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A Survey of the Regulation of Public Offering of Shares and Convertible Securities in India

by

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A Survey of the Regulation of Public Offering of Shares and Convertible Securities in India[1]

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ABSTRACT

The idea of regulating public offering of securities typically brings to mind the Disclosure and Investor Protection Guidelines, 2000 (DIPG) of the Securities and Exchange Board of India. In addition to the DIPG, which governs the conduct of Indian issuers, there are distinct laws governing the corporate financing aspect of securities offerings as well as the decision to list a security for public trading. Further, a slew of regulations have evolved on account of the number of specialist agencies who manage specific aspects of a modern public offering, which in itself is a complex process of producing, certifying and disseminating information. The regulations seek to minimise the risk of opportunistic behaviour or mere indifference on the part of the various participants in the issue process. Using a simple framework based on literature in the fields of corporate finance, initial public offerings and securities regulations this paper surveys the various agencies involved in the public offering process in India and the purpose that these regulations might possibly serve. The survey could be a useful first step towards further research into the evolution and the impact of these institutions on the development of the securities market in India.

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The importance of regulation to the functioning of securities markets in general and the role of institutions such as Securities and Exchange Board of India (SEBI) has been examined in some detail in Sabarinathan (2003).

This paper focuses on the current regulation of public offering of securities in India, in particular equity shares and securities convertible into equity. In particular, the paper focuses on the regulation of public offerings of securities as part of a broader endeavour to understand the regulation of primary markets.[2, 3]

What is a public offering?

The term public offering has a fairly precise definition under Indian law. A company which has already issued equity share capital is required to offer its subsequent issuance of equity shares to existing shareholders in proportion to their shareholding in the company.[4,5] These are known as rights offerings. Any offering other than on a rights basis will require the permission of the shareholders of the company in the case of a public company and that of the Board of Directors in the case of any other company such as a private company.[6] Public offerings are also distinct from rights offerings in that they require the issuance of a prospectus,[7] thus attracting disclosure requirements that are different from that of a rights offering.

How do firms go public?

A public offering of securities may take various forms. Companies that are closely held or privately owned could make a public offering for the first time, also known as Initial Public Offerings (IPOs). Companies that are already listed could make one or more subsequent offerings, also referred to as Seasoned Equity Offerings (SEOs). Both seasoned offerings and

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[2] The primary market is that part of the capital market where companies offer their securities to public investors for the first time, as opposed to secondary markets where investors trade securities they already own. (Harris: 2003)

[3] The focus of this paper is on the financial / economic aspects of the regulation and not so much on the legal nuances and interpretations. In order to limit the paper to a manageable length we present our comments and observations on the various provisions in the main body of the paper. Regulatory provisions, paraphrased from the original text of the provisions, are presented in footnotes. Relevant provision references are presented alongside the provisions.

[4] S 81 of Indian Companies Act, 1956

[5] References to sections, clauses and provisos follow standard Indian legal terminology.

[6] S 81(1) of Indian Companies Act, 1956

[7] S.... Of Indian Companies Act, 1956

IPOs could be by way of offering of existing securities by incumbent shareholders, also known as offer for sale (OFS) or by way of issuance of new securities. The regulations discussed here cover all these different forms of public offerings.

The relevance of IPOs

From a policy planner's stand point IPOs are important because they help companies raise capital from the public at large[8] as well as augment investment opportunities in the secondary market (Draho:2004).

To the issuing firm, other benefits of IPOs include an important exit mechanism for venture capital (VC) investors (Black and Gilson: 1998), for entrepreneurs (Zingales 1995), inspiring faith in the firm among creditors, investors, customers and suppliers (Loughran and Ritter: 2002), providing currency for acquisition as in the case of internet companies (Schultz and Zaman: 2001) or simply for realising better valuations for their businesses (Pagano, Panetta and Zingales: 1995) or to create an avenue for incumbent owners to divest their holdings subsequently or attract better managerial talent. Draho (2004) reviews literature which suggests that going public results in the better marketability of shares through greater visibility to investors and analyst coverage, liquidity and the possibility of providing stock options which in turn help attract high quality managerial and engineering talent.

The Process of Going Public

The process of going public varies from country to country and is a function of the institutional features prevalent in that country. However, in most regimes, the going public process starts with a decision by the Board of Directors of the company and therafter by the shareholders to offer the shares to public investors and list the shares for trading on a stock exchange. Companies need to ensure that they qualify to make a public issue under the prevalent regulations. Listed companies

[8] Some scholars such as Mayer [1990] and Pal [undated] have expressed doubts about their importance as a source of corporate finance in the European and Indian context respectively.

are bound by the continuing disclosure norms under the listing agreements to inform the SE(s) of the issue.[9]

The process of going public is informationally intensive in terms of production, dissemination and certification of quality of information. The other central concern is that of making commitments to governance and monitoring which will help minimize the agency cost in raising capital. The information produced in the process impacts the valuation of the shares and therefore the return to incumbent shareholders. It also affects the product market as competitors evaluate and respond to the strategic implications of the public issue by the firm. The company appoints a merchant banker (MB) who plays an important role in managing this process as we shall see later.

In the first stage the issuer produces a formal set of documents detailing the offer and providing information on the financial outlook for the issuer which will enable the investor to value the shares as well as negotiate a contract that will govern the investment relationship. Thereafter the issuer and the MB engage in a communication programme in the form of meetings with prospective investors, commonly known as roadshows.[10] These meetings are also used to assess the "investor appetite" for the proposed offering, the likely demand at various price levels, inputs on similar and other offerings that are scheduled to open around the time proposed for the offering since they might compete for investor funds and so on. (Benveniste and Wilhelm:1997 and Srinivasan: 2003) The feedback from prospective investors is also used to design contracts that will address investor concerns about agency issues.

Once the issue opens again there is a considerable exchange of information. Investors could potentially recalibrate their assessment of the prospects for the issue by observing the response to the issue from other investors. The method of allotment may also impact the investor response. Allocations of large blocks for sophisticated institutional investors may signal the intention of the issuer to subject itself to the monitoring and governance expectations. Purely proportionate allotment systems without any constraints may tilt the allocation in favour of large institutional bidders.

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[9] Clause 41 of the listing agreement. Listing agreements have been considerably standardised in the past decade thanks to the regulatory oversight of SEs by SEBI. The continuing disclosure requirements in question here are as mandated by SEBI and enforced through the SEs.

[10] The format of roadshow meetings varies across markets. Usually it is a combination of one on one meetings with investors and small conferences with groups of investor at various locations.

Post closure of issue, the allotment and post allotment processes are important from preserving investor confidence in the integrity of the system.

Issues of Corporate Finance in firms going public

Companies would like to go public only if they or the selling shareholders, as the case may be, are sure that the price paid by the investor would be equal to the present value of the cash flows that the investor will receive from the investment. [REF]

Information asymmetry problems (Myers and Majluf: 1976) and the difficulty in signalling the quality of disclosures (Akerlof: 1970 and Black: 2000) adversely affect the valuation of securities. Agency costs may also affect the valuation in the form of inadequate effort on the part of managers, or worse, managers seeking private benefits of control over the cash flow of the firm by investing the same in pet projects or in by consuming costly perquisites in ways that destroy shareholder wealth. (Jensen and Meckling: 1977)

Smith (1986) finds that the "announcement effect" in the form of negative returns is higher in the case of equity issuances than in the case of issuance of preference shares or convertible securities, where the impact of information and agency problems is perhaps most profound.

A third factor that affects the prospects for raising equity capital in the case of businesses without much operating history is the difficulty in valuing the business. If the company is in a new industry valuation becomes even more daunting. Information and agency problems in such companies are even more severe.

Black (2000) points out that in the absence of ways of dealing with these concerns good quality issuers will be deterred from issuing securities in that market due to concerns about undervaluation. Poor quality issuers who are not concerned about valuation issues and who float enterprises primarily for the private benefit of control or simply for misappropriating share capital will anyway make issues of security. Thus, due to the twin effect of absence of quality issuers and the presence of poor quality issuers the securities market could slip into a lower level separating equilibrium. Glaeser, Johnson and Shleifer (2001) illustrate how equity offerings dried up in the primary market in the Czech Republic in the absence of appropriate institutions.

Another possible outcome has been described as the "export of primary markets" in Nayak ( ) as issuers "piggyback" on the regulatory regimes of other markets.[11]

Mechanisms to address the issues

Several ways have been suggested to mitigate the twin problems relating to information and agency costs and their consequences to the securities markets.

The standard market based approach suggested has been to leave it to the company to disclose credible information to the investor. These follow from challenges to the effectiveness of mandated disclosure, starting with Benston (1973), Easterbook and Fischel (1996) and Romano (1998). The payoff to the issuer in disclosing voluntarily is the reduction of the cost of information asymmetry in the form of underpricing of shares.

However, disclosure is costly (DeAngelo; DeAngelo and Rice: 1984).[12] A mandatory disclosure regime may mitigate the consequent risk of underproduction of information.
Black [2000] suggests that certification by "reputational intermediaries" such as investment bankers (Carter and Manaster:1990, Megginson and Weiss: 1990) and auditors (Beatty: 1989) can bridge this gap in credibility.

