentures held by promoters into equity shares.

6.4.2.1 Bonus shares

Bonus shares are "free shares" issued by capitalization of reserves. Under Indian law they are issued to shareholders whose names appear in the register of members as on the date of closure of books for the purpose of the bonus issue. (In the case of dematerialized shares bonus shares are issued to shareholders who are registered as owners of beneficial interest in the records of the depository.) Bonus shares are allotted to all shareholders in the same proportion. It is well recognised that bonus share issues do not alter the financial worth of the company as measured by the ability of the company to produce cash flows. However, bonus issues alter the book value per share of the company.[674] Further, bonus shares are also perceived by the investment community, inter alia, to be indicative of the prospects for the company.[675] These factors, independently or together, may result in a post bonus issue share price, which is not proportionate to the ratio of the bonus issue.[676]

The Companies Act, 1956 does not place any restrictions on the issue of bonus shares against reserves such as revaluation reserves, even though such reserves may not always necessarily represent an increase in the market value of the assets[677]. Promoters could take advantage of this absence of restrictions in the following manner. Prior to an IPO the share capital of the company is owned by the promoters and their associates. The company revalues its assets prior to the IPO and issues bonus shares to the pre IPO shareholders. This helps the pre IPO shareholders in two ways. First, it expands the paid up share capital without any infusion of cash. It may thus help the company meet the minimum paid up capital criteria to qualify for listing on many

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[674] Book value has been defined as (Equity Share Capital + Free Reserves) / No of Equity Shares Outstanding.

[675] Although this belief flies in the face of financial wisdom, the idea here is that by issuing bonus shares companies agree to expand their paid up share capital and are signaling a willingness and / or confidence to pay dividends on a larger number of shares; hence, the belief that bonus shares may signal a sanguine outlook for the profitability of the company.

[676] If markets are efficient, the post bonus issue price of the shares of a company must be reduced to the extent of the increase in paid up share capital of the company, in line with the contention that a bonus issue by itself does not alter the value of the share capital of the company. Thus, assume a share trades at a price of Rs 100 prior to the bonus issue. Assume further that the share price reflects the intrinsic worth of the company, as it ought to, in a perfect capital market. If the company were to declare a 2:3 bonus issue the number of shares would increase by 67%. The price of the shares after the bonus issue, ex bonus, would reduce to Rs 60 per share in the absence of the kind of effects noted above.

[677] An upward revaluation of the book value of the assets of the company based on some arbitrary considerations not related to market phenomena would be an example. Corresponding to the increase in the value of the assets an amount would be credited to the revaluation reserves account of the company.

exchanges. Promoters then issue themselves shares to the public at a disproportionately higher price. They are able to do so because in terms of book value per share after the bonus issue the shares of the company offered in the public issue price may appear inexpensive; whereas in terms of valuation of the company the public offering price may be high. This is a form of the wealth effect of bonus shares that we explain in an earlier footnote. It is a problem that we encounter due to the fallacy of tying the price or value of a share to book value as opposed to the present value of the company's future cash flows accruing to the shareholder as enunciated under contemporary financial economics. Secondly, as we note below, there is a widely held belief that bonus shares suggest robust financial prospects for the company. This in turn helps promoters charge a higher price per share in the public offering. A third and a more frequent source of advantage arises from the fact that often times these reserves do not represent genuine profits from the business but questionable reserves from revaluation of assets, as noted earlier.

In order to regulate the indiscriminate issue of bonus shares to increase the promoters' stake in the company, the guidelines imposed restrictions on the capitalisation of certain types of reserves and the frequency of the capitalisation of reserves.[678] The general thrust of

[678] Bonus shares were permitted only out of share premium collected in cash and free reserves built out of "genuine profits" of the company only [Clause M (a) of DIPG 1992] and not out of revaluation of fixed assets [Clause M (b) of DIPG 1992]. The guidelines did not define what "genuine profits" were. However it may be reasonable to assume that these profits were to be arrived at under the provisions of the Companies Act for estimating distributable profits. The second key requirement was that the residual reserves after the proposed bonus issue was to be at least 40% of the increased paid up capital [Clause M (e) of DIPG 1992] and 30% of the profit before tax of the company for the previous three years was to yield a rate of dividend of 10% on the expanded capital [Clause M (f) of DIPG 1992]. The shares were to be fully paid up before declaring bonus issues. Although the guidelines did not specify what was possibly intended was a minimum yield of 10% since the endeavour of the provision must have been to ensure that the maintainable profit of the company was adequate to provide a minimum yield for the shareholder. Residual reserves could not include capital reserves as a result of revaluation or reserves "without accrual of cash resources" [Clause M(g) of DIPG 1992] and had to be calculated after providing for contingent liabilities [Clause M(d) of DIPG 1992], but could include development rebate reserve and investment allowance reserve [Clause M (c) of DIPG 1992]. The company could not be in default of dues on fixed deposits, debentures or in

these provisions was to ensure that the issue of bonus shares was based on genuine reserves and that the company's profits in future was adequate to maintain a minimum dividend on the expanded capital of the company and that bonus shares were not used as a mechanism to increase the percentage shareholding of the promoters by lowering the price through an accounting sleight of hand.

The practical implications of this provision are somewhat difficult to comprehend. For eg., company law allows bonus shares to be allotted only to those who are shareholders of the company and in proportion to their shareholding in the company. The expansion of the paid up capital through a bonus issue is bound to affect the rights and the proportionate ownership of PCD / FCD holders of the company prior to the capitalisation of the reserves. There is no known mechanism under law to protect their rights or value of ownership in the company prior to the proposed bonus issue[679]. Thus one extreme implication of

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respect of statutory dues [Clause M(j) of DIPG 1992]. The bonus proposal had to be implemented within six months from the date of approval by the Board of Directors and did not have the option to change the decision [Clause M(k) of DIPG 1992]. The company needed to ensure that the expanded capital was not greater than the authorised capital [Clause M (m) of DIPG 1992], that the articles allowed the capitalisation of reserves [Clause M(l) of DIPG 1992] and indicated the proposed dividend in the year immediately following the bonus issue [Clause M (n) of DIPG 1992]. Bonus issues were not allowed within twelve months of a public / rights issue [Clause J(a) of DIPG 1992] and then were to be subject to the relevant provisions of the guidelines [Clause J of Clarification I dated 17-6-1992]. The bonus issue could not dilute the value or the rights of debenture holders with partial or full convertibility [Clause M(o) of DIPG 1992] where the conversion fell due within twelve months of the date of the rights or bonus issue as the case may have been. In case such bonus or rights issue had to be made the shares that would have been allotted to the debentures holders if such conversion had taken place had to be "reserved" and issued to the debentureholders on the occurrence of the conversion. [Clause M (ii) of Clarification No II dated 16-7-1992]. The guidelines were not clear as to whether this applied only in the case of mandatory conversion or was applicable both in the case of mandatory as well as optional conversion. In the case of mandatory conversion it may have been reasonable to presume that the "reservation" was to apply only to the extent that the option to convert had been exercised. The difficulty in that event would have been in estimating the post bonus issue paid up capital and ensuring compliance with the residual reserve requirement. Even in the case of a rights issue practical administrative questions might may have arisen such as the number of share for which board and shareholder approval needed to be obtained.
Where the issuer was a listed company, compliance with the guidelines had to be certified by statutory auditor or company secretary in practice [Clause M (i), Clarification No II dated 16-7-1992].

679 Some technical possibilities might be to alter the terms of the outstanding PCDs / FCDs to protect their rights or value of their ownership but that would require the approval of not just the debentureholders but also that of shareholders. Such a proposal is unlikely to meet with the

the provision might be that as long as there are PCDs / FCDs with outstanding conversion rights the company may not be in a position to declare bonus shares. More fundamentally, in the absence of a corresponding provision in the company law the legal tenability of this requirement, which affects the rights of existing shareholders to allow themselves a bonus issue of shares, must have been questionable.

Several substantive changes were made to the regulation of issue of bonus shares in 1994.[680] The most important of the changes was to limit the provisions initially to listed companies. One possible justification for the same might be that the concern about promoters using bonus issues to allot themselves shares may have been partly addressed through the requirement that these shares would not be considered for minimum promoters' contribution and further that such bonus shares issued within twelve months prior to the IPO would be locked in for a period of one year. Thus, overall the guidelines sought to ensure that promoters had a minimum cash stake in the company and that shares obtained costlessly were not used to make a quick buck by the promoters. The second key change was that the residual reserve test requirement, the minimum dividend yield requirement and restriction on bonus in lieu of dividend were dropped. The residual reserve test imposed a quantitative restriction on the extent to which the reserves could be capitalised, as discussed earlier. Under the new guidelines the company could issue bonus shares in any ratio.

The provisions regarding issue of bonus shares have remained unchanged as above till date.[681]

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approval of the shareholders in the absence of an incentive to approve a bonus issue even under those conditions. Although such circumstances could have been envisaged theoretically, practically they may not have been feasible.

[680] RMB (DIP Series) Circular No 2 (94-95), dated 15-5-1994

[681] Chapter XV of DIPG 2000 as amended contain the provisions regulating issue of bonus shares.

