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Material Information in a Prospectus

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ABSTRACT

The article revolves around the Securities Exchange Board Of India and its efforts to regulate the financial market in India. The paper highlights the importance of disclosures and ways in which SEBI regulates and penalizes offenders who fail to make proper disclosure during an initial Public Offer. The paper aims to shed light on why disclosure forms such an important part of an Initial Public Offer and why keeping a public investor important is of utmost priority to SEBI. The paper also talks about various regulations in place to help regulate the process of a Public Offer. Through this research paper it becomes highly evident that although SEBI gives utmost priority to investor protection they also seem to have wide discretionary powers in respect of deciding whether a company or individual has defaulted. The main question that drew me towards this topic was whether the company raising the capital has enough discretion to decide what according to them is material for the public offer.

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I. INTRODUCTION

Every Company however large or small needs funds to grow and expand their business. They do so by borrowing money through debt instruments such as loans, issuance of debentures or by issuing the company's shares to private investors or the public at large. **Section 23** of the

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Companies Act, 2013 (The “**Act**”) prescribes the manner in which a public and private company may issue securities. Under the law, a public company can issue its securities by issuing a prospectus, otherwise known as '**Public offer**'. The process by which a private company issues shares to the public at large for the first time is called an Initial Public Offering (“**IPO**”). In order to make an IPO the company must issue a Prospectus as required u/s 23 of the Act in accordance with the rules and regulations of the Securities and Exchange Board of India. The Securities and Exchange Board of India (“**SEBI**”) is a statutory regulatory body entrusted with the responsibility to regulate the Indian capital markets. It monitors and regulates the securities market and protects the interests of the investors by enforcing certain rules and regulations to be followed by all parties of a capital transaction. One of the main functions entrusted upon SEBI is to protect the interests of the investor and to ensure that all the information necessary to make an informed investment is available to the investor. It does so during the process of an IPO by forming rules and regulations of disclosures to be made in the prospectus. SEBI derives its power to regulate the sale of securities of a company from Section 24 of the Act.

II. PROSPECTUS

A prospectus is also known as an Offer Document. Section 2(70) of the act defines a prospectus as “any document described or issued as a prospectus and includes a red herring prospectus, shelf prospectus, any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.”² In layman terms a prospectus is a legal document which consists of the company’s dealings such as its financial statements from the past 5 years, its legal affairs, management, past dealings, risk factors and material information that is necessary for the investor to make an informed choice. The prospectus must have several chapters including but not limited to management information, regulatory obligations, financial statements, legal compliances and most importantly Risk factors. The company under several regulations is obligated to mention all relevant information related to the offer in the prospectus for the investors to scrutinize and make an informed choice.

III. NON-DISCLOSURE OF MATERIAL INFORMATION IN THE PROSPECTUS AND ITS LEGAL IMPLICATION

Disclosure based approach is based on the caveat emptor philosophy which implies that the

² S. 2(70) The Companies Act, 2013

investor has to make his own judgment and make investment decisions on the basis of the information disclosed in the prospectus. Disclosure norms eliminate the information advantage that insiders enjoy over outsiders in financial markets. The company has an obligation to disclose all material facts that are important to the IPO being launched. Any mis-statement by the company in the prospectus can become a liability on the company. This obligation is put upon the company by two statutes and various rules and regulations made under the same;

1. The Companies Act, 2013

Section 23 states that a public company can make an offer for sale of securities to the public through a public offer (which for the purpose of the chapter includes an initial public offer and further public offers). Section 25 of the companies act says that any document in which a company offers its securities for sale to the public at a particular price is deemed to be a prospectus and the liability of the loss of the public due to the mis-statements made in the prospectus/offer document lies on the company, its directors and its officers. Section 34 and 35 give the criminal and civil liabilities (respectively) for mis-statements made in the prospectus. Section 26 of the Companies Act, 2013 also gives the matters to be enlisted in the Prospectus. Finally Section 24 of the Companies act gives SEBI the power to regulate the issue and transfer of shares of the companies in India. SEBI derives its regulatory powers in respect to an IPO from this specific section.

2. The Securities and Exchange Board of India Act, 1992. (“SEBI Act”)

The Securities and Exchange Board of India was established on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992. SEBI plays a huge role in whether or not a company can be listed for an IPO as it duly scrutinizes the prospectus to make sure that every detail mentioned in it is true and relevant to the IPO. Another task that the SEBI takes care of is whether the company has put in all the material information necessary for the investor to make an informed choice about their investment. The company is not only liable to SEBI to disclose material facts under:

- i. Regulation 57 (1) and 57(2)(a)(ii) of the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009³ (“**ICDR Regulations**”)

³ “Regulation 57 (1), 57 (2) (a) (ii) of the ICDR Regulations: Manner of disclosures in the offer document 57 (1) the offer document shall contain all material disclosures which are true and adequate so as to enable the applicants to take an informed investment decision. (2) Without prejudice to the generality of sub-regulation (1): (a) the red-herring prospectus, shelf prospectus and prospectus shall contain: (ii) the disclosures specified in Part A of Schedule VIII, subject to the provisions of Parts B and C thereof.