The problem of agency cost may be addressed through a system of incentive compensation involving share ownership by managers of the company (Holmstrom and Tirole: 1993) or by adopting governance structures such as Boards of Directors with an independent majority. However, incumbent managers may entrench themselves by appointing to the Board "independent" directors who are favourably disposed to the incumbent managers.

Delegated monitoring by a bank (Diamond: 1984) or strategic partners who are shareholders could result in extraction rents in the form of privileged deals with the issuer or encourage the

[11] "Piggybacking" involves issuers riding on (presumably) more investor friendly regimes of other countries to access their capital markets. It was originally developed in Coffee (1999). The possibility of piggybacking has been examined in some detail in Black [2000].
[12] Primarily these costs comprise the cost of filing information under the various disclosure regimes and may be categorized into (i) out of pocket costs of information production (ii) the value of management's time spent in overseeing the production of information as well as communicating these to intermediaries in the capital market such as securities analysts and (iii) reduction in form value due to disclosure of valuable information otherwise unavailable to the firm's competitors. While these cannot be measured easily and may vary across firms considerably, the direct costs can be more easily measured.

management to be risk averse as has been observed in some bank centric financial systems like in Germany. [REF] The alternate mechanism of mitigating agency cost, namely, direct monitoring by seeking progress reports and / or periodically reviewing the operations is costly and requires specialized skills requires large shareholders such as venture capitalists, who enjoy benefits of scale as well as can capture the benefits unlike small, dispersed shareholders who may be deterred by free riding concerns.(Barry et al: 1990, Gorman and Sahlman: 1989, Sapienza: 1992 and Sahlman: 1990) However, the evidence on performance of Indian financial institutions in monitoring and ensuring corporate governance does not appear to support this view (Patibandla: 2005) whereas Goswami (2000) claims that companies in which foreign institutional investors are shareholders appear to have a better governance record.

Implementation alternatives

The mechanisms discussed above may be implemented to varying extent in the forms of private contracts between issuer firms and investors. But the cost of enforcement and the lack of adequate contracting and skills may simply make it unattractive and lead to an overall failure of the securities market. La Porta, Lopez-de-Silanes and Shleifer [2002] (or LLS, hereafter) point that out general law and private contracting are insufficient to keep promoters from cheating investors because the incentives to cheat might be too high for "long run" benefits of honesty to matter and because private litigation may be too expensive and unpredictable to serve as a deterrent.

The other alternative would be to develop a set of regulations based on these considerations. The regulations would then provide for a common contractual framework between issuer and investor. To reduce enforcement costs and opportunistic behaviour by managers, a regulatory and contracting framework dictated by securities laws is required. (LLS:2002).

Regulations can standardize the disclosure of information as well as organization of litigation against non-disclosure. Securities laws may mandate the specifics of information that needs to be disclosed such as ownership, compensation, self-dealing transactions and other material

information that may be of interest to an average investor may be included in this. LLS (2002) identify a few such disclosure requirements.[13]

Thus our discussion of the IPO regulation regime is based on a framework built on following principles: (i) Better disclosure leads to an active securities market where issuers raise equity capital cost effectively (ii) Issuers commit themselves to high standards of governance through governance structures (iii) There are collateral institutions such as reputational intermediaries such as investment baking and accounting professionals, with appropriate incentive mechanisms in place. (iv) These mechanisms are provided for and enforced through public regulatory system and (v)At the core of the regulatory system is a suitably empowered regulatory agency with the powers to draft regulation, monitor and enforce

In this paper we identify the principal institutions / players at each stage of the public offer process and the roles they play. We then survey the elements of regulation governing the activity of various categories of participants. We confine ourselves primarily to regulations governing the securities markets.[14,15]

We survey regulatory provisions under one or more of the following heads: (i) Provisions specifying criteria of merit for firms or individual economic agents to qualify to participate in the market in any capacity (ii) Provisions relating to disclosure and certification of the same (iii) Provisions to align interests of managers / owner managers to that of external shareholders (iv) Provisions relating to the distribution of securities issued (v) Provisions governing the contractual relationship between the various parties concerned: (a) Shareholders inter se, and (b) Issuer and intermediaries involved in the management of the issue, and (vi) Provisions for mitigating various risks that investors could be exposed to while applying for the shares as well as after they have been allotted shares (vii) Provisions relating to the management of the issue process.

[13] These are (i) directors' share ownership and compensation since compensation is an important source of self-dealing (ii) whether contracts outside the ordinary course of business are entered into and (iii) details of related party transactions.

[14] For eg., regulations governing banking institutions may impact MBs in the investment banking business but we confine ourselves to those SEBI regulations governing MBs.

[15] The survey of regulatory provisions has been based on a compendium of the original regulations of SEBI downloaded on June 22, 2005, when work on the current versions of this paper started. The guidelines have constantly evolved and may have undergone changes since then. However to keep the survey and analysis we had to freeze the updation as of the above date. The provisions of Companies Act, 1956 and Securities Contract Regulation Act, 1956 and Securities Contract Regulation Rules, 1957 have been based on the bare act and Ramaiya (2004)

The principal actors common to most IPOs, or for that matter to any public offering of equity shares, are the following: The issuer company, investors, a host of intermediaries such as stock exchanges, investment banks, the registrar, depository, banker to the issue, underwriters and brokers. We survey the regulatory provisions relating to each of these categories of players. In addition, there are a whole host of other service providers such as accountants, lawyers, printers and advertising and communication agencies who do not come formally or directly under the purview of the regulatory institutions. We do not cover these institutions in this survey.

The rest of the paper is organised as follows. The first section surveys the provisions of the SEBI Disclosure and Investor Protection Guidelines, 2000, the principal piece of regulation governing the public offering of securities, administered by SEBI. We then survey survey provisions governing each category of intermediary mentioned earlier. In the third part we survey provisions of the Companies Act, 1956[16] and the Securities Contract Regulation Act, 1956 and Securities Contract Regulation Rules, 1957 insofar as they apply public issuance of equity securities. The final part concludes.

It is also 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.

1.0 SEBI (Disclosure and Investor Protection) Guidelines, 2000

[16] Further to the provisions of the Companies Act, the Department of Company Affairs announces rules for the implementation of the provisions of the Act and issue circulars for the administration of companies under the Act. Both the rules and circulars have the force of law and can be of considerable economic consequences. Given the scope of the paper we have confined ourselves to the provisions of the Act. In any case we believe that the provisions of the Act will cover the principal elements of the regulation.

These are the core of the SEBI regulations governing the public issue of securities[17] and intended to regulate issuer conduct. The DIPG 2000 is perhaps one of the most voluminous among the various SEBI regulations and is the result of considerable evolution and change since its was first announced in 1992.

1.1 Access Conditions

The DIPG has specific criteria that unlisted companies have to fulfill for companies to make a public offering of equity shares. These are summarized below[18].

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

- [18]Tangible net assets of Rs 3 crore in each of the three preceding years, less than 50% of which may be held in the form of monetary assets
- Networth of Rs 1 crore in each of the three preceding years
- Track record of distributable profits in accordance with the provisions of the Companies Act (S 205 of Companies Act, 1956) in each of the three preceding years
- Not being subject to a ban from accessing the capital markets by an order or direction passed by SEBI (Reg 2.2.1 of DIPG 2000).
- Not less than one thousand prospective allottees of securities (Reg 2.2.2 A of DIPG 2000). This requirement was introduced recently and appears to be intended to ensure a minimum level of distribution of ownership.

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

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

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

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

Public as well as rights issues of debt instruments, convertible into equity or otherwise, would need to have credit rating of not less than investment grade from at least two credit rating agencies. Further, the issuer cannot be in the list of willful defaulters of Reserve Bank of India, nor can it be in default of interest

The access criteria reflect a "merit approach" to regulation (as opposed to a pure disclosure based regime) involving certain minimum standards to qualify to access the public equity markets. It is worth noting that the Companies Act does not have criteria which decide who may make an issue of securities other than what might be required under general contract law.

The access criteria suggest that the regulator has chosen size and profitability track record as proxies for quality. Leaving aside questions of appropriateness of these proxies, a single static benchmark cannot be used across sectors or time. The benchmark will have to be recalibrated.

The alternate criteria seem to indicate that the quality of an issuer may be "certified" by the participation of financial institutions and banks, presumably on the belief that banks are equipped with better ability to seek and analyse information. The certification value of a lending bank, whose risks as a lender are much lower than that of an equity investor, is somewhat questionable. Further, the agency conflict between a lender and equity investors has been widely acknowledged by practitioners as well as in theory.

The mandatory allotment to Qualified Institutional Buyers (QIBs)[19], who are primarily institutional equity investors, could potentially help in the discovery of the price of the securities at the time of issuance as well as in subsequent monitoring of the performance of the company.

The criterion about the minimum paid up capital or market making as alternative criteria appear to reflect a concern about liquidity. The concern regarding liquidity might well be genuine.

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payment to the public on debentures for more than six months. Where the issuer has ratings from more than two agencies all the ratings will have to be disclosed and all ratings obtained during the three years preceding the issue have to be disclosed as well. The issue has to be allotted to not less than fifty allottees.

There shall be no outstanding options in favour of incumbent shareholders to acquire equity shares in the company after the public issue (Reg 2.6 of DIPG 2000) or partly paid up shares (Reg 2.7 of DIPG 2000). All issuers have to indicate "firm arrangements of finance through verifiable means" for at least 75% of the project outlay apart from the proposed offer. The guidelines do not specify what firm arrangements and verifiable means stand for however.