6.4.2.2 Structuring Convertibility Options

A key feature of the original guidelines was the attempt to define the convertibility options that could be offered to the public. The assumption presumably was that individual investors could have ended up subscribing to instruments which did not leave them with adequate optionality. The regulations even required that the letter regarding rollover of debentures was vetted by SEBI to ensure that the debenture holder indeed had an option to stay invested or to exit. While provision such as these might be considered to be examples of mismanaging it must be considered equally likely that the regulator may have been trying to plug attempts by issuers to defeat the former's endeavour ro protect the lay investor through clever practices. The provisions,[682] which were quite detailed, related to the price and the terms of conversion. A guiding consideration behind all these provisions appears to have been to ensure that the issue price to be paid for the equity shares by the promoters was the same as that paid by the

[682] The guidelines provided for the issue of fully convertible debentures (FCDs) as well as partially convertible debentures (PCDs). FCDs with a conversion period in excess of 36 months had to allow for optional convertibility with put and call options to both the issuer as well as the subscriber to exit from the investment without exercising the conversion option [Clause F(a) of DIPG 1992]. Conversion in part or in whole between 18 and 36 months had to be at the option of the debentureholder [Clause F(e) of DIPG 1992]. The distinction between debentures convertible in less than 18 months and those convertible after 18 months seemed to be based on the view that FCDs / PCDs convertible in less than 18 months were considered quasi equity while convertibility after 18 months was deferred equity. The premium amount at the time of conversion in the case of a PCD as well as FCD and the time of conversion in the case of staged conversion in the case of FCDs and redemption amount, period of maturity and yield on redemption in the case of PCDs / NCDs were required to be stated on the prospectus. [The distinctions in the disclosure requirements between a FCD and PCD appear unwarranted since the parameters could have been applicable to both PCDs and FCDs.] Compulsory credit rating was required if the FCD was convertible after 18 months [Clause F (b) of DIPG 1992] and in the case of NCDs / PCDs with maturity of greater than 18 months [Clause F(f) of DIPG 1992]. The roll over of non convertible (debt) portion of a PCD as well as a NCD required to be at the option of the debenture holder and to be rolled over only on receipt of positive consent of the debentureholder [Clause F (i) of DIPG 1992], had to be preceded by a fresh credit rating six months prior to the roll over [Clause F(j) of DIPG 1992] and the letter regarding roll over had to be vetted by SEBI[Clause F(k) of DIPG 1992]. There were detailed provisions regarding the servicing and protection of the interest of debenture holders, which we do not discuss here since our interest in regulations relating to issuance of equity and convertible securities [Clause N(1) and N(2) respectively of DIPG 1992].

public investors in the debentures on conversion.[683] The stipulation regarding credit rating appeared to ensure that the promoters did not use conversion structures to use superior information to their advantage in structuring and exercising their conversion options. All convertible debt instruments were required to be compulsorily rated by approved credit rating agencies, irrespective of their maturity / conversion period.[684] This was subsequently modified to require that in the case of issues great than Rs 100 crores rating by two approved credit rating agencies was compulsory and all the ratings, including the unfavourable ones, were to be disclosed. Where rating was obtained from more than one agency, all ratings including those that had not been accepted had to be disclosed in the offer document. Further, all credit ratings obtained during the three years preceding the public or rights issue for any listed security of the issuer were to be disclosed. The issuer had to commit himself co-operate with the rating agency to provide rating watch.

6.4.2.3 Warrants and Options

Options and warrants are claims allotted to investors for subscribing to the equity share capital of the company. These could be exercised at the holders' option at a later date, contingent upon the occurrence of an event, or without any such conditionality, at a fixed price or at a price related to a benchmark such as a performance milestone. Usually these are allotted as performance incentives, as in the case of stock options. Options are also used extensively in structuring funding packages for early stage businesses for sharing risk and reward between entrepreneurs and investors.

[683] Preamble to Clarification No IV dated 21-9-1992
[684] Part C of Clarification No XXII dated 5-6-1998 vide RMB (DIP Series) Circular No 1 (1998-99) dated 5-6-1998]

Promoters of companies, who are owner-managers, may also use options to acquire shares in the company in case they find it financially rewarding to do so. Options may also be used to allow promoters to acquire shares at a later date when their personal liquidity allows them to pay for the same. Such a facility may be particularly useful for first generation entrepreneurs. Options may be allotted to the owner-managers even before the company makes a public offering and may be exercisable after the public offering has been made. In place of such options, a company may issue warrants. The financial impact of warrants is quite the same as that of options.

The other important feature of an option is that it provides the holder of the option to subscribe or not to subscribe. The purchase price of the shares is fixed in advance. He has the choice of purchasing the shares with the benefit of the information that the price has appreciated. In case the price has declined he can allow the option to lapse. Thus an option holder is at an added advantage over the investor who subscribes to the shares at a fixed price. It is this advantage that allows options to be abused by promoters.

The effect of such options, as has already been noted, is to reduce or "dilute" the share of the wealth represented by the company for the other shareholders who have not been allotted those options. The dilution impact may be estimated quite easily, albeit in a simplistic fashion, by reworking the value of the shares, assuming that the options are exercised by the option holders. If the price per share to be paid on exercise of the option is less than the value of the share at that time a transfer of wealth takes place, from shareholders who do not have the option in favour of the option holders.[685]

[685] In case the price is higher than the value a rational option holder would not exercise the option.

In order to plug the abuse of such warrants and options SEBI disallowed outstanding warrants or financial instruments of any other nature which would give pre IPO shareholders / promoters, right to acquire shares after the IPO. Further, presumably in an attempt to prevent promoters allotting themselves shares at a lower price through the exercise of warrants and options just prior to a public issue at a premium, it said that if the public offer was at a premium and if the warrants and options had been exercised within twelve months prior to the IPO, the shares so issued could be considered for the purpose of promoters' minimum contribution. Further, such shares were to be locked-in as per guidelines in force.[686]

The provisions relating to warrants and options raised several questions. What were the provisions relating to lock-in? Prior to the press release there were no regulations relating to the shares allotted on exercise of warrants and options. There was however a requirement that shares issued at par within twelve months prior to the IPO were to be locked in for a period of three years and that they would be ineligible for reckoning minimum promoters' contribution in the case of an issue at a premium.[687] In both those cases the promoters' shares were to be locked in for a three year period. If those were the provisions alluded to in this instance the applicable lock in would have been for three years.

In a related context, SEBI observed that "(T)he issue of instruments containing an option for conversion at a later date at a premium or

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[686] The provisions relating to issue of warrants and options have been based on Press Release dated 25-8-1994 cited in Taxmann's Corporate Laws (1998)

[687] Clarification No V dated 4-11-1992 and Clause L (a) of Clarification No V dated 4-11-1992. The two provisions related to different contexts but the spirit of the two requirements was to ensure that shares issues to promoters at par within twelve months prior to the public issue could qualify for promoters' minimum contribution only if shares were issued to the public on the same terms as the promoters.

otherwise will have to be treated as if the issue is being made at the time of the proposed public issue for purposes of computation of promoters' contribution, lock-in period, etc., and the guidelines as may be applicable to the companies covered by Section A, B or C of the guidelines are to be complied with."[688] The instruments referred to in the para include convertible preference shares, convertible debentures and warrants and so on.

6.4.3 Distribution of Issues

We have noted in Chapter IV that broadly, the distribution of shareholding can serve as a mechanism for aligning the interests of the owner managers and the external shareholders. Accordingly, we discuss these provisions under the mechanisms for aligning the interests of the owner managers and external shareholders. Further, we have noted in the previous chapter that the regulations provide for two sets of mechanisms that aim to influence the distribution of shareholding after a public offering. These are provisions intended [i] to directly influence the proportion between public shareholding, the shareholding of promoters and that of institutional investors outside of the promoter group and [ii] Provisions that optionally provide for allotment of shares to institutional investors. The economic significance of these two types of provisions has been discussed in Chapter IV. We now discuss the evolution of these provisions.

6.4.3.1 Firm allotments and reservations

The guidelines provided for firm allotments and reservations to four broad constituencies, namely, (i) employees, (ii) financial institutions

[688] Clause 1 of Clarification VII dated 10-8-1993

such as mutual funds and development financial institutions and (iii) promoting companies and their shareholders and (iv) promoters.

In the case of new companies the guidelines originally provided for reservations in favour of employees, promoting companies, associate companies and working directors on a "suitable percentage". Allotment on preferential basis was allowed in favour of shareholders of group companies in the case of existing companies and shareholders of promoter companies. Reservation for NRIs was based on schemes proposed by RBI from time to time.[689] The regulations did not propose any quantitative limits. The expression "suitable percentage" appeared to suggest that SEBI may have intended to specify the limits on a case to case basis, from time to time. Further, the rationale for limiting the reservation to some categories to certain types of issuers was also unclear.

