CONTENTS

Prerequisites of an Initial Public Offer

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Prerequisites of an Initial Public Offer

☞ INTRODUCTION

Initial Public Offer (**"IPO"**) is when a company makes a fresh issue of securities for the first time to the public. The requirements regarding the eligibility of companies to make an IPO are provided under the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000 (**"DIP guidelines"**) and the Companies Act, 1956 (**"Act"**). These requirements have been put in place to protect the interest of the public, who invest in such companies.

This month's newsletter focuses on the basic requirements a company must fulfill before it can actually proceed with the formalities of making an IPO. Briefly, it touches upon the requirements stipulated under the Act and the DIP guidelines.

1.0 Requirements under the Companies Act, 1956

The company proposing to make an IPO must be a public company since there is a restriction on private companies to invite the public to subscribe to its shares.[1] A company to qualify as a public company under the Act must have a minimum paid-up capital of INR 500,000[2] (USD 12500),[3] a minimum of seven shareholders[4] and a minimum of three directors.[5]

Further, a company must also meet the requirement provided under section 81(1A) of the Act. Under this provision, the company must either (i) pass a special resolution[6] in a general body meeting to issue securities to the public, or (ii) pass an ordinary resolution in favor of the issue and also obtain the Central Government's approval. The application has to be made by the Board of Directors.[7] Unless one of these requirements is met, the issuing company cannot proceed with the pre-issue formalities.

2.0 Requirements under the DIP guidelines

The Indian capital market regulator, Securities and Exchange Board of India (**"SEBI"**), governs issue of securities made by companies to the public, under the purview of the DIP guidelines. The DIP guidelines, which are a compilation of all the circulars issued by SEBI, provide the eligibility requirements to be satisfied by the companies proposing to make an IPO.[8] These requirements are as follows:

1. The issuing company must have net tangible assets[9] of at least INR 3 crores (USD 750,000), in each of the preceding three (3) years and not more than 50% of such assets

[1] Section 3(1)(iii)(c) of the Act.
[2] Section 3(1)(iv) of the Act.
[3] 1 USD = 40 INR.
[4] Section 12(1) of the Act provides that seven or more persons, or where the company to be formed will be a private company, any two or more persons, associated for any lawful purpose may, by subscribing their names to a memorandum of association and complying with the requirements of this Act in respect of registration, form an incorporated company, with or without limited liability.
[5] Section 252(1) of the Act provides that every public company other than a public company which has become such by virtue of section 43A shall have at least three directors, provided that a public company having (a) a paid up capital of INR 5 crores (USD 1,250,000) or more; (b) one thousand or more small shareholders, may have a director elected by such small shareholders in the manner as may be prescribed.
[6] Section 189(2) of the Act.
[7] Section 81(1A)(b) of the Act.
[8] Chapter II, clause 2.2.1, DIP guidelines.
[9] Net tangible assets means the sum of all net assets of a company, excluding intangible assets as defined in Accounting Standard 26 (AS26) issued by Chartered Accountants of India.

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should be monetary assets.[10] If more than 50% of the net tangible assets are held as monetary assets, the company should make firm commitments or declarations that it would utilize the excess monetary assets in its business activity,

2. The issuing company must have a consistent track record of distributable profits[11] for three (3) preceding years, in order to be eligible for making an IPO. To meet this requirement, extraordinary items[12] would not be taken into consideration while calculating the distributable profit,

3. The issuing company must have a net worth[13] of at least INR 1 crore (USD 250,000) in each of the preceding three (3) years,

4. In case the issuing company has changed its name within the previous year, at least 50% of the revenue earned during the preceding year should be attributable to the activity suggested by the new name, and

5. The aggregate of the proposed issue, in terms of size, should not exceed five (5) times the pre-issue net worth of the issuing company as per the audited balance sheet of the last financial year.

Clause 2.2.2 of the DIP guidelines further provides eligibility requirements for companies which do not satisfy the above mentioned eligibility criteria. The requirements under clause 2.2.2 provide that:

1. The issue is to be made by the book-building process and 50% of the net offer to public must be allotted to the Qualified Institutional Buyers (**"QIBs"**).[14] In the alternate, QIBs should be allotted a minimum of 10% of the issue size where the "Project" undertaken by the issuing company has at least 15% participation by financial institutions or banks, and of this minimum percentage, at least 10% is from the appraiser(s), and

2. The minimum face value of the capital of the issuing company, after making the issue should be INR 10 crores (USD 2,500,000), or the company must compulsorily undertake market-making for a period of 2 years from the date of listing of the shares.[15]

Additionally, the issuing company should also have a minimum of 1000 allottees, failing which would imply non-eligibility to issue IPO.[16] Here, allottees imply the person(s) to whom the shares offered through the IPO are allotted in return of their subscription under the IPO. Where the company does not meet these basic requirements, it would not be able to proceed with the pre-issue formalities.