[19] QIBs have been defined as (i)public financial institutions defined in S 4A of Companies Act, 1956 (ii) Scheduled Commercial Banks (iii) Mutual Funds (iv) Foreign Institutional Investors Registered with SEBI (v) Multilateral and Bilateral Development Financial Institutions (vi) Venture Capital Funds registered with SEBI (vii) Foreign Venture Capital Investors registered with SEBI and (viii) State Industrial Development Corporations (viii) Insurance companies registered with the Insurance Regulatory and Development Authority (ix) Provident Funds with minimum corpus of Rs 25 crores and (x) Pension funds with minimum corpus of Rs 25 crores (Reg 2.2.2B (v) of DIPG 2000)

However, does size, as measured in terms of paid up capital, guarantee liquidity is a point that deserves empirical examination.

The problem with precise or quantified access criteria is that in an industrial economy that is evolving rapidly these criteria lose their significance quite quickly as issue sizes increase. Another consequence might be that certain businesses such as biotech or other high tech companies, which eminently qualify for public market subscription on other counts, may not qualify under these criteria. Many technology companies go public on the NASDAQ and other second tier markets at an early stage, much before they start posting profits, and eventually become profitable and successful enterprises.

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

1.2 Disclosure requirements

1.2.1 Prospectus

The most important information and disclosure related requirements pertain to the need for preparation of a prospectus, the procedure for registration and publication of the prospectus. All issuers are required to prepare and file a prospectus or an offer document.

The offer document shall contain "all material information which shall be true and adequate so as to enable the investors to make informed decision on the investments in the issue."[20] The contents of the offer document and the statutory provisions relating to the same are incorporated in the Companies Act and Schedule V thereto, as noted earlier. The guidelines concretise these in relation to a company that is planning to make a public offer.

[20] Reg 6.2 of DIPG 2000

1.2.1.1 Substantive Business and Issuer Related Disclosure Requirements

The substantive requirements of disclosure relating to the issuer are similar to those specified in Schedule V of the Companies Act in terms of broad contours. The requirements in the Companies Act are too broad and general to be able to ensure that promoters provide the necessary details. (We have already stated our position that if disclosure levels are left to the market, there might be a risk of under-production of information.) The detailing of information in the DIPG makes an important contribution to the disclosure regime governing IPOs by enabling an investor to arrive at a better assessment of the quality and the value of the securities on offer. [21]

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[21] Considerable additional detailing is required regarding plant and machinery (Reg 6.9.2.1(b) of DIPG 2000), the technical collaborator (Reg 6.9.2.1(c) of DIPG 2000), infrastructure facilities (Reg 6.9.2.1 (d) of DIPG 2000), board composition, compensation of managing and whole time directors, compliance with corporate governance requirements, directors' shareholdings, other business interests of the directors, details of key managerial personnel, confirmation by the LMB that the persons stated in the prospectus as permanent employees of the issuer are indeed in the employment of the company and changes, if any, in the key seniot managerial personnel during a one year period prior to the date of filing of the prospectus (various clauses of Reg 6.9.5 of DIPG 2000), historical share price and volume data around capital structure changes (Reg 6.7.13 of DIPG 2000). The prospectus is required to provide certain common particulars of promoters who are individuals (such as business and financial activities, photograph, voter ID number) as well as corporate promoters (company registration number, bank account details) and details of the promoter in the establishment of the company) (Reg 6.9.6 of DIPG 2000). In this regard, the regulations thus go considerably beyond the requirement of the Companies Act, 1956 (Clause V (d) of Part I of Schedule II of Companies Act, 1956). Some of these details appear to be means of pre-empting fly by night operations, which led to the phenomenon of "vanishing companies".

The DIPG extends the information required for companies under the same management, listed as well as unlisted, promoted by the promoters (Reg 6.10.3 of DIPG 2000). The nature of the information sought is such as to enable the prospective investor to assess the managerial competence of the promoter team as well as to bring out potential instances of self-dealing within the promoter group. The guidelines go beyond the definition of S 370(1)(B) so as to provide for a more inclusive definition of businesses under the control of the promoters. In addition to details of pending litigations and defaults required as per the Companies Act (Clauses VIIa and VIIb of Part I of Schedule II of Companies Act, 1956) guidelines require mention of the likely adverse effect of these litigations on the issuer's financial performance (Reg 6.11of DIPG 2000).

The Companies Act and the guidelines have fairly similar requirements with regard to the issuer's products and services. The guidelines require a more detailed discussion on the historical demand and supply (capacity details). (Reg 6.9.2.2 (b) of DIPG 2000) The guidelines ask for capacity utilisation for each product for three years in the past as well as in the future and explanation for any proposed increase of more than 25% in future. More importantly, the Companies Act requires the prospectus to discuss future prospects to the extent of the year in which the company is expected to earn cash and net profits. (Clause V (k) of Part I of Schedule II of Companies Act, 1956) The guidelines do not require this; on the contrary, the guidelines do not permit forecasts to be included in the appraisal (Reg 6.9.2.2 (b) (ii) of DIPG 2000). (The apparent dichotomy between the Companies Act and the DIPG in this regard does raise an interesting question of whether an issuer who wishes to make a forward looking statement may do so under the cover of the requirement of the Companies Act which is considered to prevail in the event of a conflict or inconsistency between the guidelines and the Act.) The guidelines require a discussion by the management

1.2.1.2: Points of Law and Disclaimers

The second set of disclosures relate to provisions of law as well as details of issue processes that the investor would need to be aware of. These are mandated to be introduced into the offer document as "boilerplates". They are generally in the form of undertakings and warranties relating to [i] company law related [ii] investor servicing and [iii] investor protection and [iv] the process for applying to the issue [v] time lines for various activities [vi] issue related logistics and [vii] roles of various agents and [viii] investor protection and grievance redressal.

A third set of disclosures relate to disclaimers.[22] The disclaimers appear to be typically a way of getting the issuer to acknowledge circumstances that could go against the company and the investor and thus potentially cause a loss to the investor, make him aware of certain responsibilities of the issuer and pre-empt the possibility of the issuer holding out that the offer documents have any official endorsement from SEBI.

1.2.1.3 Risk Factors

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of the financial conditions and results of the operations as reflected in the financial statements [Management Discussion and Analysis or MDA hereafter.] (Reg 6.10.4 of DIPG 2000)

If the issuer is an already listed company promise versus performance in the case of past issues is to be provided (Reg 6.12.20 of DIPG 2000). Similar comparison is to be provided for the issue in the most recent past of all listed companies in the group / associate companies and an explanation for the shortfall is to be provided. (Reg 6.12.20.2 of DIPG 2000) The guidelines however do not define "group / associate companies".

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

[22] The main disclaimers relate to inability to assure an active or sustained trading in the shares after the issue, general word of caution about a "degree of risk"in investing in equities, that the securities have not been recommended or approved by SEBI, nor does SEBI guarantee the accuracy or adequacy of the document, issuer's absolute responsibility for the information on the offer document, issuer's responsibility being limited to statements made in the prospectus, or any other material issued at instance of the issuer,[22] undertaking to refund the proceeds in case of non receipt of minimum subscription (Reg 6.3.8 of DIPG 2000), assurance regarding despatch of allotment letters / refunds within thirty days, (Reg 6.5.1.1 of DIPG 2000) utilisation of stock invests (Reg 6.5.4.3 of DIPG 2000) and procedure for despatch of refund orders or share / debenture certificates worth Rs 1500.

The final set of disclosures in our survey relate to risk factors and management perceptions of the same which are required to be discussed as part of the prospectus.[23] The guidelines do not specify the types [in terms of marketing, management, access to critical resources and so on] of risk factors to be identified in the prospectus. They are required to be categorised as those that are specific to the project and internal to the issuer and those that are external to and beyond the control of the issuer. Risk factors need to be included if they are considered material collectively, even if they do not matter individually, irrespective of whether their impact is quantitative or qualitative and irrespective of whether they might matter in future or at present. The discussion on risk is required to include proposals to mitigate the same, apart from listing the sources of risk.

The disclosures relating to risk appear to be rather broadly defined, which is in contrast to the various other heads discussed earlier. Admittedly, given the diversity of businesses it may not be feasible or advisable to specify these in greater detail. The fact that proposals to mitigate the risk are required could be expected to compel the management to state their views and plans with regard to those factors affecting the business. The materiality requirement could also be fairly all encompassing. Finally, as in with other aspects of disclosure, it is quite possible that some, if not much of the level of disclosure required by the regulator may be achieved through the comments and observations of SEBI on the draft offer document.