A clear enunciation of the relationship between firm allotments, reservations and offer to the public, as given below, was first introduced into the DIPG much later. The definition appeared to have been in use much before it was spelt out in the DIPG. It is not clear if these requirements were spelt out in circulars to MBs, which are not examined as part of this review. The guidelines defined "Issue Amount" as the sum of "Promoters' contribution in proposed issue" and "Firm allotment" and "Offer through Offer Document". "Offer through the Offer Document" was defined as the sum of "Net Offer to Public" and "Reservations to Permitted Reserved Categories" and did not include promoters' contribution in the proposed issue and firm allotment. "Net Offer to Public" meant offer made to Indian public and

[689] Section H of DIPG 1992

did not include reservations / firm allotments / promoters' contribution.[690]

These definitions were significant as they set certain limits to the possible shareholding patterns of companies. Further, the requirements relating to minimum allotment to the public refer to the net offer to the public as a basis. As the definitions above suggested, the net offer was the issue made to the public and it made sense therefore to link these requirements to the same. In other instances, where appropriate, the regulations referred to the size of the issue for some purposes (such as staging of infusion promoters' contribution, calls made to various investors, trigger for monitoring utilization of proceeds by financial institutions).

We discuss below the evolution of provisions relating to each category of allottee.

Upto 10% of the proposed total issue of capital was to be reserved on a "competitive basis" for mutual funds[691]. Competitive basis was formally defined as "allotment of shares in proportion to the shares applied for by the concerned reserved categories. This was applicable where the number of shares applied for in any category exceeded the number of shares reserved for that category."[692] The shares were not

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[690] Regulation 8.4 of DIPG 2000

[691] SEBI spelt out details of permissible reservations out of public issues [Section H of Clarification No V dated 4-11-1992]. The clarification explained that the proposed details were "with a view to making available as much portion of the issue as possible to the public." Reservations were allowed out of the public issue for "permanent employees" including Indian working directors and permanent employees of companies promoting new companies (except employees of financial institutions where the financial institution was a promoter) [Clause H (3) of Clarification No V dated 4-11-1992], subject to a ceiling of 5% of the "issue size" and a maximum of 200 shares of Rs 10 each per employee as equity or on conversion of FCDs / PCDs (The notion of "net offer to the public" and "present issue amount" had been defined in a broad sense in a circular to merchant bankers. [RMB (GI Series) Circular No 7(93-94), dated 20-1-1994]. The same circular specified the basis of computing percentage of reservation, basis for reporting promoters' contribution and so on.).

[692] Note (a) to Section III of Clarification VII dated 10-8-1993

subject to lock-in but could not be disposed of in any manner other than through the secondary market.[693] Buybacks or standby or similar arrangements were not allowed with persons who receive firm allotments against reservations.[694]

The guidelines provided for a stock option scheme for employees as far back as 1992 subject to a limit of 5% and a maximum of 200 shares per employee.[695] The provision did not define "permanent employee". Since it included directors it may have been presumed to include contractual or covenanted appointments. It did not specify whether the Rs 10 per share was the issue price or the face value per share either.[696]

The basis for deciding the maximum number of 200 shares per employee has not been explained anywhere. SEBI has noted that the "equitable distribution of shares among the employees will contribute to the smooth working of the scheme."[697] That still leaves the question of whether a maximum limit of 200 shares was warranted since an equitable basis may not have meant fixing a low maximum such that the difference across people was too insignificant from an equity angle. Since the overall ceiling of 5% of the issue size had already been set, one of the possible explanations that may be speculated upon is that the provision appeared to ensure that the 5% allocation was not "cornered" by the promoters or other interested groups by allotting large blocks out of the overall limit to a small group of employees who were beholden to the group, or who may have even been used as

693 Clause I (i) of Clarification No III dated 13-8-1992. At the time these provisions were in force, MFs were not allowed to invest in the primary market other than through these reservations.
694 Clause (b) of Section C of Clarification No XIII dated 12-10-1995
695 [Section K of DIPG 1992].
696 At the time of this clarification Companies Act, 1956 provided for face value of Rs 10 and Rs 100 and did not have the current flexibility to fix face value at multiples of Re 1 as in S -----.
697 Taxmann's Corporate Laws (1998)

benami holders on behalf of the interest groups, a concern that has been articulated by SEBI at least on one occasion: (C)ompanies are hereby advised to ensure that the shares reserved under the employees' quota be allotted to the bona fide employees...and the shares remaining undersubscribed may be offered to the general public through prospectus."[698]. The limitation with an agency such as SEBI fixing the number was that allotment to employees was meant to be, inter alia, a reward for those employees whom the company valued. The maximum number may have come in the way of a distribution policy that was reflective of the company's assessment of the value of the employee. Since the overall limit had been fixed at 5% of the issue the individual limit appears to have been an instance of over-engineering the distribution of shares by SEBI.

The reason for limiting allotment to employees of promoting companies has not been explained anywhere either. Here again, it may be speculated that the presumption was that employees of promoting companies may have played a role in creating the new business and by providing them a shareholding in the new company they were rewarded for that effort. If the business had been retained in the promoting company and had not been spun off into a new company those employees (of the promoting company) who had been involved in developing that business would have benefited from the value of that new business entirely.

It must be noted that the idea of incentivising employees through share ownership in the company had not been well developed at the time of these provisions time and that these may have been the beginnings of such incentivisation mechanisms.[699]

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[698] Clarification vide Press Note No. 10 /14 / 92 – CL –V dated 14-10-1992 cited in Taxmann [1998]

[699] The first ESOP guidelines were announced in 1999

It was hardly a surprise when SEBI finally withdrew the limit on the maximum number of shares per employee and merely retained the limit of 10% for that category, three years after they had been introduced.[700]

Upto 10% of the "public offer"[701], subject to a maximum of 200 shares of Rs 10 each per share were allowed to be allotted to shareholders[702] of the promoting companies in case of new companies and shareholders of group companies in the case of existing companies.[703]

As in the case of allotment to employees, the provision in this case made a distinction between new and existing companies too. If the promoting companies or group companies had external shareholders, public or otherwise, the reservation could have been viewed as compensation to the public shareholders of those companies for giving up the opportunity to participate in the new project. If the promoting or group companies did not have external shareholders the beneficiaries of such firm allotments would have been the promoters themselves. This view assumed that the reservation was really meant for external shareholders. If the shareholders of the group companies were entitled to a firm allotment it was not clear as to why the firm allotment

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[700] Clarification No XIV dated 1-3-1996 w.e.f 4-4-1996

[701] The provision used the term "issue size" in the previous clause and "public offer" in this clause. While there appeared to be no formal definition of either term anywhere in the guidelines, it appears reasonable to presume that the terms had been used synonymously and were meant to suggest the total offer through the prospectus including reservations, firm allotments and net offer to the public.

[702] The provision did not clarify whether "shareholders" meant the first of the shareholders in the case of joint holding and whether in the case of joint holdings with different first holder in each folio in the register was to be treated as a distinct "shareholder". For the purposes of reckoning rights and entitlements in the case of bonus issues, company law would have treated "member" in this fashion. However, such an interpretation would have gone against the intention of the provision to pre-empt concentration of allocation in the hands of a few sets of individuals although it would seem that from a materiality perspective such an apprehension may have been practically far-fetched.

[703] Clause H (1)(b) of Clarification No V dated 4-11-1992

in new companies was to be limited to shareholders of the promoting companies.

NRIs and overseas corporates controlled by NRIs who paid for their subscription out of convertible funds, Indian mutual funds, foreign institutional investors and financial institutions were the other categories of investors entitled to reservations.[704] There were no limits to any of these categories. We could think of two reasons as to why there were no limits to these categories. Firstly, these investor categories may have been viewed as categories to which the issue was to be marketed in order to get subscription support. Hence issuers may have been allowed the freedom to set aside as much of the issue as they wished to. In contrast, reservations in the case of shareholders of group companies or promoter companies or employees may have been viewed as an incentive or reward as discussed earlier and hence the upper limit. The participation of mutual funds, financial institutions and FIIs may be also viewed as a certification of the offer at the proposed price. Finally, FIIs and MFs were both subject to investment limits which may have been meant to ensure that the reservations to these categories were not used as indirect means to increasing the promoters' holding in the issuer company. Financial institutions that were eligible in this category were essentially state owned or state controlled banks and (mostly developmental) financial institutions and hence the premise that these were unlikely to have served as proxies for private promoter groups.

Reservations under this clause were subject to a three-year lock-in,[705] which were then withdrawn. Interestingly, except in the case of firm allotments to MFs, there were no restrictions on the sale back of these

[704] Clause H (1)(c) to H (1) (f) of Clarification No Vdated 4-11-1992
[705] Clause H (2) of Clarification No V dated 4-11-1992

firm allotments to the promoters and hence these institutions may have been used as "parking mechanisms" for promoters with an intent to eventually buy the shares back at pre-determined prices and thus increase the promoters' shareholding in these companies.

In sum, the guidelines pulled in the categorywise limits of reservations and firm allotments as follows.

