

# Capital Markets Hotline

January 06, 2011

## IPO COMPLIANCES: SEBI SETS HIGH STANDARDS FOR INTERMEDIARIES

### Introduction:

In a move that will force intermediaries like merchant bankers to take IPO compliances and disclosures more seriously, the adjudicating officer of the Securities and Exchange Board of India ("SEBI") has *vide* its order dated December 31, 2010 ("SEBI Order")<sup>1</sup>, imposed a penalty of 2.5 million on one of the leading domestic intermediary Enam Securities Private Limited ("Merchant Banker"), for its violation of the provisions of Regulation 13<sup>3</sup> of SEBI (Merchant Bankers) Regulations, 1992 alongwith relevant provisions of the erstwhile SEBI (Disclosure and Investor Protection) Guidelines, 2000 ("DIP Guidelines")<sup>2</sup>.

### Facts of the case in brief:

SEBI conducted an inspection of books and records of the Merchant Banker in August 2005 to examine the role of the Merchant Banker in the public issues. Thereafter, in June 2007, based on the above inspection, a notice was issued to the Merchant Banker requiring it to show cause as to why an inquiry should not be held against it and why penalty, if any, should not be imposed on it under Section 15HB<sup>4</sup> of the SEBI Act, 1992 for violation of the provisions of Regulation 13 of SEBI (Merchant Bankers) Regulations, 1992 and certain provisions of then existing DIP Guidelines issued under SEBI Act, 1992.

In SEBI's report, the following important observations were, *inter alia*, made as emerging from the inspection:

- I. That the Merchant Banker failed to make disclosures in respect of the entity Rabobank International Holding B.V. ("Rabobank") as a promoter in connection with the initial public offering ("IPO") by Yes Bank Limited ("Yes Bank");
- II. That preferential treatment accorded to certain foreign institutional investors in allotment of shares pursuant to the IPO by Yes Bank; and
- III. That Merchant Banker failed to discharge duties as a post-issue lead merchant banker to the public issues in relation to allotment of shares, redressing investor grievances and other matters pursuant to closure of the public issues.

### Decision:

During the course of proceedings, written responses were filed by Merchant Banker on various occasions in 2009 and 2010 and opportunity for personal hearings was given to the Merchant Banker. The various submissions as made by the Merchant Banker were considered by SEBI in the SEBI Order.

The following is the summary of submissions and holdings of SEBI on each of the aforementioned observations:

#### I. Rabobank being held as a promoter

*Merchant Banker:* (i) Rabobank was mentioned as co-promoter in the application for obtaining banking license only because of the support that it was providing to the promoters in a controlled and limited manner as permitted by Reserve Bank of India ("RBI"). Further, "the word 'Promoter' is not a term which is understood uniformly and each of the usage is coupled with the underlying purpose for which the term is used. The person defined under a connotation of a promoter or co-promoter by a financial institution or RBI or Government etc may not necessarily be called a promoter going by other defined connotations such as by SEBI Guidelines."

It is also important to note that the auditor's report on financial statement as appearing in red herring prospectus and the letter from Rabobank to RBI explicitly states Rabobank as "financial investor" and "technical partner" respectively.

(ii) As per the definition of "promoter" under the DIP Guidelines, Rabobank was neither in control<sup>5</sup> of Yes Bank (Rabobank has two nominee directors out of 12 directors on the board of Yes Bank) nor were they instrumental in the formulation of a plan or programme pursuant to which the offer was made.

In light of the above, Rabobank was not named as the promoter in the offer documents of Yes Bank.

*SEBI held:*

(i) Under Section 22 (1) of the Banking Regulation Act, 1949, to commence banking operation the following terms and conditions must be complied:

- The promoters' contribution shall be maintained at a minimum of 49% of the paid up capital at all points of time;

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- and
- 49% of the bank's pre-issue share capital held by promoters (domestic and foreign) was to be locked-in for five years from the licensing of the bank.

It is important to note that above conditions are imposed by RBI **only on promoters** of a bank.

On one hand in order to comply with the basic licensing condition of RBI (i.e. to maintain the minimum promoters' contribution of 49%), Rabobank was included in the promoter category for the 49% promoters' contribution requirement and its shares were also locked in for five years as prescribed by RBI. On the other hand, the same entity has not been disclosed as a promoter entity in the prospectus. Further, it was observed that the press release issued by RBI at the stage of the grant of the "in principle" approval clearly stated that certain banking professionals at Yes Bank alongwith Rabobank have been found suitable for setting up a new bank in the private sector."

In light of the above, the rationale for disparity in disclosure with RBI and SEBI and Rabobank being disclosed as mere 'technical partner' or 'financial investor' was not accepted by SEBI.