1.2.1.4 Contracting Investor protection

Apart from the disclosures alongwith the offer document the issuer also provides the an undertaking to SEBI undertaking regarding addressing issue related complaints, listing of the issue within the stipulated time, providing requisite funds for despatching refund orders, making available allotment letters / certificates to the RTI, bringing in the promoters contribution in full before the issue opens and underwriting the public portion of the issue. Further, the issuer has to certify to SEBI that that refund orders and allotment certificates have been despatched in the case of earlier issues, if any and that the instruments have been listed as mentioned in the offer documents.[24] A public or a rights offer cannot be made unless it has entered into an agreement with a depository and gives an option to investors to receive securities in a dematerialised form.[25]

[23] Reg 6.7 of DIPG 2000 and Clause VIII of Part I of Schedule II of Companies Act, 1956.
[24] Clause 3.2, RMB (GI Series) Circular No 2 (93-94) dated 26-5-1993
[25] Reg 2.1.5 of DIPG 2000

1.3 Aligining the Interests of Shareholders and Managers

1.3.1 Pricing of Securities

Regulations relating to pricing may be used to serve two purposes. One, the regulator may lay down criteria for valuing shares or even determine the issue price, as one extreme instance of merit regulation.[26] At the other extreme, pricing regulations may be limited to ensuring that free pricing of securities are not misused by a group of shareholders who have majority or significant minority control to issue themselves shares below their intrinsic worth. In either case the endeavour appears to be to ensure that the owner managers do not enjoy a price advantage vis a vis the external shareholder.

The current regulations allow free pricing in the case of all companies that qualify to make a public issue of equity shares, except in the case of banks where the price is subject to regulations of the RBI. Further subject to certain limits they provide for the price to be discovered and firmed close to the process of applying for securities at the issue.[27] A few restrictions apparently intended to pre-empt opportunistic behaviour by those in control of the company such as the promoters or other large shareholders have been provided though.[28] The restriction of a higher

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[26] The Controller of Capital Issues, an official of the Government of India, used to lay down valuation parameters and decide whether share deserved to be priced at greater than the par value till the act governing the institution was rescinded in 1992.

[27] The issuer may indicate a price band instead of a specific price, the upper limit of the range being not more than 20% over the lower limit or the floor. The exact price may be determined by the Board of Directors through a resolution. Listed companies need to provide a notice period of 48 hours for the meeting to decide the price, to the SEs on which they are listed.

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

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

The other major restriction on pricing is that linking the offer price in the case of private placements of blocks of new shares by listed companies in favour of certain sets of shareholders. The idea here has been to ensure that groups of shareholders who wield control do not get wealthy at the expense of other, especially minority shareholders by allotting themselves shares below their market price. Preferential allotment pricing provisions are attracted in the case of participation by promoters in a public issue beyond the 20% that they are required to participate in the case of listed companies (Reg 4.8.1 of DIPG 2000) or in

differential pricing and on offering discounts appear to be to plug the tendency noticed among issues where firm allotments were made to certain categories of investors at prices lower than that offered to the public with the idea of garnering their investment support or simply to provide an unfair price advantage to the promoters.

1.3.2 Minimum promoters' contribution

The requirements relating to promoters' contribution have exhibited a high level of persistence in spite of the numerous changes that they have been through across the years. The key features of these provisions are summarised below.[29] A minimum equity contribution from the promoters

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the case of listed companies they are excluded from the computation of promoters' contribution (Proviso to Clause (a) of Reg 4.10.1).

[29] The regulations require that promoters hold at least 20% of the post issue paid up capital of an unlisted company that makes a public issue. In the case of a listed company promoters need to subscribe to 20% of the issue or ensure that they have 20% of the post issue capital of the company. In the case of listed issues by companies, composite [rights and public issue] or otherwise, it appears that the regulations expect that if the promoters do not subscribe to 20% of the issue they would at least need to ensure that promoters hold at least 20% of the post issue capital. The regulations are not clear whether in the case of listed companies the lower or the higher of the promoters' contribution is expected to be complied with. However, a reading of 4.10.1 would seem to suggest that the promoters' participation cannot be greater than the higher of the two options without attracting the provisions of the pricing for preferential allotments, especially where the issue price is lower than the price determined by the provisions of the preferential allotment pricing policy. Thus it would appear that the stance of the regulation on what is expected would at least to some extent depend upon whether the offer price is greater than or less than the price determined by the provisions of the preferential pricing policy.

The regulations dwell at length on the securities that would not qualify to be considered as part of promoters' contribution. (Reg 4.6 of DIPG 2000) Securities that have been acquired for consideration other than cash, or as bonus shares against revaluation reserves during the three years preceding the public issue or shares acquired for a price lower than the public offer price during one year preceding the public issue are considered ineligible. Subscriptions against promoters contributions are required to be from firms and individuals who are not business associates and have to be for a minimum of Rs 25000 in the case of individuals and Rs 100,000 in the case of applicants who are firms and companies. Promoters' contribution may not be raised through private placements raised solicited from "unrelated persons". Finally, the holders of securities to be included in promoters' contribution need to consent in writing to the inclusion. In the case of an issue of convertible securities if the conversion price has been determined upfront at the time of the issue the promoters have the option to bring in their contribution either in the form of the convertible instrument or in the form of equity subscriptions directly. Even if the conversion were to take place in stages, the effective price at which the promoters bring in their contribution is required not to be lower than the weighted average conversion price of all the equity capital raised through the conversion price. If the issue price has not been determined the promoters have to bring in the subscription in the same form or instrument as that on offer to the public. In no case does the promoter have the option not to convert into equity. The promoters' contribution has to be brought in entirely at least a day before the opening date of the issue. Promoters' contribution in excess of Rs 100 crore may be brought in advance of the calls on public investors on a pro rata basis.

indicates a demonstrated financial stake and possibly closer alignment of the financial interests between the external investor and the promoters or owner managers. This intent is further reflected in the terms of subscription and conversion prices in the case of issuance of convertible securities.

The different lock in periods also appear to suggest different considerations behind the lock in requirements. The three year lock in for the core contribution are presumably intended to bind the promoters' financial interests to the long term success of the company. The shorter lock in periods are meant to restrict offloading by pre-issue shareholders of the company from making quick profits from early after market price increases. Sometimes these also help in preventing a huge selling pressure soon after the shares are listed and pre-empt extraordinary volatility in the early after-market.

The elaborate structure of the provisions relating to minimum contribution are indicative of how complex the regulations can get as it tries to catch up with the devices that promoters can come up with in practice as they try to get around the regulation. Some of the amendments such as those relating to the retail mobilisation of promoters' contribution indicate the difficult balance between retaining the spirit of the original provisions and yet accommodating certain ground realities in raising a large amount of promoters' contribution.

Exemption from the requirement of promoters' contribution has been provided for in the case of companies which have been already listed for a three year period and with a dividend payment record for the three preceding years, in the case of rights issues and in the case of companies which do not have an identifiable promoter.

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

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

The concern here is that the percentage of equity held by the promoters need not necessarily be an unmixed indicator of the promoters' commitment to the interests of the external investor. Promoters could well view their share of equity as a measure of control rights over the cash flow. As an alternative to issuing shares with differential voting rights[30] the promoter may seek to maximise his shareholding so as to be the majority or the single largest shareholder and exercise control over the cash flows. At the same time minority ownership positions of the promoters in a company could be said to exert pressure on the owner managers to maximise shareholder value, failing which they would be subject to the market for corporate control. Stated differently, high promoter holdings do not necessarily mean that the owner managers would work to maximise the welfare of outsider shareholders just as much as low holdings do not mean that they would not have enough incentive to maximise firm value.

It is this confusion about the signalling value of the minimum promoters' contribution that appears to be manifest when the regulations require that any participation in excess of the minimum required would have to be at the higher of the offer price or the price determined under the preferential allotment guidelines. (See foonote # 24)

1.3.3 Distribution of Shareholding

The guidelines also seek to regulate the distribution of issues among the shareholders. Traditionally, there has been a policy tilt towards wider distribution of shareholding.[31] A similar concern seems to have prevailed among the regulators in prescribing a basis for allotment of securities in case of an oversubscription. The provisions are summarised below.[32]

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

[31] Rule 19(2)(b) of Securities Contract Regulation Rules, 1956, which has been further reiterated vide Reg 8.3.1 and 8.3.2 of DIPG 2000 and Clause 40A of Listing Agreement which deals with share ownership patterns for continued listing.

[32] The guidelines require that the number of shares allotted to applicants in each category of application size (in terms of number of shares) shall be in proportion to the total number of shares applied for in that category and the extent of oversubscription. (Reg 7.6.1.1 of DIPG 2000. The regulation lays down the details of the procedure to be followed in the allotment process.) One of the interesting features of the guidelines in this regard is the idea of reservation for "small individual applicants". (Reg 7.6.1.2 of DIPG 2000) Small individual applicants are entitled to get the higher of the minimum of 50% of the net offer of securities to the public or the proportion of the net offer that they would be entitled to as a category under the proportionate allotmemt formula. Further, the LMB has to ensure that the allotment is finalised in a "fair and proper manner" in accordance with the guidelines. (Reg 7.6.1 of DIPG 2000) In order to certify the fairness in the allotment process the drawal of lots in the case of oversubscription shall be conducted in

In the past, in India, reservations and firm allotments were considered to be means of securing firm commitments while marketing the issue. They were also means to allotting large block of securities to friendly investor groups. This must have been all the more important given the mandated minimum public ownership of 25% to 40%.[33] The maximum limits were therefore necessary to ensure that these reservations and firm allotments did not defeat the purpose of a broadbased share ownership that the government seemed to prefer.[34]

These guidelines are not relevant in the case of book built issues where institutional investors may subscribe up to 75% of the issue. Further, the access criteria noted earlier appear to see merits in encouraging institutional ownership of securities. The advantage of having large blocks of institutional shareholding in terms of monitoring the performance of the company has been noted earlier. The DIPG try to ensure a minimum distribution of ownership across at least one thousand prospective allottees for an unlisted company to make a public offering.[35] Given these considerations, it may suffice for the regulations to merely define a minimum limit for the public floatation and a sub-limit for the retail investor as is the case with book built issues. The kind of

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the presence of a representative of the designated stock exchange and the basis of allotment has to be signed as correct by the Executive Director or the Managing Director as the case may be of the Designated Stock Exchange, the public representative, the LMB and the Registrar.