Reservations and firm allotments, including promoters' contribution were not to exceed 75%. Reservations / firm allotments were also subject to limits for each individual category as below.[706] Allotments by way of reservations out of the public issue to all categories except employees and shareholders of group / promoter companies were to be on competitive basis.[707] A similar set of limits by way of firm allotments was further provided for subsequently.[708]

Firm allotments[709], if any, were to be all locked in for a period of three years[710], which was withdrawn subsequently in the case of mutual funds, financial institutions, FIIs (including NRIs and OCBs) and employees of issuer companies). Presumably, in order to ensure integrity of pricing and pre-empt the use of incentives to garner support for firm allotments / reservations and / or the handing back of cash back to promoters and other "insiders" from the promoting companies who participated in these firm allotments / reservations, the guidelines

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[706] Indian and multilateral DFIs – 20% (ii) Indian mutual funds – 20% (iii) FII (including NRIs and OCBs) 24% (iv) Permanent / regular employees of issuer – 10% (v) Shareholders of group companies in the case of existing companies and shareholders of promoter in the case of new companies – 10%

[707] Part III of Clarification No VII dated 10-8-1993

[708] Part A of Section III of Clarification No VIII dated 10-10-1993

[709] The start date of the lock-in was not specified in the clarification but it would be reasonable to presume the start and end date prescribed in the other cases – later of allotment date or commencement of commercial production – may have applied in this case as well. This included firm allotments to financial institutions such as state level and national development institutions out of the public issue and promoters' quota [Clause I (ii) of Clarification III dated 13-8-1992].

[710] Section H of Clarification No II dated 16-7-1992

did not permit the payment of discounts and commissions by the issuer, directly or indirectly to the allottees of such reservations / firm allotments.[711]

These reservation limits were subsequently modified[712] to 20% each to MFs and FIs both on competitive basis, 24% to FIIs, 10% to eligible employees and 10% to eligible shareholders. Scheduled commercial banks were added to the list of institutions entitled to reservations / firm allotments under the category of Indian / multilateral developmental financial institutions. As before, employees and shareholders were subject to the maximum of 200 shares of Rs 10 each. The modifications further allowed the unsubscribed part of these reservations to be allocated to other categories, subject to the condition that the overall limit for that category was not exceeded. Similarly, unsubscribed portions from all of these categories were allowed to be added back to the public offer portion. Merchant bankers were allowed a reservation of 5%of the proposed issue size.[713] This was made mandatory in book built issues.

Investors in the firm allotment category [other than employees] and in the reservation category [other than employees and shareholders] were not allowed to apply in the net offer to the public category.[714] Unsubscribed portions from each of the reservation and firm allotment categories were allowed to be transferred inter se as well as to the net public offer category. So also spill over by way of excess subscriptions from the former were allowed to meet shortfalls in the net public offer in the case of under-subscribed issues.[715] Promoters were required to make good the shortfall arising from withdrawal from firm allotments

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[711] [Clarification No XV dated 17-4-1996]
[712] Clause 3.1 of Clarification No. VII dated 10-8-1993
[713] Clause 3 (b) of Clarification No XX dated 29-9-1995
[714] Clause 8.5 a (i) and (ii) of DIPG 2000
[715] Clause V of Section B of Clarification No VIII dated 11-10-1993

after the prospectus has been filed with the RoC, with the subscription amount to be brought in at least one day before the public issue. The shares thus brought in were to be locked in for a period of three years.

The percentages indicated in the provisions discussed above are with reference to the public issue component in the case of a composite issue.[716]

Limits on reservations to various categories of investors and employees were withdrawn finally in 1995. The limits in respect of shareholders and employees were to continue however.[717]

6.4.3.2 Size of Applications, Distribution of Issues, Oversubscription and Par Values

Yet another mechanism for regulating distribution of issues was providing for size of applications. A minimum number of 500 shares of face value of Rs 10 each or a minimum amount payable of Rs 5000 in the case of premium issues and convertible issues was initially prescribed.[718] These were reduced to 200 shares and Rs 2000 respectively in an apparent effort to make public offerings more accessible to a larger number of investors who did not have the resources to apply to issues with a larger minimum size of applications.[719]

The provisions also required shares to be allotted in tradable / marketable lots of 100 shares each.[720] Instead, "in order to encourage participation of small investors in highly priced public issues / offers for

[716] Clarification No V dated 4-11-1992
[717] Vide Clarification No XII dated 29-9-1995
[718] Clause 7.2 of Clarification No VIII dated 11-10-1993
[719] Clause 2 Part C Clarification No XVII dated 9-12-1996
[720] Clause 7.2 (iii) of Clarification VIII dated 11-10-1993

sale" the guidelines gave an option to the issuers to fix the minimum marketable lot on the basis of offer price subject to the condition that the marketable / tradable lot shall not be more than 100 shares.[721]

Yet another device for achieving the distribution objective was that of proportionate allotment. The guidelines contained provisions dealing with over-subscription.[722]

Subsequently SEBI seemed to have recognised that "the system of proportionate allotment enables body corporates / institutions to participate to a greater extent than the individual investors in a public issue." SEBI then went on to specify that "in the larger interests of investors in securities", while finalising the basis of allotment, the LMB responsible for post – issue work had to ensure that not less than 50% of the net offer to the public had to be allotted to investors who applied for 1000 securities or less and the remaining 50% to be made available to investors including corporates, institutions and individuals. The unsubscribed portion of retail investors was allowed to be allotted to institutional investors.[723] This was modified[724] to say that the proportionate system of allotments in the case of oversubscribed issues was subject to a reservation of the minimum of 50% of the net offer of securities to the public and the share due to the category of "small individual applicants"[725]. These were defined as individual applicants who had applied for less than ten marketable lots of shares or debentures or the securities offered.[726] The idea of small individual

[721] The guidelines prescribe lots of 100 shares for offer price up to Rs 100, 50 shares for the offer price in the range of Rs 101-Rs 400 and 10 shares for offer price greater than Rs 400.
[722] Clarification No VIII dated 11-10-1993
[723] Clarification No XI dated 29-5-1995, w.e.f. 1-6-1995. The guidelines provide a numerical illustration for this.
[724] Reg 7.6.1.2 of DIPG 2000
[725] Thus if the proportionate share due to that category was 70%, the allocation would be 70% and not 50% as clarified in explanation to Reg 7.6.1.1
[726] Clause 7.6.1.2.1 (a)

investor was modified thereafter to refer to "retail individual investor".[727] Retail individual investors were defined as those who applied or bid for securities of value of not more than Rs 50000.[728] This was subsequently increased to Rs 100,000.[729] These procedures were not to apply to book built issues.[730] The provision for reservations in book built issues has been traced separately as part of the discussion on the evolution of the book building regime. These provisions were modified substantially in 2003 and 2004 as follows. The term "small individual applicants" was replaced by "retail individual investor".[731] This harmonization of terminology must have finally helped some avoidable confusion that must have been an irritant in the guidelines until then for investors, issuers and intermediaries alike. The minimum application size as fixed and disclosed by the issuer[732] was made the basis for the allotment procedure in place of the previous method which decided the number of shares for applicants in each category of size as explained earlier. The minimum application size in turn was decided as Rs 5000-Rs 7000 per application, the number of shares corresponding to this sum being determined on the offer price per share.[733] The percentage reservation for retail individual investors remained at 50%. It was further clarified that in case the proportionate system resulted in an allotment of greater than 50% to investors who applied for less than 1000 shares they would get a share of greater than 50% and not be

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[727] vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003. Although the heading and the earlier part of the provision uses the term "small individual investor", clause 7.6.1.2.1 (a) which provided for the reservation used the term "retail individual investor". The inconsistency in terms appears to have been an oversight.

[728] Defined in Reg 1.2.xxiv (a) of DIPG 2000. Definition introduced vide SEBI/CFD/DIL/DIP Circular No 11 dated 14-8-2003

[729] Vide SEBI/CFD/DIL/DIP/15/2005/29/3 dated 29-3-2005

[730] Proviso to 7.6.1 of DIPG 2000

[731] Vide SEBI/CFD/DIL/DIP/12/2004/8/4 dated April 8, 2004

[732] The method for calculating this size was explained in Schedule XVIII. The method of calculating the minimum application size is provided in Schedule XVIII A. Schedule XVIII was modified vide SEBI Circular No SEBI/CFD/DIL/DIP/13/2004/28/5 dated 28-5-2004. Schedule XVIII-A was introduced vide the same circular.

[733] Reg 8.6.1 (iii) of DIPG 2000

constrained by the minimum.[734] The provision relating to book built issues remained unchanged.

SEBI also introduced a provision for issuing shares in smaller face value of up to Re 1 or multiples thereof, subject to the condition that a company could have a share of only one face value,[735] and further subject to requirements relating to disclosure and certain other procedural requirements detailed below.[736]

Apart from the reservations to investors out of the public issue the regulations tried to ensure a minimum amount of public holding in listed companies. The raison d etre for this has already been discussed in one of the earlier chapters.