Certain companies, such as banking companies and infrastructure companies are exempt from the application of these requirements.[17] A banking company which has been formed under Section 5(c) of the Banking Regulation Act, 1949 as a private bank under a license of the Reserve Bank of India, or a banking company which has been formed under the Banking Companies (Acquisition and

[10] Assets denominated in monetary terms (for example cash, account receivables or bonds), as opposed to non-monetary assets such as land, building or equipment.
[11] Distributable profits herein imply dividend being paid out of the profit, in terms of Section 205 of the Act.
[12] Extraordinary items are one-time entries that are not likely to reoccur. For example, the receipt from the sale of a large subsidiary or the payment received in connection with a lawsuit is a one-time event that is not expected to be repeated every year.
[13] Net worth means the aggregate of value of the paid-up equity capital and free reserves (excluding reserves created out of revaluation) reduced by the aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not written off) as per the audited balance sheet of the company.
[14] Clause 2.2.2B(v) of the DIP guidelines defines QIBs as: (i) public financial institution as defined in section 4A of the Companies Act, 1956; (ii) scheduled commercial banks; (iii) mutual funds; (iv) foreign institutional investor 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; (viii) state industrial development corporations; (ix) insurance companies registered with the Insurance Regulatory and Development Authority (IRDA); (x) provident funds with minimum corpus of INR 25 crores (USD 6,250,000); (xi) pension funds with minimum corpus of INR 25 crores (USD 6,250,000).
[15] Market-making is a process wherein a broker or dealer firm accepts the risk of holding a certain number of shares of a security, in order to facilitate trading in that security.
[16] Clause 2.2.2A of the DIP guidelines, inserted vide SEBI/CFD/DIL/DIP/Circular No. 11 dated August 14, 2003.
[17] Clause 2.4 of the DIP guidelines.

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Transfer of Undertaking) Act, 1970 Banking Companies (Acquisition and Transfer of Undertaking) Act, 1980, State Bank of India Act 1955 or State Bank of India (Subsidiary Banks) Act, 1959 as a public sector bank, are exempt from meeting all the requirements listed above. Also, an infrastructure company which has been appraised by a Public Financial Institution (**"PFI"**)[18] and a minimum of 5% of the project cost has been financed by one or more of such PFIs either by loan or by subscription to equity or a combination of both is exempt from the eligibility norms prescribed under Chapter II of the DIP guidelines.

3.0 Promoter's contribution

SEBI has explained the term *Promoter* as person(s), including a group of persons or a company, who is in over-all control of the company and is instrumental in the formation of the plan or programme,[19] in furtherance of which the IPO is made.[20] It includes the person(s) mentioned as promoter(s) in the prospectus of the company.[21] SEBI has provided for a mandatory contribution and lock-in period for promoters to protect the interest of the prospective investors. The DIP guidelines provide that in case of a fresh issue by an unlisted company, the minimum contribution of the promoter should be 20% of the post issue capital, and the promoter's contribution is to be locked-in for a period of three years. If the contribution of the promoter is below 20%, the issuing company would be obligated to refund the total amount received under the IPO to the investing public.

In case the contribution of the promoter is more than 20%, then it would be treated as a preferential allotment under chapter XIII of the DIP guidelines.[22] The minimum lock-in period for such contribution is three years from the date of allotment in the proposed issue, and the last date of the lock-in is three years from the date of commencement of commercial production or from the date of the allotment, whichever is later.[23] The issuing company has to ensure that the promoter's contribution is brought in before the issue is actually opened to the public and is kept in a scheduled bank in an escrow account. The amount in this account would be released to the company along with the rest of the public issue proceeds.[24]

The implication of the promoters' contribution in excess of the stipulated 20% of the total issue, being treated as a preferential allotment is the same as the lock-in requirement of the promoter's contribution.[25] Apart from this lock-in requirement, the preferential allotment guidelines provide for transfer of the locked-in securities but only amongst promoters or to a new promoter(s), for the remaining period and compliance of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (as applicable).[26]

☞ CONCLUSION

From the above, it is clear that no company can make an issue of an IPO unless the aforesaid requirements stipulated in the Act and the DIP guidelines are satisfied. In case a company does proceed with the pre-issue formalities without meeting these requirements, the IPO would be rendered void. In such a case, the company would have to refund the full amount received as subscription and may also be penalized by SEBI. This punishment may take the form of a fine or the company may be barred from making an IPO for a particular period. Therefore, a company proposing to make an IPO should ensure that it meets all the requirements, to avoid the issue from being cancelled at a later stage. ***(Ashutosh Chandola)***

(This E-Newsline is prepared by Ashutosh Chandola, a fifth year law student at Amity Law School, Delhi, who is pursuing his internship at PSA).

[18] Infrastructure Development Finance Corporation (IDFC) or Infrastructure Leasing and Financing Services Ltd. (IL&FS) or a bank which was earlier a PFI.

[19] The plan or programme refers to the project for which the IPO is made and the object for which the monies are proposed to be raised.

[20] Clause 6.4.2(k) under chapter VI of the SEBI guidelines.

[21] Ibid.

[22] Clause 4.8.1 of the DIP guidelines.

[23] Clause 4.11.1 and 4.11.2 of the DIP guidelines.

[24] Clause 4.9.1 of the DIP guidelines, inserted vide SEBI Circular No. DIP (Compendium) Circular No. 3 dated August 04, 2000.

[25] Clause 13.3.1 of the DIP guidelines.

[26] Clause 13.3.2 of the DIP guidelines, vide SEBI Circular No. RMB (Compendium) series 2003-04 Circular no.9 dated May 2, 2003.

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