As noted earlier the guidelines specify a minimum "net offer to the public" of 10% or 25%, as the case may be. The net offer to the public is the part of the issue through the prospectus to which institutional and retail investors may apply. Beyond the minimum net offer to the public and subject to the provisions of the guidelines the issuer is free to make reservations and / or firm allotments to various categories of persons as provided for in the guidelines (Reg 8.3.4 of DIPG 2000). These may be of two types: Firm allotments and reservations. The guidelines define "reservations" as "reservation on competitive basis wherein allotment of shares is made in proportion to the shares applied for by the concerned reserved categories." (Explanation 1 to Reg 8.3.4 of DIPG 2000). However, firm allotments may be contrasted with reservations in that the allotments in this category may not be on a competitive basis. Reservations are currently allowed to (i) permanent employees (including working directors) of the company and in the case of a new company the permanent employees of the promoting companies (excluding employees of financial institutions where the said institutions are the promoters themselves) (ii) Shareholders of the promoting companies in the case of a new company and shareholders of group companies in the case of existing companies (iii) Indian mutual funds (iv) Foreign Institutional Investors (including non resident Indians and overseas corporate bodies) and (v) Indian and multilateral development institutions. (Explanation 2 to Reg 8.3.4 of DIPG 2000) Firm allotments are allowed to pretty much the same shareholder categories excluding category (ii) above and permanent employees of the promoter companies but including commercial banks. (Explanation 3 to Reg 8.3.4 of DIPG 2000)

[33] Rule 19(2)(b) of SCR Rules, 1956. The current minimum requirement subject to certain conditions is a much lower 10%.

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

[35] Reg 2.2.2A of DIPG 2000

elaborate schedule of maximum permissible firm allotments and reservations seem to have limited use.

Roles and regulation of intermediaries

The general approach to the regulation of the intermediaries has been by way of a mandatory registration and licensing requirement. Non-compliance with the rules and regulations governing the respective category of intermediaries can lead to a number of penal measures including revocation of license. The licensing process requires certain fitness criteria such as capital adequacy in the case of merchant bankers and adequacy of infrastructure in the case of RTIs. The process of renewal enables SEBI to ensure that the intermediary concerned continues to meet the fitness criterion.

Roles and Responsibilities of Merchant Banker

The regulations define the MB as an intermediary engaged in various aspects of issue management and specify qualifying criteria.[36] The regulations provide for the registration of MBs, renewal of registrations and penalties in the event of non compliance.[37] Thus the regulations provide a comprehensive framework of determining the right to participate in the market on a continued basis as a well graded system of incentives (penalties) depending upon the level of infraction.

[36] In order to ensure a minimum quality of participants, the MB is required to be a body corporate, other than a non banking finance company (NBFC) (as defined in S45IA of Reserve Bank of India Act, 1934) with minimum prescribed infrastructure and at least two professionals who have the experience and prescribed qualification to conduct MB business. Apart from the applicant being a "fit and proper" person, the MB cannot be connected with persons who have already been refused registration by SEBI or have partners or directors involved in litigations connected with the securities market or convicted of moral turpitude or found guilty of economic offences. The MB also needs to meet the minimum capital adequacy requirements. Minimum of Rs 5 crore.

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

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

As a market participant the MB is governed by the SEBI (Merchant Bankers) Regulations, 1992 and SEBI (Merchant Bankers) Rules 1992.[38] The precise responsibilities are mentioned at various points in the DIPG 2000. Not surprisingly therefore many of the specific aspects of the role to be performed by the MB mentioned in the DIPG also appear in the circulars or instructions issued to the MBs under the regulations governing MBs.

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

The regulations place the responsibility almost entirely on the MB for the issuer complying with the regulations. To enable the MB to play that role the guidelines require that every issue of securities has to be lead managed by a Lead Merchant Banker (LMB). Further, every company is required to enter into a Memorandum of Understanding with the LMB before making a public or a rights offer of securities.[39,40].

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

[39] Reg 5.3 of DIPG 2000

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

The regulations try to ensure that there are no conflicts of interest between the functioning of the various issue related intermediaries and the issuer. The issue cannot be lead managed for eg., by a merchant banker who is considered a promoter, associate or director of the issuer as defined in the regulations.[41] Similarly, the LMB cannot be a registrar to an issue where it is handling post issue responsibilities. The interests of the LMBs and the issuer are further sought to be aligned by requiring the latter to accept underwriting commitments of the lower of Rs 25 lakhs or 5% of the issue.[42]

2.1.2 Production and Certification of Information

Apart from verifying the contents of the offer document though a process of due diligence, the LMB has to issue certificates to SEBI about the accuracy of the disclosures as well the incorporation of SEBI's comments on the draft.[43]

(i) investors are provided with true and adequate information (ii) adequate steps are taken for fair allotment of securities / refund of application money without delay (iii) investor complaints are adequately dealt with. MBs are prohibited from creation of false market, price rigging, manipulation, passing on of price sensitive information or any action, which is unethical or unfair to investors.

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

[42] Reg 5.5.3. The outstanding underwriting commitments of the LMB shall not however exceed twenty times its networth at any point in time [Reg 5.5.4]

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

The LMB is responsible for filing the draft offer document simultaneously with SEBI and the SEs where the securities are proposed to be listed. (Reg 2.1and Reg 5.6.2 of DIPG 2000) The offer document filed with SEBI is to be made public for a period of 21 days from the date of filing and the MB is responsible for making the same available on various media such as the MB's website. At the end of the 21day period the LMB has to report back to SEBI the complaints received on the prospectus and the manner in which the complaints were dealt with (Reg 5.8 of DIPG 2000).
The LMB is required to conduct "due diligence" to ensure the veracity and accuracy of the disclosures in the draft offer document and other necessary compliance (Reg 5.1 of DIPG 2000 and Reg 5.3.3 of DIPG 2000). The term "due diligence" itself has not been mentioned anywhere in the guidelines or in Indian Company Law. This liability of the merchant banker is expected to continue after the issue process is completed.

Apart from ensuring that the offer documents are in conformity with the DIP Guidelines, the LMB has to ensure that the format of the prospectus conforms to the format prescribed by the Department of Company Affairs, Ministry of Law Justice and Company Affairs. (Vide GSR 614(E), dated October 3, 1991 and Clause 3.1, RMB (GI Series) Circular No 2 (93-94) dated 26-5-1993. The Offer documents are to be made

The certification role is not limited to the information that is required to be disclosed but extends to ensuring that intermediaries such as registrars and share transfer agents, bankers to the issue, and authorized collection agents (where necessary) have the license and the organisational financial capacity as required under respective regulations to discharge their functions in the management of the issue.[44,45,46].

The regulations expect the LMB to serve as the primary source of information on the progress and performance of an issue through mandatory periodic reports as well as updates on important developments about the issues during the intervening periods.[47]

Once the issue process is underway, the LMB has to ensure that the offer documents and other issue related documents are dispatched to various SEs, brokers and other as agreed upon.[48]

There are also detailed instructions to the LMB relating to the number of copies of prospectus to be distributed and the date by which it has to be distributed and so on.[49]

Through the provisions above, the regulations delegate the onus of the quality, extent and timing of disclosure on to the MB. The certificate from the MB goes considerably beyond confirming compliance with the format and addresses the contents of the same.

2.1.5: Incentives

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public on the internet. (SEBI (Primary Market Department) Press Release No 112/97 dated 9-10-1997 There are certain aspects of company law administration, compliance with which is sought to be enforced through MBs. For eg., MBS are required to ensure that issuers do not include statements regarding delayed listing of securities which are in contravention of S 73 of the Companies Act, 1956. Similarly the MB has to ensure that issuers have appointed qualified company secretaries before filing of documents with the RoC.[43] [Letter dated 17-2-1993 from Department of Company Affairs to SEBI].

[44] Reg 5.10.1 and Reg 5.10.3 of DIPG 2000

[45] Reg 5.4.3

[46] Reg 5.5 of DIPG 2000

[47] RMB (GI Series) Circular No 3(1995-96) dated 26-7-1995

[48] Reg 5.7 of DIPG 2000

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

Non-compliance could lead to award of penalty points in a graded fashion, depending upon the gravity of the breach, suspension[50] or even worse cancellation[51] of registration . In order to facilitate better more effective supervision those MBs that are not a bank or a financial institution are prohibited from carrying on business other than that in securities market after June 30, 1998 after June 30, 1998.

2.1.3 Issue Logistics

The responsibilities of the LMB in the post issue phase have been spelt out in great detail.[52] and cover practically all the facets of the post issue activity to ensure that the issue allotment process is conducted and completed in a fair, transparent and timely manner so as to maintain investor

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

[51] in the case of fraud or the MB being convicted for criminal offence or repeated default.