The guidelines required that issuers comply with the provisions of SCR Rules, 1957[737] in terms of minimum offer to the public of 25% of the post issue capital in the case of IPOs and that not less than 25% of the issue size was to be offered to the public in the case of listed companies.[738] Exemptions were initially made in the case of infrastructure companies[739] and unlisted companies in the information technology companies, which were allowed to offer upto 10% instead of 25%. The latter category of companies had to satisfy certain

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[734] Circular PMD / PKN / 2390/96 dated 4-4-1996

[735] [Clause 3 of Part B of Clarification No XXV dated 11-10-1999 vide RMB (DIP Series) Circular No 2 (1999-2000) dated 11-10-1999

[736] All financial data affected by the changes in denomination of shares were to be clearly and unambiguously presented in the offer document. [ii] Comparison of financial ratios representing value per share and comparison of stock market data in respect of price and volume of securities were to be clearly and unambiguously presented in the offer document and [iii] the capital structure incorporated in the offer document were to be clearly presented, giving all the details pertaining to the change in denomination of shares. [Part E of Clarification No XXV dated 11-10-1999 vide RMB (DIP Series) Circular No 2 (1999-2000) dated 11-10-1999]

[737] Rule 19(2)(b) of the SCR Rules, 1957, as modified

[738] Clause 8.3.1 and 8.3.2 of DIPG 2000

[739] Clause 8.3.3; "infrastructure companies" have been defined in Clause 2.4.1(iii) of DIPG 2000

conditions to qualify for the exemption.[740] The rest of the issue was allowed to be allotted as reservations or firm allotments, subject to the relevant guidelines. Media / entertainment and telecommunication industries were added to the information technology sector later.[741],[742] The regulations made an elaborate endeavour made to define these sectors. Defining these industries must have been quite daunting, given the emergent nature of these sectors and the consequent preference among a number of firms to be claim to be in one of these sectors so as to avail of the flexibility in dilution. [We do not discuss these definitions, given the elaborate nature, their limited use from the point of view of our research and the fact that these were quickly rendered irrelevant.] The dilution requirement was then modified to 10% or 25%, as the case may be for all companies, both listed and unlisted, no matter what industry they were in.[743] Whether this resulted in a statistically significant drop in the extent of equity offered to the public following these changes in regulations, is an empirical issue. Unlisted companies were also allowed to seek exemption from rule 19(2)(b) in case shares of the unlisted company had been allotted to shareholders of a listed company, pursuant to a scheme of reconstruction or amalgamation under the provisions of the Companies Act, 1956 and where the scheme had been sanctioned by the High Courts.[744] This exemption was subject to a number of rules, the broad thrust of which is to ensure that [i] in place of listing 25% of the shares of the transferor they are allotted to shareholders of the listed company, achieving indirectly thereby a minimum public shareholding

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[740] Vide Clarification No XXVI in RMB (DIP Series) Circular No 3 [1999-2000] dated 15-10-1999. The conditions were [1] minimum of twenty lakh securities to be offered to the public excluding reservation, firm allotment and promoters' contribution and [2] minimum size of offer to public of Rs 50 crores.
[741] Vide DIP (Compendium) Circular No 3 dated 4-8-2000
[742] vide DIP (Compendium) Circular No 3 dated 4-8-2000
[743] Clauses 8.3.1 and 8.3.2 modified vide RMB (Compendium) Series Circular No 1 dated July 17, 2001
[744] Clause 8.3.5 of DIPG 2000, inserted vide RMB (Compendium) Series Circular No 1 dated 17-7-2001

and [ii] consequent to the scheme the shares transferred do not escape the minimum lock-in that they were originally subject to.[745] Finally, the guidelines required a body corporate making a public to have at least five public shareholders for every Rs 1 lakh of net capital offer made to the public.[746]

The distribution criteria were sought to be made a part of the access criteria by requiring that for an unlisted company to qualify for an IPO it was to have at least one thousand prospective allottees.[747]

6.5 Investor Protection

We have discussed briefly the idea of investor protection in the previous chapter and the measures that may be possibly conceived for the same. Broadly, the entire guidelines may be viewed as measures intended to protect the investor. However, certain specific provisions may be viewed as measures intended to protect the investor from actions that are outright and immediately harmful to investors. We trace the key regulatory elements of the latter kind in this section.

The provisions ranged from measures to prevent outright fraud on the part of issuers and their promoters to elimination of practices that would have impaired investor welfare in less egregious ways. For eg., the guidelines required that if the company made arrangements have to be communicated to shareholders.[748] Provisions were also enacted to prevent fraudulent encashment of refund orders.[749]

6.5.1 Payment Mechanism for Investors

[745] Various provisions of Clause 8.3.5 of DIPG 2000
[746] Vide SMD/RCG/JJ/1819/96 dated 15-5-96
[747] Reg 2.2.2A of DIPG introduced Circular No 11, dated 14-8-2003
[748] Section V of Clarification No VIII dated 10-8-1993
[749] Section VI of Clarification No VII dated 10-8-1993

- The guidelines specified requirements relating to the handling of stock invests. The purpose of stock invests was to ensure that investors did not lose out on the opportunity to earn a return on their funds while their application for shares was being processed. This was significant given [i] the relatively high cost of funds in those days [in excess of 12% per annum for one year bank deposits], the low likelihood of allotments given the high levels of oversubscription for many popular issues and the long time that it took investors to receive allotments or refunds [in excess of 70 days, most of the time. Stock invests fell out of favour because of their numerous limitations as well as their irrelevance in an environment where the conditions outlined earlier that made them useful had all changed. All provisions relating to stock invests were dropped in 2004, with the withdrawal of stock invests as a payment mechanism.[750]

6.5.2 Liability for wrong certification

These provisions comprised an assurance to the investor about the nature of information provided to them by the issuer with provisions that render the certifying party liable in case of negligence in such certification. For eg., the guidelines required that in addition to providing details of who constituted promoters and their individual shareholding, the issuer would provide to the SEs details of the Permanent Account Number, Passport Number and Bank Account Number of the promoters at the time of filing the draft offer documents to the promoters.[751] Similarly, to ensure that the securities had the benefit of dematerialized trading the LMB was required to ensure that the issuer had entered into an agreement with all depositories and also

[750] Most of these provisions were dropped vide SEBI/CFD/DIL/DIP/12/2004/8/4 dated 4-8-2004 and vide SEBI/CFD/DIL/DIP/14/2005/25/1 dated 25-1-2005
[751] Vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003

provide an option to subscribers to the issue to receive securities in a dematerialized form[752] and that in the case of unlisted companies trading was to be in dematerialized form only.[753] (The benefits of dematerialized trading have been discussed elsewhere in this thesis.)

6.5.3 Mitigating risk due to non availability of funds and diversion of funds

One of the important sources of risk was that the proposed project might not be completed due to non availability of funds, leaving the investor's funds stuck in half complete projects. The regulations had been aware of this issue for a long time. This was sought to be addressed in the following ways: [i] Disclosure of Investment Outlays and the means of financing for the same. These provisions have been discussed as part of the disclosure related requirements [ii] Underwriting [iii] Provisions relating to tying up means of financing [v] Mobilisation of promoters' contribution [vi] Disclosure relating to deployment of funds

6.5.4 Underwriting

All public issues had to be underwritten. Underwriting had to be to the extent of net offer to the public,[754] so as to ensure a minimum subscription of 90%.[755] The stipulation regarding underwriting was withdrawn subsequently "so as to reduce the cost of the issue' and the same was left to the issuer's option.[756] However, the issuer was

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[752] Vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000. This requirement was originally introduced vide Clarification XXV in RMB (DIP Series) Circular No 2, (1999-2000) dated 11-10-1999. This came into effect w.e.f 11-10-1999. This requirement was made a part of the eligibility criteria for a company to make a public issue.
[753] Clause 6.35 (c) vide Vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000.
[754] Clause D of Clarification No I dated 17-6-1992
[755] Clause D of DIPG 1992
[756] Press Release dated 12-10-1974 cited in Taxmann's Corporate Laws (1998)

required to refund the subscription amount if 90% of net offer to the public was not received from the public subscription[757], and in the event of under-subscription, subscription from the underwriter against their contractual obligations on devolvement and / or other sources could also be used to meet the minimum requirement of 90%.[758]

The regulations required that in case of non-receipt of 90% of the issued amount (receipts from public subscription and accepted devolvement from underwriters, taken together, within 120 days from the opening of the issue, the company was to refund the subscription amount in full.[759] The period allowed was reduced to sixty days from the date of closure of the issue subsequently. Simultaneous procurement of devolvement from other sources was also permitted, subject to disclosures being made in the prospectus.[760]

6.5.5 Securing Means of Financing

The DIPG introduced a provision in 2003 that required that a public or a rights issue of securities could be offered only if 75% of the financing other than through the proposed offering had been tied up.[761] The provisions perhaps intended that at least 75% of the financing was to be tied up although the provisions did not say so.

6.5.6 Mobilisation of Promoters' Funds

Given that the minimum promoters' contribution was a mandated requirement there could have been an incentive for the promoter to

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[757] This requirement did not apply to offers for sale vide Part D of Clarification No XVI dated 17-7-1996
[758] The option to approach other sources was added vide Clarification No XIX dated 14-5-1997
[759] Clause (b) of Section D of DIPG 1992
[760] Clause (I) of Part A of Clarification No XIX dated 14-5-1997
[761] Clause 2.8 of DIPG introduced vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003

misuse or divert funds from the public issue and show them as his cash contribution that the promoters were required bring to the business. While these would have involved deceitful means which would have constituted fraudulent acts, SEBI appears to have not ruled out this possibility, as suggested by the provisions below.

