<u>Regulation of Public Offerings of Equity Shares and Convertible Securities in India</u>

<u>Overview of the Thesis</u>

Public offerings of securities constitute an important means of raising capital for companies in a market economy. They are also useful as a liquidity mechanism for investors who subscribe to the shares of a company in its formative stages. Well developed markets for public offerings, commonly referred to as primary markets, provide a supply of securities for the secondary market to trade in. Thus, public offerings are essential for the development of the secondary market. In sum, there are compelling grounds for creating and sustaining a well-functioning market for public offerings of equity shares and securities convertible into equity shares.

Securities markets require an institutional framework for their orderly functioning. The history of securities markets is replete with instances of markets collapsing due to abuse by its participants, in the absence of institutions that govern their conduct. The form that these institutions take and the role they play may vary however from one country to another.

The market for public offerings poses issues that are characteristic of any market for securities. It also poses certain problems that are unique to it. A considerable body of empirical research is now available to suggest that some, if not many, of these problems that are unique to the primary market are nearly ubiquitous and persistent across time. Institutions may be useful in mitigating some of these problems, even if they cannot be eliminated completely.

The Indian primary market, like primary markets elsewhere in the world, is not homogeneous in terms of its constitution. For eg., broadly there are two segments, namely the market for debt and the market for equity and convertible securities. Our focus is on the market for equity shares and convertible securities because of its unique and interesting economic features.

The Indian market for public offerings of equity shares and convertible securities is as old as the Indian securities market itself. Its record however has not been consistent on many counts. The extent and style of regulation of the India primary market have also varied over time. Since 1992 it has been regulated by the Securities and Exchange Board of India (SEBI). Prior to the establishment of SEBI the Indian capital market was regulated by the office of the Controller of Capital Issues (CCI). The CCI exercised such sweeping powers which regulated every aspect of the functioning of the capital market that the scrapping of this institution and the establishment of SEBI in its place may well be considered a watershed in the evolution of the Indian market.

In our attempt to develop an appreciation of the economic aspects of SEBI's regulatory activity with regard to the public offerings of equity shares and convertible securities we did not come across a framework that enables us to critique its functioning. As a first step in our endeavour to evaluate the effectiveness of SEBI's regulations governing the primary market, in this thesis we develop a framework based on currently available literature. We view this synthesis of the knowledge from across these fields to develop an integrated framework as one of the more important contributions of this thesis. We then apply the framework to the extant SEBI regulations governing the public offering of equity shares and convertible securities to examine whether the regulations meet the requirements that emerge from the framework.

The SEBI guidelines deal with public offerings of all kinds of securities by all types of issuers, both first time issues and subsequent issues. This is true of regulations in many countries. Of these, the first issue of its equity shares, by a company, for public subscription, commonly referred to as an Initial Public Offerings (IPO), poses economic puzzles that have intrigued economists for many years now. We find the policy implication of these puzzles especially interesting and of great practical consequence for the efficient functioning of markets.

Given the interesting features of the IPO market and the voluminous literature available in this area, we end up with a conscious drift, in our analysis, towards the market for IPOs in many places although the regulation of the public offerings of equity and convertible securities overall is the primary focus of this thesis.

The outline of this thesis is as follows. Chapter I discusses the significance of financial systems. Chapter II briefly discusses the various approaches to the regulation of financial markets, in general and that of securities markets in particular. Chapter III builds on Chapter II to provide an overview of the regulatory strategy governing securities markets as a whole in India. Chapter IV develops a framework for the regulation of public offerings of equity shares and convertible securities, an important segment of the securities market and the focus of this research. Chapter V assesses the current state of regulation of public offerings of equity shares and convertible securities in India, specifically the SEBI regulations. Chapter VI traces the evolution of the key elements of SEBI's regulation of Indian primary markets from its beginning in 1992. Chapter VII analyses the issuance activity in the market for public offerings of equity shares and securities in India since 1993-94. It examines whether the descriptive statistics suggest any patterns that may be considered to be the result of the evolution traced in Chapter VI. These could then constitute the basis for further empirical work on the effectiveness of one aspect of the regulation of securities market in India. Chapter VIII concludes with a few key observations and suggestions flowing from our research.