[52] Further, the LMB is generally responsible for the distribution of the material relating to the issue (in particular application form accompanied by abridged prospectus), (Reg 5.13 of DIPG 2000) ensuring that the issuer has entered into the necessary arrangements for dematerialisation of the securities and finally, obtain within fifteen days of the filing of the draft offer document with the SEs an in-principle approval to list the securities. Thus the responsibility of the LMB stretches all the way to ensuring that the securities are offered, allotted and listed in compliance with the regulations. (Reg 7.7.7 of DIPG 2000)

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

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

confidence in the market. In particular, this part of the guidelines lay considerable emphasis on investor servicing and the redressal of investor grievances.[53] The guidelines prescribe the minimum number of collection centres for issues and provide for authorized collection agents and their roles[54]. The LMB has to ensure that a SEBI nominated public representative is associated with the process of the finalisation of allotment.[55] The LMB is required to ensure that in each class of securities being offered to the public the minimum number of shares that will qualify for being listed[56] are offered to the public.[57]

2.1.3.1 Book building[58]

Perhaps one of the most significant developments relating to the public offering activity in recent times is that of book building as a price discovery mechanism. In brief, the activity involves the assessing investor interest in the offering on the basis of a red herring prospectus (See 3A.1 below). There are two broad sets of options for bok building. The most common method involves allotting 75% of the offer to Qualified Institutional Buyers, 15% to retail investors (whose application size is not more than Rs 50000) and the remaining 10% to non institutional, non-retail investors such as high networth individuals, corporates and so on. The price is finalized on the basis of the "book" that is built for the offering from institutional investors. Non institutional investors have the option to invest at the cut off price determined for institutional investors or bid their own prices. The information issues and some of the procedural issues that book building faces in the light of the extant legal framework are beyond the scope of this paper. But it is certainly important that these issues will assume centrestage in discussions on

[53] For eg., the Rule 4(C) on conditions of grant / renewal of certificate of registration of merchant bankers requires MBs to take adequate steps for redressal of investor grievances within one month of receipt of the complaint. So also Reg 36 (iii) says that a MB who fails to resolve investors' complaints or give a satisfactory explanation to the Board in respect of the same may face imposition of penalty or suspension of registration. Reg 25 of SEBI (Merchant Banker's Guidelines) requires the LMB to continue to be associated with the issue till the subscribers have received the share or debentures certificates or the refunds, as the case may be. Reg 18(2) of the said guidelines requires that the rights, liabilities and obligations in the MoU between the issuer and the MB ought to cover the allotment and refund processes as well.

[54] Reg 5.10 of DIPG 2000

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

[56] Under Rule 19(2)(b) of SCR Rules, 1956

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

[58] Chapter XI of DIPG lays down the procedural details regarding book building

institutions in the public offerings market, relegating many of the other existing aspects to irrelevance.

2.1.4 Collateral Disclosures

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

For eg., advertisements relating to a public offer are required to be truthful, fair and clear and not contain any statement which is untrue or misleading.[59] Statements without appropriate substantiation and which provide an exaggerated picture of the company or statements which imply an inaccurate picture of the past or that the performance of the past will be sustained are considered misleading. Towards these the guidelines have a number of detailed provisions. [60] Similarly the LMB has responsible for ensuring compliance with the provisions relating to issuance of research reports.[61] These provisions seek to ensure that the research reports are not

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[59] Reg 9.1.1 of DIPG 2000

[60] The guidelines prohibit selective extracts from the offer document, (Reg 9.1.2 of DIPG 2000) require clear, concise and understandable language and prohibit the use of models, slogans, brand names, fictional characters, celebrities, landmarks and so on. If the advertisement has to carry financial data the minimum financial data that has to be included has been specified as well. (Reg 9.1.11 of DIPG 2000) All issue advertisements [including corporate advertisements during the twenty one day period after filing of prospectus till closure of that corporate], except issue opening and closing announcements, have to highlight risk factors in fonts of minimum prescribed size risk factors. (Reg 9.1.12 and Reg 9.1.13 of DIPG 2000) Issue of advertisements announcing opening, closing and level of subscriptions to issues have been specified to possibly pre-empt abuse of such communications to create inaccurate impressions of the level of interest or quality of such issues. (Reg 9.1.16 to Reg 9.1.19 and Reg 7.5.2 of DIPG 2000) The LMB has to ensure that advertisements providing details of oversusbcription, basis of allotment, date of despatch of certificates and refund orders have to be released within ten days of completion of "various activities" in one newspaper each in English language, Hindi and the regional language daily circulated at the place where the registered office of the issuer is situated. (Reg 7.5.1 of DIPG 2000) (The guidelines do not define "various activities" but it is reasonable to assume that it means the finalisation of the basis of allotment and despatch of securities, obtaining demat credit or despatch of refund orders and applying for listing. It does not require that listing permission have been obtained.) The LMB has to obtain an undertaking from the issuer that the material used in issue related communications will be limited to the material available in the offer documents and has to further approve the material in all communications before they are released.

[61] The LMB has to ensure that research reports cannot use or be based on information beyond what is available in the offer documents and that there is no selective disclosure of information to limited constituencies. It is presumed that the reference here is to information relating to the company and the

used to circumvent disclosure regulations to provide an informational advantage to a certain set of investors or to provide misleading information.

2.2 Registrars to the Issue and Share Transfer Agents

The regulations governing registars to the issue (RTIs)[62] define an RTI as a person appointed to (i) collect applications from investors in respect of an issue (ii) keeping a proper record of applications and monies received from investors and paid to sellers of securities (iii) assisting the issuer in (a) determining the basis of allotment of securities (b) finalising list of persons entitled to allotment (c) processing and despatching allotment letters, refund orders or certificates and other related documents in respect of the same.[63] Our discussion in this paper is largely confined to the role of the RTI since the STA's role relates largely to post issue trading in the secondary market.[64]

2.2.1 Participation Rights and Incentives

Only registered RTIs are allowed to provide the service in the case of public issues.[65] Left unregulated, RTIs could be accomplices in dubious allotment practices, which can threaten the integrity and the efficiency of the market. The RTI's relationship with the issuer is governed by a

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issue and not to industry, technology and so on that may be gleaned by the analyst from other published and non-published sources. However this has not been clarified in the regulations.
Similarly issue of research reports by the issuer or any member of the issue management team or syndicate has been prohibited for a period starting 45 days immediately preceding the filing of the draft offer document and ending 45 days after commencement of trading in securities. [Research report related provisions are covered in Reg 9.3.]

[62] The SEBI (Registrars to and Issue and Share Transfer Agent) Regulations, 1998 and The SEBI (Registrars to and Issue and Share Transfer Agent) Rules, 1998

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

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

Technically speaking the STA's conduct can affect outcomes in the primary market. For eg., the transfer of shares in the after market could be delayed by the STA as a connivance in a mechanism of price rigging, which in turn could affect the integrity and public confidence in the primary markets. [REF] Situations like these require the regulation of the conduct of the STI. However, we confine our discussion to the RTI since the scope of this paper is limited to the issuance and listing of securities.

[65] Rule 3 of SEBI (Registrars to and Issue and Share Transfer Agent) Rules, 1998

formal agreement, the minimum requirements of which have been spelt out in the model agreement.[66,67]

Given the large volume of activity RTIs must have the necessary infrastructure to ensure that the allotment is done in a fair, transparent and efficient manner. Barring marginal differences,[68] RTIs are subject to a set of incentives quite similar to that of MBs.

2.2.2 Information related provisions

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

2.2.3 Ensuring market integrity

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

2.3 Underwriters

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[66] Rule 4 (1)(b) of SEBI (Registrars to and Issue and Share Transfer Agent) Rules, 1998

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

[68] RTIs/ STAs are subject to eligibility requirements and a code of conduct similar to that for MBs. Additionally, the code of conduct for RTIs also requires them not to engage in unfair competition which will be will be harmful to other RTIs or competitively disadvantage them. So also the definition of associate in the conflict of interest clause is more encompassing under these regulations than that in the case of MBs.[68] (An associate has been defined as a situation where (i) Direct / indirect control of not less than 10% of the voting power of one is held by the other (ii) He / any of his relative is a director of RTA / body corporate as the case may be. Interestingly this definition is broader in its applicability and raises the question of why it ought to be so.) Apart from non-compliance with registration conditions and relevant regulations, RTIs are also liable for contravention of SCR Act and SCR Rules. The specific provisions of the SCR Act and Rules that apply to the role of the RTI have not been spelt out.

The regulations[69] do not define the role or activity of an underwriter unlike in the case of other intermediaries, namely, MB, RTI or a banker to an issue. An underwriter is expected to step in with capital to the extent of a shortfall in subscription from public and institutional investors, in return for a fee.[70] Underwriting assumes particular importance because of the requirement that in case the issue does not achieve a minimum 90% subscription[71], including capital brought in by underwriters,[72] the issuer is bound to return the entire application money. Thus underwriting can help avoid serious financial uncertainties for the company and the investors therein.

2.3.1 Participation rights and Incentives

The LMB has to ensure that only those intermediaries who are licensed by SEBI and certified stock brokers and MBs may participate in the underwriting of public issues.[73] Underwriters are required to have a minimum capital of Rs 20 lakhs under the SEBI regulations[74] or such additional / higher capital adequacy requirements stipulated by the SE of which they are a member. Further, the total underwriting exposure cannot exceed twenty times the networth of the underwriter.[75] Underwriters are subject to the same requirements as other intermediaries relating to unfair competitive practices, exaggerated claims, divulging privileged information and so on.