The guidelines initially required that the entire promoters' contribution was to be brought in before the public issue[762] and that the capital brought in was to be made fully paid up before the public issue[763], except in cases where the issue proceeds were subject to monitoring.[764] The requirement must have posed many practical problems, apart from leaving open problems of interpretation of terms such as "before the public issue".[765] After several clarifications[766] eventually this was simplified to state that where the promoters' contribution exceeded Rs 100 crores, the promoters could bring in fifty percent of their contribution, including premium if any, before the opening of the issue to the public and balance fifty percent to be brought in pro rata, before the calls on the public are made.[767] This was modified that in the case of issues of greater than Rs 100 crores, 50% of the contribution was to be brought in before the opening of the issue and the remaining pro rata, in advance, before calls are made on the public.[768] This was further relaxed by requiring that if the minimum

[762] Clause J (b) and J (c) of DIPG 1992
[763] Clause J of Clarification No.I dated 17-6-1992
[764] Clause (b) Section L of Clarification No II to DIPG dated 16-7-1992
[765] For instance did it mean the opening of the issue, closing of the issue, allotment of shares and so on? Given that issues took a long time in the early days, this difference could have been important.
[766] This requirement was subsequently modified as follows in the case of capital intensive projects with a large equity base" and "long gestation period" [Clause 2.1 of Clarification No VII dated 10-8-1993]. A deferred plan for bringing in the promoters' contribution if the premium charged for the project was not greater than the face value of the equity share was provided, subject to various conditions [Clause 2.3 to 2.6 of Clarification No VII dated 10-8-1993]. In all other cases the promoters' contribution had to be brought in before the public issue as per the guidelines. Neither the idea of a large equity base nor that of a long gestation period was defined.
[767] Clarification No XVII dated 9-12-1996, with immediate effect
[768] Clause 2.5 (a) of Clarification No VII dated 10-8-1993. The guidelines required the receipt of funds by the company to be certified by a chartered accountant and the allotment of

contribution exceeded Rs 100 crores a contribution of Rs 100 crores was to be brought in before the public issue and the remaining brought in on a pro rata basis as above.[769] The requirement of bringing in funds before the public issue was clarified as at least one day before the issue opening date.[770] As a further measure of protection, and presumably to pre-empt withdrawal of funds or diversion of the same to uses other than that stated in the project, the funds were required to be kept in an escrow account.[771]

6.5.7 Disclosure relating to deployment of funds

Where the issue proceeds were more than Rs 250 crores (increased to Rs 500 crores subsequently[772]) the issuer was to voluntarily disclose and make arrangements for the use of proceeds of the issue as per the disclosure. Such utilization was to be monitored by one of the financial institutions. A copy of the monitoring report was to be filed with SEBI by the institutions and the company for "purposes of record".[773] The prospectus had to provide details of the deployment of the use of promoters' contribution where it had already been brought in prior to the public issue and deployed.[774]

6.5.8 Safety Nets

A safety net provision had been made for original allottees upto 500 shares per allottee (increased to 1000 shares subsequently)[775].

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securities against the same to be evidenced by a resolution of the Board of Directors. [Clause 2.5 (c) of Clarification No VII dated 10-8-1993.] This was formally applied to all cases where the contribution exceeded Rs 100 crores vide Clause 1, Part C of Clarification No XVII dated 9-12-1996.

769 Vide Circular dated August 4, 2000

770 Clause 4.9.1 of DIPG 2000 as of March 2000

771 Clause 4.9.1 modified vide DIP (Compendium) Circular No 3, dated 4-8-2000

772 Section I of Clarification No II dated 16-7-1992

773 Clause I (a) of DIPG 1992

774 Proviso to Clause 4.9.1 modified vide DIP (Compendium) Circular No 3, dated 4-8-2000

775 Clause I, Part C of Clarification No XIII dated 12-10-1995

Details of such allotment were required to be disclosed in the prospectus, the scheme itself was to be valid for six months from the last date of dispatch of securities and the financial capacity of the person making the facility available was required to be disclosed in the prospectus.[776]

6.5.9 Integrity of Allotment Processes

The guidelines required that the LMB responsible for post issue obligations ensured that a public representative nominated by SEBI was associated in the process of finalisation of basis of allotment in the case of par issues with a subscription of more than five times and in the case of premium issues with a subscription of more than two times. This was subsequently withdrawn.[777] The onus of ensuring that the "basis of allotment was finalized in a fair and proper manner" now was transferred to the LMB and the RTI and the Executive Director or Managing Director, as the case may be, of the Designated SE.[778] The guidelines had provisions for allotment under a proportionate allotment procedure.[779] Previously, this requirement was limited to oversubscribed issues, until it was modified to the requirement noted above.[780] Further, the drawl of lots to finalise the basis of allotment, where required, (see discussion on allotment process) was to be done in the presence of a public representative on the Governing Board of the Designated SE.[781] Finally, the basis of allotment had to be signed as "correct" by the ED/MD of the Designated SE, the LMB responsible

[776] Clause 4 of Clarification No VIII dated 11-10-1993

[777] Deleted vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000.

[778] Reg 7.1 of DIPG 2000, modified most recently vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003 to replace Regional SE with the term Designated SE.

[779] Reg 7.6.1.1 of DIPG 2000.

[780] Modified vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000.

[781] Reg 7.6.2 introduced vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000 and modified vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003 to replace Regional SE with the term Designated SE.

for post issue obligations, the RTI and the public representative of the Designated SE (where applicable).[782] (The guidelines did not define "correct" but it would be reasonable to presume that it refers to compliance with the aforementioned provisions relating to the procedure for allotment.)

The existence of this provision clearly pointed to the likely existence of practices that were not fair to all investors in the allotment process. The prevalence of such practices has been noted in the financial press. The issue of fair play assumes significance for two reasons, if not more. One, the prevalence of under-pricing at the IPOs has been noted in the literature on Indian IPOs. Allotments at IPOs therefore mean nearly assured short term capital gains. Secondly, allotments may be used to "corner shares" and thereby get around the requirements of widespread shareholding under Rule 19(2)(b). The subsequent requirements relating to a minimum of shareholders after the issue[783] and the compliance with the condition for continued listing point to the possible abuse of the allotment process for the purpose of defeating the requirements of Rule 19(2)(b).

6.5.10 Quality Assessment

Among the most recent initiatives of SEBI for investor protection, companies have been allowed to opt for grading of the issue from one or more credit rating agencies. Where such grading was obtained, the issuer has been required to disclose all ratings, including those that have not been "accepted" by the company. Although the guidelines did not specify it is presumed that the grading had to be obtained from

[782] Reg 7.6.3 introduced vide SEBI Circular No RMB (Compendium) Series Circular No 2 (1999-2000) dated 16-2-2000 and modified SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003 to replace Regional SE with the term Designated SE.
[783] Reg 2.2.2A of DIPG 2000 inserted vide SEBI/CFD/DIL/DIP/Circular No 11 dated 14-8-2003

those credit rating agencies that are registered with SEBI.[784] We discuss the benefits of this in the previous chapter.

6.5.11 Certification

The responsibility for ensuring the accuracy of disclosures in the offer document was cast upon the LMB. By making it a part of the disclaimers in the offer document the regulations sought to establish a liability on the LMB towards the issuer for ensuring accuracy of the disclosure.[785] In addition to the due diligence certificate to be furnished along with the draft prospectus, the lead manager was also required to [i] certify that the amendments suggested / observations made by SEBI had been given effect to in the prospectus [ii] furnish a fresh "due diligence" certificate at the time of filing the prospectus with the RoC [iii] furnish a fresh certificate immediately before opening of the issue that no corrective action was needed and [iii] furnish a fresh "compliance certificate" before the issue is closed for subscription.[786] The LMB was required to certify that listed companies were complying with requirements relating to filing of periodic information and redressal of investor grievances.[787]

6.5.12 Issue related processes and logistics

6.5.12.1 Issue Process

The LMB was to ensure that one (or more than one RTIs, depending on the size of the issue), registered with SEBI was (were) appointed in

[784] Clause 5.6B of DIPG 2000 introduced vide SEBI/CFD/DIL/DIP/21/2006/24/4 dated 24-4-2006
[785] Reg 6.3.3. of DIPG 2000
[786] Clause 3 of Section C of Clarification No XIII dated 12-10-1995
[787] Clause 5.3.3.2 of DIPG 2000 introduced vide SEBI/CFD/DIL/DIP/19/2006/31/3 dated 31-3-2006

all public issues. The RTI was primarily and solely responsible for all the activities assigned to him for the issue management.[788]

6.5.12.2 Acknowledgement from SEBI

Initially the guidelines required that the acknowledgement card was valid for a period of three months from the date of issue of the same. Further, the LMB was required to ensure that the audited and unaudited statements should were not to be more than six months old from the issue opening date.[789] This was extended to state the issue was to open within a period of 365 days from the date of issuance of the observation letter, if any, or within 365 days of from the date of filing of draft offer document with SEBI in case no observation letter had been issued.[790] This period was subsequently reduced to three months from the relevant date.[791] The subscription list was to be kept open for a period of at least three days and disclosed in the prospectus.[792] The guidelines dropped the requirement of acknowledgement card in the case of body corporates with a three year track record or in cases where the issue was proposed to be listed with OTCEI.[793] The requirements of vetting of offer documents as well as obtaining an acknowledgement card were both dropped in the case of any issue of securities by a body corporate that "was otherwise eligible to make an issue of securities." The same modification mandated that all issue of capital through a public issue was to be managed by a Category I MB. The gap between the closure dates of various issues such as rights and the issue to the Indian public was not to exceed thirty days.[794] If the issue size was above Rs