(ii) Rabobank had two nominee directors out of the 12 directors on the board of Yes Bank. As per the prospectus, Rabobank also had the right to nominate one non-rotational director on the Board; approve the names of the first three independent directors to be appointed as such by the board; and right to vote for the appointment of the chairman and the CEO and managing director to the relevant committees of directors.

This signifies that Rabobank was in control of Yes Bank as it had direct and indirect right to appoint majority directors on the board of Yes Bank and therefore satisfied the criteria of being classified as a promoter as per the DIP Guidelines.

## II. Preferential treatment accorded to certain foreign institutional investors

**Merchant Banker:** As per DIP Guidelines, the merchant banker can exercise its discretion as regards the allocation of shares. However, the final decision for allotment i.e. to whom and the percentage of shares that should be allotted rests with the issuer company. In the instant case, the Merchant Banker only made recommendations to Yes Bank /Board of Yes Bank.

**SEBI held:** Merchant Banker had a greater role to play in arriving at the recommendations of allotment and was party to the decision making process for allotment of shares to QIB. SEBI held that the arbitrary allotment of shares to selected category shows that the Merchant Banker has not exercised its discretion with utmost care, caution and in a judicious manner and therefore has failed to fulfill its obligations as a merchant banker in a professional and diligent manner.

## III. Failure to discharge duties in relation to redressing investor grievances and other matters pursuant to closure of the public issues

**Merchant Banker:** The merchant banker is not obliged to play the role of registrar and share transfer agent. It is only required to oversee, taking adequate steps in the process. Performing the act of the intermediary such as redressing investor grievance or irregularities in allotment of shares is not a job of a lead merchant banker. Further, the post issue lead merchant banker is expected to work in tandem with intermediary, however it cannot be held responsible for functions to be performed by the intermediary in any case.

**SEBI held:** The DIP Guidelines explicitly provides that the post-issue lead merchant banker shall actively associate himself with post-issue activities namely allotments, refund, dispatch and shall regularly monitor redressal of investor grievances arising.

In light of the above, it is clear that it is also the duty of the Merchant Banker to monitor the redressal of investor grievances and other matters pursuant to closure of the public issues.

## Conclusion

The SEBI Order in detail discusses the issue of promoter which has always remained a subject matter of debate. In relation to analysis of whether Rabobank has any 'control' over the Yes Bank, it is important to look back at the Securities Appellate Tribunal ("SAT") order in the matter of *Subhkam Ventures India Private Limited v. SEBI*<sup>6</sup> which clarified that veto rights (right to veto certain actions proposed to be undertaken by the company including appointment of nominee director) do not constitute 'control' under the Takeover Code. In light of both the orders, it remains to be seen whether the current SEBI Order will go a long way in developing jurisprudence on the subject.

Additionally, while the SEBI (Merchant Bankers) Regulations, 1992 lead the way in terms of regulation and governance of merchant bankers, it is through instances such as these that SEBI clearly highlights the role and responsibility of merchant bankers as envisaged by SEBI at the time of public issues – that of balancing the aspirations of issuer companies along with the primary duty of protecting the interest of the public at large by exercising due care and caution.

Also, while this order may still be challenged in SAT, what is important to note is that order such as this signals the Indian securities regulator's intent to strengthen its role towards investor protection and also signifies the obligations of the market intermediaries while dealing with public issues.

<sup>1</sup> SEBI Adjudication Order No. ESPL/AO/DRK/AS/EAD-3/231/09 -134/2010 dated December 31, 2010

<sup>2</sup> The DIP Guidelines were replaced by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. Please refer to our [hotline](#) dated September 11, 2009. The DIP Guidelines and the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 impose similar obligations on lead managers in terms of diligence and compliance in connection with public issues.

<sup>3</sup> Regulation 13 of the Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992 states that every merchant banker shall abide by the Code of Conduct as specified in Schedule III.

<sup>4</sup> Section 15HB of the SEBI Act, 1992 - Penalty for contravention where no separate penalty has been provided

*“Whoever fails to comply with any provision of this Act, the rules or the regulations made or directions issued by the Board thereunder for which no separate penalty has been provided, shall be liable to a penalty which may extend to one crore rupees.”*

<sup>5</sup> Regulation 2(1)(c) of the Takeover Code defines “control” as the right:

- (i) to appoint majority of the directors, or
- (ii) to control the management or exercise policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

<sup>6</sup> Please refer to our [hotline](#) dated January 22, 2010. Further, please note that SEBI has moved an appeal against the order of SAT in *Subhkam Ventures India Private Limited v. SEBI*.

- **Ruchi Biyani, Diptee Deshpande & Vyapak Desai**

You can direct your queries or comments to the authors

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