2.3.2. Information

The information value of the underwriting arrangement is in terms of the signalling value.

From the point of view of an issuer, having an issue underwritten may be seen as a decision to buy an insurance based on the issuer's assessment of the conditions in the primary market. The cost of a failure to meet the 90% minimum subscription requirement may be viewed as a significant enough deterrent against which the decision to buy underwriting services may be

[69] SEBI (Underwriters) Rules, 1993
[70] The role of an underwriter in the American markets and other financial markets that follow the American model is similar to that of an investment banker in the Indian context. The underwriter in this system either (i) arranges to market the securities on a best efforts basis in which case he merely does the marketing of the securities with no underlying financial exposure risk or (ii) buys the securities being offered at a fixed price and face the risk of having to pay for the same in case he does not manage to distribute all of the same at the minimum agreed upon price, thus carrying a financial exposure risk.
[71] S..... of Companies Act, 1956
[72] ..... of SEBI Regulation
[73] Rule 3 of SEBI (Underwriters) Rules, 1993
[74] Rule.... of SEBI (Underwriters) Rules, 1993
[75] Rule 7 of SEBI (Underwriters) Rules, 1993

weighed. In a sense the underwriting arrangement may be seen to reflect the issuer's cncern about the issue meeting with adeaquate investor interest.

From the point of view of the investor an underwriting may be seen to serve two purposes. The underwriter has a natural incentive to market the issue, failing which he carries an exposure risk. (It is not coincidental that in the Indian context, most of the time the underwriting facility is provided by brokers and sub-brokers who are otherwise engaged in marketing securities in public issues.) Underwriting ensures that the issue will not fail for want of subscription and hence the financial cost of applying to a failed issue is avoided. More importantly, the fee paid to the underwriter is not sizeable enough to encourage moral hazard type risk taking. In case the issue is of such poor quality as to be unable to be marketed, barring unforeseen adverse developments in the financial markets, the underwriter would not extend his support to the issue since he would be end up holding an investment that may affect his financial interests adversely at least in terms of liquidity for a while if not in terms of the value of his portfolio. In extending underwriting support the underwriter thus signals to the market the belief that the issue is likely to be fully subscribed.

The key to ensuring that the underwriter is indeed bound by these economic considerations is to ensure that the underwriter does fulfill his contractual obligations in the event of a devolvement such that he faces the risk of a negative ex post pay off in case he does not exercise commercial judgment in choosing issues for underwriting public issues.[76]

2.3.3 Risk Mitigation

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

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

The relationship between the issuer and the underwriter is required to be governed by an underwriting agreement. The contractual essence of the underwriting agreement has been pointed out to be time and and the law therefore stipulates the time within which the obligations are to be fulfilled. In case the obligations are not fulfilled within the stipulated time then the issuer / underwriter as the case may be stands discharged of the obligations under the agreement.[77, 78]

Presumably given the exposure risk for the underwriter, the underwriter is given some protection against incorrect information provided by the issuer. Apart from the right to examine the draft prospectus prior to signing the agreement as mentioned earlier, the underwriter need not be bound by the underwriting contract in case subsequent to the signing of the underwriting contract, the issuer has made disclosures that SEBI deems "material and essential" to the contract of underwriting. Further the underwriter has the option to terminate the agreement at any time prior to the opening of the issue under exceptional circumstances.[79]

2.4 Banker to an Issue

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

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[77] Clause 15 of Model Agreement to be entered into between underwriter and issuer under Rule.....of SEBI (Underwriters) Rules, 1993

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

[79] These have been specified as (i) any of the representations / statements made by the company to the underwriter and / or in the application forms, negotiations, correspondence, the prospectus or in the underwriting agreement are, or are found to be incorrect; (ii) complete breakdown or dislocation of business in major financial markets or war or, insurrection, civil commotion or sustained financial, political or industrial emergency or disturbance affecting the major financial markets or cities of Calcutta, Bombay, Madras or Delhi.

The rules define a BTI as a "scheduled bank"[80,81] carrying on any or all of the following activities:[82] (i) Acceptance of application and application monies (ii) Acceptance of allotment or call monies (iii) Refund of application monies (iv) Payment of dividend or interest warrants.

The banker's role commences from the time the issue opens till the allotment process is completed. The importance of the BTI's role is in terms of (i) reducing the financial cost of applying to an issue through speedy handling of receipt of application monies and refunds (ii) ensuring the safety and integrity of the process of handling funds in an issue in the absence of which investors may be reluctant to apply to an issue (iii) a quasi fiduciary role in ensuring that the application funds are dealt with as required by the regulations and are not misused by the issuer or other intermediaries and (iv) lastly in producing timely and quality information in terms of application to the issues which can form an important inputs to investors who look to assess the prospects for the issue from the action of other investors.

As intermediaries in the public issue the banker to an issue (BTI) is also subject to SEBI regulations.[83]

The rules require the BTI to enter into an agreement with the issuer.[84] The agreement is required to provide for service standards such as the number of banks / collections centers for collecting application monies, time limit for forwarding the monies as well as the applications and for a daily statement indicating the number of applications and the application monies received. Further, the rules specify records to be maintained by the BTI.[85] The BTI is also bound by a code of conduct that is by and large akin to the code of conduct for other intermediaries.

As a scheduled bank is also subject to the regulatory oversight of the RBI, the BTI is subject to dual regulation but the principal responsibility appears to rest with the RBI.[86]

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[80] Rule 2(g) of SEBI (Bankers to an Issue) Rules, 1994

[81] Second schedule of the Reserve Bank of India Act, 1934 (2 of 1934) Scheduled banks, as distinct from co-operative, regional rural banks and land development banks, are the regular commercial banks under Indian banking law.

[82] Rule 2(b) of SEBI (Bankers to an Issue) Rules, 1994

[83] SEBI (Bankers to an Issue) Rules, 1994

[84] Rule 14 (1) of SEBI (Bankers to an Issue) Rules, 1994

[85] Rule 12 of SEBI (Bankers to an Issue) Rules, 1994

[86] For eg., while SEBI has the right to inspect the books as in the case of other intermediaries, (Rule 18 of SEBI (Bankers to an Issue) Rules), 1994 in the case of a BTI, SEBI has to request RBI to undertake the actual inspection (Rule 17 of SEBI (Bankers to an Issue) Rules). Similarly, if a bank is disallowed from

2.5 Brokers and sub-brokers

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

3A Provisions of Company Law

In this section we survey the areas in the process of issuance of securities that the Companies Act, 1956 seeks to govern most directly.[87] We have noted earlier the position of the Companies Act on what constitutes a public offering of shares.

While the law defines two kinds of share capital[88] and limits the types of share capital that may be issued and the rights attached thereto,[89] and the process of application and allotment of shares,[90] it does not specifically provide for the conditions under which and the manner in which a company may issue securities.

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undertaking the role of BTI by RBI as part of a penal action, the BTI's certificate may be considered as suspended or cancelled as the case may be. (Proviso to Rule 15 of SEBI (Bankers to an Issue) Rules). During the course of the inspection the obligations of the BTI are to RBI,(Rule 20 of SEBI (Bankers to an Issue) Rules) which will then communicate its findings to SEBI.(Rule 21 of SEBI (Bankers to an Issue) Rules) SEBI may then take action against the banker on the basis of the RBI findings. Two implications that may be relevant flow from these provisions. One, the rules leave the timing and the execution of the inspection to RBI's control. It raises the question of whether RBI have the internal expertise to conduct the inspection, given the complexities of the issue management process.

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

[88] S 85 of Companies Act, 1956

[89] S 86 of Companies Act, 1956 as amended by Amendment Act 2000

[90] Ss 69 to 75 of Companies Act, 1956 generally

3A.1 Disclosure related

The contractual terms of the relationship between the various security holders inter se and between the management of the company and the other investors in the company are governed by the charter documents of the company, namely the Memorandum of Association[91] and Articles of Association of the company[92] as well as the various provisions dealing with the governance of the company and the roles of the directors as well as other officers in charge of the management of the company.

The Companies Act however requires "no one shall issue any form of application for shares in or debentures of a company unless that form is accompanied by a memorandum containing salient features of a prospectus as may be prescribed which complies with the provisions of this section."[93] Thus by requiring that the terms of issue of securities by the company be captured in a prospectus and by regulating the issue of prospectus the company law regulates the process of issuance of securities. In the case of a private company or a public company that does not propose to make a public issue of securities a statement in lieu of a prospectus may be filed with the Registrar.[94] A circulation of the offer to more than fifty persons is deemed to be a public offer.[95]

The law defines a prospectus as "any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in or debentures of a body corporate."[96] The law further provides for an abridged prospectus as a "memorandum that contains such salient features of a prospectus as may be prescribed."[97] This applies even in the case of an OFS where the issuer would be subject to the same liability as in the case of a fresh issue of securities.[98]

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[91] S 12 and S 13 of Companies Act, 1956
[92] S 26 of Companies Act, 1956
[93] S 56(3) of Companies Act, 1956, amended by Amendment Act, 1988 w.e.f May 31, 1991
[94] S 70 of Companies Act, 1956
[95] S---------- of Companies Act, 1956 inserted by Amendment Act of 2000
[96] S 2(36) of Companies Act, 1956, amended by the Amendment Act of 1974
[97] S 2(1) of Companies Act, 1956 inserted by the Amendment Act of 2000 w.e.f 13-12-2000
[98] S 64(1) of Companies Act 1956

One of the items of information to be provided in the prospectus under law is the offer price. However, one of the challenges in corporate finance is the pricing of securities issued by a company which does not have a trading history. The information disclosed through the prospectus could be used to discover the price that investors are willing to pay for the securities on offer. The idea of a red herring prospectus has been introduced primarily for this purpose. The red herring prospectus has all the information that a normal prospectus would have under law, except the offer price and the number of securities on offer and has to be filed under Indian law at least three daye before the opening of the issue. The law defines an information memorandum [IM] as a "process undertaken prior to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited and the price and terms of issue for such securities is assessed, by means of a notice, circular or advertisement."[99] The IM and the red herring prospectus carry the same obligations as a regular prospectus.