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788 Clause 7.1 of Clarification No VIII dated 11-10-1993
789 Clause 10.1 of Clarification No VIII dated 11-10-1993
790 Part D of Clarification No XIX vide RMB (DIP Series) Circular No 5 (96-97) dated 14-5-1997
791 Vide SEBI/CFD/DIL/DIP Circular No 11 dated 14-8-2003
792 Clause P (a) of DIPG 1992
793 Clause I, Part C of Clarification No XVI dated 17-7-1996
794 Clause P (e) of DIPG 1992

250 crores the amount to be collected on application and allotment on various issues was not to exceed 25% of the total quantum of issue.[795] No retention of excess subscription was allowed.[796]

6.5.12.3 Timeline for opening and closing of issue

The time gap between the filing of the offer documents with RoC and the date of opening of the subscription list was reduced from 24 days to 10 days. The period of ten days was supposed to provide for the time required for both dispatch of application forms as well as public announcement of the issue. This time period was made applicable to all companies making an issue of capital to the public through a prospectus.[797]

6.5.12.4 Flow of Information

The guidelines provided for periodic flow of information to SEBI on the progress of the issue. Within 45 days of the closure of an issue a report in the prescribed form with a compliance certificate from the Chartered Accountant was to be forwarded to SEBI by the lead managers.[798] The frequency of reporting subsequently provided for a 3 day post-issue monitoring report and a 78 day post-issue monitoring report in the case of public issues.[799]

6.5.12.5 Oversubscription, Issue Size

[795] Clause I (b) of DIPG 1992
[796] Clause P (c) of DIPG 1992
[797] Circular No SMD / Policy / CIR-35/97 dated 22-12-1997
[798] Clause P (d) of DIPG 1992
[799] SEBI RMB (GI Series) Circular No 3 (1995-96) dated 26-7-1995 REFERENCE NOT LOCATED

The issue size was not to be greater than the amount specified in the prospectus and no retention of over-subscription was allowed "under any circumstances."[800] This was subsequently modified to provide for excess subscription that had to be retained to meet the requirement of shares while rounding off allotments in case of an over-subscription. Retention of up to 10% of the size of the offering was allowed for this purpose.[801] Eventually SEBI introduced the green shoe option in line with practices in other securities markets.

Presumably in response to the massive increase in applications and the consequent demand on the issue management infrastructure SEBI stipulated that applications had to be of a minimum number of 200 shares of face value of Rs 10 each per share or a minimum investment of Rs 2000 (including application, allotment and call monies) in the case of issues at a premium or other convertible as well as non-convertible instruments.[802] (It may be noted that the face value of denominations of Re 1 or multiples thereof had not been introduced at that time.)

Allotments in case of successful applications were to be in tradable lots and the size of the minimum tradable lot depended on the issue price per share.[803] The minimum application monies were to be not less than 25% of the issue price and applications could not be for less than the minimum marketable lot. In case of over-subscription, the number of shares were to be allotted in proportion to the extent of oversusbcription in that category subject to rounding off to the nearest

[800] Clause P (c) of DIPG 1992
[801] Clarification No VIII dated 11-10-1993 w.e.f 1-12-1993
[802] Clarification No VIII dated 11-10-1993, as amended by Clarification No XVII dated 9-12-1996 with immediate effect.
[803] The regulations provided for a lot of 100 shares for issue prices upto Rs 100 per share, 50 shares for issue price between Rs 101 and Rs 400 and size of 10 shares for a price of Rs 400 and above.

marketable lot size.[804] The provisions allowed for retention of an excess of 10% of the issue size, as noted earlier, so as to provide for the extra shares that were required for the rounding off.

6.5.12.6 Collection and distribution logistics

In an apparent attempt to ensure that application to a public issue was feasible for all investors, the guidelines required that the issue process provided for a minimum number of collection points where payments may have been made. This was initially fixed at thirty by SEBI.[805] Subsequently, in the case of issues whose size did not exceed Rs 10 crores this was modified to a minimum of the four metros and locations, which had stock exchanges within the region in which the registered office of the issuer company was situated.[806] This was further extended to all issues irrespective of size.[807] The regulations also provided additionally for collection agents who were allowed to collect the application monies in any payment form other than cash. The acknowledgement provided by such collection agents was considered valid under the guidelines. Applications from locations that did not have either a collection centre or a collection agent were to be sent directly to the RTI by a Regd Post Ack Due with the payment by way of stockinvests.

6.6 Price Discovery

Earlier in this analysis we discussed the evolution of the pricing regime and the disclosure of the price in the offer document. In this section

[804] Thus if the number of shares entitled on proportionate basis was 130 and the marketable lot was 50 shares then the applicant was to be allotted 150 shares. If the number allotted was 120 then the applicant would be allotted 100 shares.

[805] Clause 6 of Clarification No VIII dated 11-10-1993 w.e.f 1-12-1993

[806] Clarification No XII dated 29-9-1995 w.e.f 1-10-1995

[807] Clarification No XXIII vide RMB (DIP Series) Circular No 2 (98-99) dated 12-2-99

we discuss the provisions relating to the price discovery process and the provisions relating to the same.

The first set of book building guidelines were issued in 1996.[808] The key provisions of this set of guidelines were as follows.

The option to make a book built issue was provided to issuer companies which were making an issue of capital exceeding Rs 100 crores. This was extended to all body corporates otherwise eligible to make an issue of capital to the public.[809] Book building was envisaged as an alternative to firm allotments under the guidelines in force at that time and the book built portion was to be identified as "placement portion category" in the prospectus as opposed to the remaining (mandatory) 25% that was to be identified as "net offer to the public". Underwriting was mandatory to the extent of the net offer to the public in case of book building. The draft prospectus with all information except the price was to be filed with SEBI as per the SEBI guidelines in force; however the version of the same that was circulated to the institutional buyers who were eligible for the private placement as per the existing SEBI guidelines and to the underwriters was to carry the price band within which the securities are being offered. SEBI was to issue an acknowledgement card without mentioning the price or the price band. On receipt of the acknowledgement and determination of the issue price, within two days the prospectus was to be filed with the Registrar of Companies.

The issuer was to appoint one of the LMBs as Book Runner [BR]. The BR was to maintain a record of the names and number of securities ordered and the price at which the institutional buyer or underwriter

[808] Clarification No XIII dated 12-10-1995. References to specific provisions below relate to this clarification.
[809] Vide Clause 1 of Part B of Clarification No XVII dated 9-12-1996

was willing to subscribe to the securities under the placement portion. The underwriters were to maintain a record of the orders received by him out of the placement portion, aggregate the offers for subscription so received and intimate the book runner about the same. Institutional investors could also forward their orders, if any, to the BR. The BR was to determine the issue price on the basis of this information, provided that the price for the placement as well as the offer to the public were the same. Once the price was determined, the underwriter was to enter into an underwriting agreement with the issuer indicating the number of securities as well as the price at which the underwriter was to subscribe to the securities. Spillovers from both placement and retail sections could be allotted to the other category in the event of under-subscription in that category.[810]

One day prior to the opening of the issue the BR was to collect from the institutional buyers and the underwriters application forms along with the application monies to the extent of the securities proposed to be allotted to them. The BR had the option to require the underwriters to the net offer to the public to pay in advance all monies to be paid in respect of their underwriting commitment. The issuer had to open two different accounts for collection of application monies, one each for the private placement and public subscription portions. Payment of interest was allowed till the date of allotment or deemed date of allotment, provided interest payment was given uniformly to all applicants.[811]

Allotments for the private placement were to be made on the second day from the closure of the issue. In case the underwriters had to pay the amounts in advance the shares allotted in the private placement

[810] Vide Clause 3 of Part B of Clarification No XVII dated 9-12-1996
[811] Vide Clause 3 of Part B of Clarification No XVII dated 9-12-1996.

category were to be listed by the eleventh day from the closure of the issue. Securities allotted under the public category were listed as per prevailing statutory regulations. One implication of this would have been that the two sets of securities would not have been pari passu with each other, having been allotted on different days. This discrepancy was resolved by requiring that issuer was to have one date of allotment which was deemed to be the date of allotment for both the public as well as the placement portion of the issue.[812]

The first major revamp of the BB guidelines was issued in October 1997 with the announcement of the 100% BB facility. By a further modification in 1999, these guidelines, as amended, were made the only operative guidelines.[813] The guidelines of 1996 discussed above were rendered irrelevant.

Initially the 100% BB facility was open only to issues of Rs 100 crores or more. This was modified to extend it to companies with a paid up capital of Rs 25 crores or more.[814] BB was available only for the portion of the issue other than promoters' contribution and allocation made to permanent employees of the company, permanent employees of the promoting company in the case of new companies, shareholders of promoting companies in the case of a new company and shareholders of group companies in the case of an existing company either on a "competitive basis" or "firm allotment" basis. The guidelines introduced the concept of a Lead Book Runner [LBR], who had to be a Category I Merchant Banker, a requirement that was not there in the previous guideline. The other Category I merchant bankers were referred to as Co-Book Runners. However the primary responsibility of

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[812] Clarification No XVII dated 9-12-1996

[813] Clause 1 of Part A of Clarification No XXVII in RMB (DIP Series) Circular No 4 (1999-2000) dated 26-11-1999.