This thesis fills a part of the gap in research on public offerings in India, in general, and on Initial Public Offerings (IPOs) in particular. Research relating to the Indian context so far has focused essentially on underpricing of IPOs, with a limited emphasis on the institutional features prevalent at that time. Our understanding of the institutional arrangement prior to embarking on this research led us to believe that the institutional arrangements in India have been dynamic and that many market outcomes, including under pricing, may be attributed to those institutional developments. Further, there are several other dimensions to the primary market beyond underpricing and long run underperformance. Those other aspects have so far been examined by scholars in the field of law, with much of the emphasis being on the legal aspects.

As a first step in this direction it is important to understand the institutional changes in detail. This will serve as the starting point for further empirical research that can examine the effectiveness and efficiency of regulatory institutions in India. From a public policy perspective this work will provide some insights to Securities and Exchange Board of India (SEBI) and other policy formulating bodies as they embark on reviewing and possibly recodifying the regulations governing the market for public offerings of equity shares and convertible securities in India.

A Note on Sources and Methodology

The focus of this analysis is on the financial / economic aspects of the regulation and not so much on the legal nuances and interpretations. The objective is to (i) identify and critically examine the important provisions of the regulation as it stands presently and (ii) trace major milestones in the evolution of the regulations and examine their economic rationale so as to eventually examine whether these developments have had any impact on the functioning of the market.

The main sources of law applicable to the securities markets are

- The Acts of Parliament, as amended. In this case these are the Companies Act, 1956, Securities Contract Regulation Act, 1956, SEBI Act, 1992 and the Depositories Act,1996
- The rules and regulations under the various Acts
- The administrative circulars under the various statutes
- Judicial pronouncements by various Courts of Law
- Guidelines to regulate various aspects of the functioning of the securities market, promulgated by agencies such as SEBI
- Standardised contracts such as the Listing Agreement between SEs and issuers

We limit our analysis to a study of the main Acts, the relevant guidelines issued by SEBI and the standard listing agreement.

This research, as the title suggests, is confined to the regulation of primary market; even within that area it is further confined to the issue of equity and convertible securities in the primary market. The thesis is intended to be a starting point to enable further empirical assessments of the regulatory activity of SEBI in this area.

It is worth noting that both the Companies Act and the SCR Act are acts of the Indian Parliament and are therefore part of the laws of the land. The regulations enunciated by SEBI, on the contrary, are "subordinate legislation". Thus, in the event of a conflict or inconsistency between the provisions of the SEBI regulation and the formerly mentioned acts of parliament the former acts would prevail.

The survey focusses on the economic aspects of the regulation rather than on the jurisprudential. However, we try to ensure that in broad terms our interpretation of the economic aspects would not be overturned by a jurisprudential interpretation of the same.

The approach adopted has been as follows. Based on existing literature we first develop a framework for understanding the role that regulation may play in the Indian primary markets. We then study the provisions relating to the issuance of securities, from the sources identified above, especially those relating to equity and convertible offerings, using the framework.

While paraphrasing we capture as much of the details of the provisions as possible. It is our belief that the details of regulations matter and influence market outcomes. Hence we pay considerable attention to the details. These details also help us comment on the provisions more authoritatively.

The analysis of the provisions is presented in the main body of the thesis. Regulatory provisions, paraphrased from the original text of the provisions, are presented in footnotes. Relevant references are presented alongside the provisions. Where appropriate we also provide our observations on or interpretation of the rationale for the provisions.

We use the term company specifically to denote companies with unlimited liability as well as those companies where the liability is limited. We do not use the term to cover other forms of incorporated bodies provided for in the Indian legal regime. We avoid using the term firm to include companies since under Indian law the term "firm" is more commonly used to refer to unincorporated business entities such as partnerships and proprietorships. The term "listed companies" in this thesis refers to companies whose shares are listed on a stock exchange. Our usage of the term implies that the company is also a public company as defined under Companies Act, 1956.[1] We consider this appropriate because under current Indian law companies cannot list their shares on a stock exchange without offering the same for public ownership.[2] Similarly, our use of the term IPO implies that the company's equity shares have not been listed until then. In other words, we imply that all IPOs have to be made by companies whose shares, or securities convertible into equity shares, would not have been listed until the IPO. It is possible for a company whose shares have not been listed to offer their debt instruments on a stock exchange under the SEBI guidelines. Companies which list only their debt instruments, without listing their equity shares, would still be referred to as unlisted companies in this thesis.

[1] Section 3 of Companies Act, 1956

[2] Certain markets offer the option to "introduce" shares as a listing mechanism without a public offer. Once the shares have been introduced, a market for the shares may develop based on investor interest.