In an important way the disclosure requirements relating to annual accounts and balance sheet,[100] and the provisions relating to the form and contents thereof,[101] and the provisios relating to the dissemination of the same,[102] are important from a disclosure perspective since they form the basis on which the historical information presented in the offer documents are prepared. Authentication of annual accounts is provided for in the case of all body corporates.[103]

3A.2 Alignment of Interests between Shareholders and Managers

The law does not specifically provide for intermediaries such as MBs, registrars or bankers to the issue. It appears that these have been left to SEBI's supervisions given that these are entities associated with the securities market, rather than just corporates.[104] The law has extensive provisions relating to the governance of the corporation as well as the relationship between the shareholder and the management, which are beyond the scope of this paper.

3A.3 Issue Process

[99] S 2(19B) of Companies Act, 1956 inserted by the Amendment Act of 2000 w.e.f 13-12-2000
[100] S 210 of Companies Act, 1956
[101] Ss 211, 212, 215, 216, 217
[102] Ss 218-220
[103] Ss 224 to 233B
[104] To the extent they are corporates their formation and governance are subject to the provisions of the Companies Act except specialized agencies like banks and development financial institutions.

In addition the law lays down the requirements to be followed in the allotment of shares,[105] issuing calls on share capital,[106] and provisions for issuing shares at a discount to face value.[107] The law[108] provides for payment of underwriting commission, subject to a ceiling, although it does not define the notion of underwriting anywhere.[109] The law also provides for appointment of brokers.

3B Provisions of the SCR Act, 1956 and SCR Rules, 1957

The preamble to the SCR Act, 1956 (SCRA)[110] defines it as an "Act to prevent undesirable transactions in securities by regulating the business of dealing therein". Only those securities included in the definition in the SCRA may be traded on a stock exchange. The SCR Act and the rules are one of the important levers by which SEBI regulates stock exchanges. (Sabarinathan: 2003). The SCRA allows SEs make bye laws which govern inter alia the listing of securities and further provides that the companies listed on a SE shall be governed by the conditions of the listing agreement with that exchange.[111] SCRA also provides for appeal by a company to the Securities Appellate Tribunal (SAT) [112]against the decision of a SE to refuse listing permission.

The SCR Rules, 1957 (SCRR) deal with the operationalisation of the provisions of the SCRA. From the point of view of a public offering of securities the SCRR specifies the procedure and the documents that have to be submitted alongwith the application form by a company seeking listing on a stock exchange. These documents / information go beyond the requirements of the prospectus under the Companies Act and the DIPG, presumably intended to help the SE decide on the suitability of the shares for listing.[113] The SE may stipulate such other terms and conditions, as it may deem appropriate for listing. In addition the company has to satisfy the exchange that the articles of association of the company allow for transfer of shares.[114] The

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[105] S 69 to S 75 of the Companies Act, 1956
[106] Ss 91 and 92 of Companies Act, 1956
[107] S 79 of Companies Act, 1956
[108] S 76(3) of Companies Act, 1956
[109] However court decisions have ruled that an "underwriter agrees to take those shares that have not been taken by the public (Lord Tomlin in Australian Investment Trust Ltd v Strand and Pitt Street Properties Ltd cited in Singh (2001) and that an underwriting may be allotted shares directly without waiting for further application (Singh:2001)
[110] The Act has been amended in 1995, 1999 and 2001. The reference here is to the act as amended.
[111] S 9(m) of SCR Act, 1956
[112] S 22A of SCR Act, 1956
[113] Rule 19 of SCR Rules, 1957
[114] Rule 19(2) of SCR Rules, 1957

company accepts as a condition precedent several obligations relating to share register administration and share transfer related obligations.[115] Further, it accepts an obligation to the SE to provide on- going information on a range of business and capital structure issues and corporate actions such as dividends[116] and comply with any additional requirements that the SE may impose.[117] Most interestingly, SEBI retains the right to waive or relax the requirement relating to these listing rules, indicating the sweeping over-riding powers that SEBI has in the administration of the listing rules, which it exercised for eg., in waiving infrastructure companies from these requirements.[118] The most important of these rules perhaps relates to the minimum extent of dilution for a company to qualify for listing. A company is normally required to offer at least 25% of each class of securities to issued to the public to qualify for listing.[119] However, this may be reduced to 10% subject to certain conditions.[120] The SE may suspend or withdraw admission to dealings in the securities of a company either for breach or non-compliance with any of the conditions of admission to dealings or for any other reason.[121] The company is entitled to a show cause notice in writing[122] and a further right to appeal to SAT if the suspension is more than for three months.[123] The SE on its own or under order from SAT restore the scrip to listing.[124]

Provisions of the standard listing agreement

The listing agreement between the issuer and the stock exchange is a private contract. However, listing agreements have been standardized to a considerable degree by SEBI.[125] The bulk of the provisions relate to the on-going conduct of the company in terms of disclosures and investor

[115] Rule 19(3) (a) of SCR Rules, 1957 and various sub-clauses thereof
[116] Rule 19(3)(f) to Rule 19(3)(o) of SCR Rules, 1957
[117] Rule 19(3)(t) of SCR Rules, 1957.
[118] Rule 19(7) of SCR Rules, 1957
[119] Rule 19(2)(b) of SCR Rules, 1957
[120] The conditions are that (i) a minimum of 20 lakh securities are to be offered to the public, excluding reservations, firm allotments and promoters' contribution (ii) the value of securities on offer at the offer price is not less than Rs 100 crores and (iii) the issue was made through the book building route with 60% of the issue being allotted to QIBs as required by SEBI.
Any subscription to a list of development financial institutions and investment institutions identified in the explanation to Rule 19(2)(b) will not be considered as part of the 10% or 25% minimum above, as the case may be.
[121] Rule 19(5) of SCR Rules, 1957
[122] First proviso to Rul 19(5) of SCR Rules, 1957
[123] Second proviso to Rule 19(5) of SCR Rules, 195&. The right to appeal to SAT is under Section 15K of SEBI Act, 1992
[124] Rule 19(6) of SCR Rules, 1957
[125] S 3 of SCR Act, 1956 requires that the bye-laws require SEBI's approval whereas S 10 of the same Act provides that SEBI may amend the bye-laws of a SE, suo motu or at the request of the SE's governing Board.

servicing issues (such as allotment, transfer of shares, dividend payment and closure of books).[126] The provisions of the listing agreement that are of direct relevance to a public issue are those relating to the requirement that a listing application has to be accompanied by an acknowledgement card for the issue from SEBI and a certificate of compliance with the provisions of the DIPG from the LMB.[127] Companies already listed agree not to make issue any offer documents unless an acknowledgement card has been obtained from SEBI.[128] The other provision relates to the eligibility conditions for listing on various SEs, which have been left to the discretion of the SE.[129] Finally, the listing agreement lays down minimum conditions for share ownership distribution for continued listing of the shares on the SE.[130] This condition essentially seeks to ensure that the shares are held among an adequately large number of shareholders, which in turn will contribute to the liquidity of the shares. This is understandable given that liquidity is one of the key concerns of the management of any SE.

Conclusion

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

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

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[126] These are important to the IPO process inasmuch as they impose a fixed cost to being listed on a SE and could therefore have a bearing on the decision making process. However, the focus of this paper is on the process of going public once the decision is made and the market access conditions to going public.
[127] Clause 24 (d) of the Listing Agreement
[128] Clause 24 (c) of Listing Agreement
[129] However as part of the approval process of bye-laws the eligibility conditions also require the approval of SEBI.
[130] Clause 40A of the Listing Agreement. If the company does not maintain the minimum required of 10% or 25% as the case may be at the time of listing the promoters will have to tender an open offer under the Takeover Regulations. The company will not be able to make a preferential offer or buy securities back in case the share ownership will drop below the minimum as a result of the same. These restrictions do not apply to companies that have been registered with the Board for Industrial and Financial Reconstruction under the Sick Industrial Companies Act.

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

The various intermediaries discussed in this survey are all important to the issue process and they will continue to be so until the processes are changed dramatically either due to paradigm shifts in regulation and / or due to changes in the technology of making public issues. Given this scenario, the regulations governing each of this category of players is important to the orderly functioning of the market for public offerings of securities, in particular that of equity shares and convertible instruments. In fact, an examination of the evolution of these regulations indicates that these regulations have attempted to address potential sources of failure in the market observed from the experience of offerings in the past.

Any study of the functioning of the market for public offerings will need to examine this tightly interlocked web of regulations in order to explain the development of the securities market in India over time.

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