[814] Vide Part A of Clarification No XXIII in RMB (DIP Series) Circular No 2 (98-99) dated 12-2-99. These provisions are effective from 9-8-1998.

the building the book was to be that of the Lead BR. In case the BB process involved more than one LBR the rights, obligations and responsibilities of each had to be delineated.[815] The manner of engagement with the BRs and the salient aspects of the prescribed issue management process are in the footnotes below.[816]

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[815] Annexure I to Clarification No XVII dated 9-12-1996

[816] The BRs were to appoint as "syndicate members" SEBI registered intermediaries who were permitted to carry on the activity of an underwriter. The details of these syndicate members were also to be indicated in the offer document in addition to the details of other intermediaries such as banker to the issue, registrar and so on. [Annexure I to Clarification No XVII dated 9-12-1996]. As in the previous guidelines the draft offer document filed with SEBI had to provide all details except the price; but the size of the issue had to be mentioned in the draft prospectus. This was later modified as "either the issue size or the number of securities to be offered to the public, subject to compliance with the requirement of Rule 19(2)(b) of the Securities Contracts (Regulation) Rules, 1957 as modified from time to time". [Clause 2 (i) of Part A of Clarification No XXVII in RMB (DIP Series) Circular No 4 (1999-2000) dated 26-11-1999.] In addition, the documents were to also state that "The issue price had been determined by the issuer in consultation with the Book Runner(s), on the basis of assessment of market demand for the offered securities by way of book building".[Annexure I to Clarification No XVII dated 9-12-1996] This was in place of accounting ratios that would have constituted the basis for pricing in a non-book built issue.[Those disclosure requirements had been specified vide Clause 7, Clarification XIV, which dealt with the Basis for Issue Price.] The guidelines required that investors be provided more or less the same accounting ratios, but based on audited information. [These were [i] EPS pre issue for the last three years, adjusted for changes in capital [ii] P/E pre issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken) [iii] Average Return on Net Worth in the last three years [iv] Net Asset Value per share based on last balance sheet. These ratios were to be calculated after giving effect to increase in capital on account of compulsory conversions as well as exercise of options, if any.] [vide Annexure I to Clarification No XVII dated 9-12-1996] Additional disclosures with respect to the arrangements made for meeting the deficit in the means of financing and the pattern of deployment of excess funds were required by a later modification. [Clause 2 (i) of Part A of Clarification No XXVII in RMB (DIP Series) Circular No 4 (1999-2000) dated 26-11-1999.]
An additional 10% of the size of the offer to the public through the prospectus had to be compulsorily offered.

After receiving the final observations, if any, on the offer document from SEBI, the issuer company could issue an advertisement in an English daily with wide circulation, a Hindi national newspaper and a regional language newspaper with wide circulation at the place where the registered office of the issuer is situated. The advertisement was required to provide the following items of information. (i) Date of opening and closing of the bidding [not less than five days] (ii) The method and process of bidding [iii] Names and addresses of syndicate members as well as the bidding terminals for accepting the bids. A series of advertisements was required to be issued for a continuous period of three days in the same kind of newspapers as above, announcing the price, determined on the basis of bidding, as well as a table showing the number of securities applied for and the amount payable by the investor. These advertisements were to be issued such that there was a minimum gap of five days and the issue opening date. The advertisement may be issued before the filing of the offer document with the RoC. [Annexure IV to Clarification No XVII dated 9-12-1996, providing Model Time Frame for Book Building]

The guidelines had provisions regarding the bidding process. [Annexure II to Clarification No XVII dated 9-12-1996]

The BR was to maintain a final book of demand showing the result of the allocation process. The BRs and other intermediaries who were involved in the BB process were to maintain records of the BB prices. SEBI had the right to inspect the records, books and documents relating to the BB process.

The BR and the issuer company were to determine the issue price [also referred to as the cut off price], based on the bids received through the syndicate members and the number of securities shall be determined as the issue size determined by the price. In a later development, the issuer was permitted to fix a minimum bid size for the BB portion. [Clause 2 (i) of Part A of Clarification No XXVII in RMB (DIP Series) Circular No 4 (1999-2000) dated 26-11-1999.] All bidders whose bids are above the cut off price were entitled to allotment of securities. Investors were to be intimated about their entitlement immediately upon determination of the same. Investors who were entitled to allotment were not to be paid any incentive in cash or kind. Syndicate members were to enter into an underwriting agreement with the BRs indicating the number of securities they would subscribe to at the predetermined price. This arrangement did not cover allotments that were excluded earlier from the purview of the book building process. The BR was to in turn enter into an underwriting agreement with the issuer and be responsible for bringing in the devolved amount in case syndicate members defaulted. The final prospectus containing all disclosures as per SEBI Guidelines and including the price and number of securities proposed to be issued were to be filed with the RoC.

The offer to the public was to remain open for at least three working days after completing the requirement of advertisement and dispatch of issue material to the SEs. The guidelines prescribed that after the final observation has been received on the offer documents the requisite number of copies of offer documents and applications forms were to be dispatched to active members of SEs where shares listed as well as other to SEs. The forms and copies of offer documents were to be dispatched such that a gap of fourteen days is maintained between the receipt of the applications and the issue opening date. [Annexure IV to Clarification No XVII dated 9-12-1996 providing Book Building Model Time Frame.] The issuer was to arrange for collection of application forms by appointing mandatory collection centers, the number of such centers depending upon the size of the issue. Those investors who participated in the bidding and were intimated about their entitlement were required to submit the application form along with the application monies. Other individual investors who had not received intimation of entitlement or who had not participated in the bidding process may also make an application. Allotment was to be made no later than fifteen days from the closure of the issue failing which interest will be paid to investors @ 15%. [It is presumed that the rate was per annum; the guidelines were not explicit about this.]

At least 10% of the issue was reserved for individual investors who had not participated in the bidding process or had not received intimation of entitlement to allotment. [The guidelines clarified that those who had bid and received intimation of entitlement were not eligible for this 10% allocation.] The 10% allocation was with reference to the net offer to the public; net offer was defined as the post issue capital in an IPO or the issue size in the case of a listed company making a further public issue less the promoters' participation. The shares issued under this category were considered to be in excess of the original offer. The number of securities being allocated under this category had to be added to the base initially proposed [i.e., without taking into account this 10%] paid up capital (in the case of an IPO) or the issue size (in the case of a follow on public offering) as the case may have been. The minimum promoters' contribution had to meet the norms required under DIPG [Clause 4.1 and 4.3 of DIPG 2000 respectively for IPOs and FPOs] on the basis of these enhanced number of securities to be issued. [Annexure II to Clarification No XVII dated 9-12-1996] In the case of an IPO by way of an OFS the issue size did not get increased since the size of the paid up capital did not get altered by these allocations. [Annexure III to Clarification No XVII dated 9-12-1996] Further, 15% of the issue size was to be reserved for individual investors applying for up to ten tradable lots through syndicate members. [Although the guidelines used the term "issue size" as the basis for calculating 15% reservation for this category, the actual reference point was the post issue capital as provided in the clarificatory example in the guideline. - Annexure III to Clarification No XVII dated 9-12-1996]. Allotment to investors under these reservations was on a proportionate basis.

Chapter VII

Issuance Activity in the Primary Market: Trends and Outcomes

The focus of this thesis is on an economic analysis of the current regulatory regime and tracing important developments in the evolution of the same. Our assessment of the regulation informs us that as it stands currently the regulation has adequate provisions to enable the efficient functioning of the market. While scope for improvement and efficiency gains remains, it has to be acknowledged that several important changes have been initiated over the years to improve efficiency.

Our review needs to be complemented by asking three related questions. First, have the regulations led to the market outcomes intended or desired by the regulator? Second, have these initiatives been cost efficient? Third, have the market outcomes attributable to these regulatory initiatives enhanced efficiency in a Pareto sense or in a Hicks-Kaldor sense?[817] All of these are complex questions and require considerable research effort. This chapter examines data from the issuance activity in the primary market to see if there are broad patterns across the years that might suggest that the regulations may have led to market outcomes intended by the regulation. These patterns may thereafter be further examined more rigorously thereafter.[818] We try to relate the trends, if any, across the years to

[817] In his book on Company Law, (Company Law: Theory, Structure and Operation, Clarendon Press, U.K., 1997.) Brian Cheffins suggests that policy in the realm of securities regulation might target Hicks-Kaldor optimality. Under Pareto optimality the welfare of all concerned has to be enhanced to yield a superior outcome in terms of welfare. In the Hicks-Kaldor paradigm the welfare of the system or community as a whole is enhanced while not every individual constituency might gain. In the context of securities regulation investors might appropriate most of the gains from an improvement in welfare of the community, leaving behind issuers and intermediaries, who are the other main constituencies.

[818] In empirical work, prior to analyzing the data using econometric or statistical tools, it is a common practice to examine whether the data suggest the existence of evident patterns. In this chapter we conduct a simple analysis of the data using rudimentary statistical parameters.