- ii. Under Regulation 21⁴, 23A (a)⁵ and 23E⁶ of the Securities Contracts (Regulations) Act, 1956. (“SCRA”)
- iii. Penalty under section 15HB of the SEBI Act.
- iv. Section 15A of the SEBI Act imposes a maximum penalty of 1 crore rupees on defaulting parties and its officers.

But also to the stock exchange under clause 36 of the Listing Agreement signed between the designated stock exchange and the company as per the provisions of Regulation 109⁷ of the ICDR Regulations. A listing Agreement is basically a legal document which lays down the companies rights and obligations to the Exchange, a declaration that the company will comply with all of the SEBI regulations with respect to its securities. Non-compliance of the terms of the listing agreement would lead to the company getting delisted and penalties being imposed on the company and its officers in charge.

IV. CONCEPT OF MATERIAL INFORMATION & DUE-DILIGENCE

The Cambridge dictionary defines Material fact as “important information, especially financial information that a company must legally give to people who have invested or are going to invest in it”. Whereas another source defines it as “Material fact is a fact that is important, significant or essential to a reasonable person in deciding whether to engage or not to engage in a particular transaction, issue or matter at hand. It is a fact that is significant or essential to the issue or matter at hand”. SEBI being the regulating body for securities transactions has come up with several regulations throughout the years which make it necessary for companies to mention material facts in the prospectus. These regulations dictate provisions for dealing with issues and matters related with capital and disclosures to be made by the listed companies in India, to make the trading in securities flawless and beneficial both to the listed companies and the investors. When a company first decides to launch an IPO they must appoint merchant

⁴ Conditions for Listing Regulation 21 Where securities are listed on the application of any person in any recognized stock exchange, such person shall comply with the conditions of the listing agreement with that stock exchange.

⁵ Regulation 23A: Any person, who is required under this Act or any rules made thereunder,— (a)to furnish any information, document, books, returns or 109[report to the recognised stock exchange or to the Board, fails to furnish the same within the time specified therefor in the listing agreement or conditions or bye-laws of the recognised stock exchange or the Act or rules made thereunder, or who furnishes false, incorrect or incomplete information, document, books, return or report], shall be liable to a penalty for each such failure

⁶ Regulation 23E: f a company or any person managing collective investment scheme or mutual fund [or real estate investment trust or infrastructure investment trust or alternative investment fund], fails to comply with the listing conditions or delisting conditions or grounds or commits a breach thereof, it or he shall be liable to a penalty which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees.

⁷ (1) Every issuer or the issuing company desirous of listing its securities on a recognised stock exchange shall execute a listing agreement with such stock exchanges.

bankers who vet their company to make sure that all necessary compliances are adhered to and complied with. These Merchant bankers are also obligated to present all material facts during an IPO under Regulation 13 of the Merchant Bankers Regulations and under of Clause 1 of Form C of Schedule VI of Regulation 8(2)(b) of ICDR Regulation During the IPO stage a company as well its Book Running Lead Merchants (“**BLRMs**”) must also disclose all material information of its past, current and future dealings to the stock exchanges compulsorily under clause 36 of the listing Agreement which derives its meaning from Regulation 109 of the ICDR Regulations made by SEBI. The prospectus of the company serves as an Offer Documents during an IPO. As mentioned above the company as well as the BRLMs have a fiduciary duty to act in utmost good faith to its investors and to provide full and fair disclosure of all material facts, and make sure that they undertake reasonable care to avoid any misleading statements or facts. However, excessive disclosure may be tedious as it could make the offer document unreadable and would defeat the purpose of the regulations. Therefore, the question before the courts was “what would constitute a material fact”. The US court answered in a case as follows: A fact is said to be material if there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as giving significantly altered the “total mix” of information available”⁸. A report submitted by the SEBI sub-committee on integrated disclosures emphasized the need to make disclosures meaningful, non- duplicative and non-burdensome⁹. Similarly according to scholars if the company issuing the prospectus is anxious to omit any reference to a particular contract this is cogent evidence that it is material. A similar approach has been taken by the securities Appellate Tribunal in the matter of Electrosteel Steels limited and ors V. SEBI wherein the adjudicating authority stated that “The emphasis is on disclosure; not otherwise, which means disclose even when the issuer doubts whether there is any materiality. In other words, it would imply that only facts/ events which the issuer is undoubtedly sure of having no relevance to the issuer or to the issue can be excluded from disclosure”¹⁰. Moving further in India, SEBI has the power and discretion to impose penalty on the offenders under the SEBI Act. The discretion to impose a penalty must be exercised judicially. The supreme court clarified in a case that a penalty will ordinarily be imposed in cases where the party acts deliberately in defiance of law, or is guilty of contumacious or dishonest conduct, or acts in conscious disregard of its obligation; but not, in cases where there is a technical or venial breach of the provisions of the Act or where the breach flows

⁸ Basic, Inc v. Levinson, 485 U.S. 224, 231-32 (1998)

⁹ The Report of the Sub-Committee on Integrated Disclosures, Securities and Exchange Board of India (2008), para 2.1.

¹⁰ SAT, Misc. Application No. 381 of 2016 and Appeal No. 223 of 2016

from a bona fide belief that the offender is not liable to act in the manner prescribed by the statute.¹¹

V. CONCLUSION

With the abovementioned information it can be summed up that the financial markets in India are fairly regulated by SEBI. The regulator also has the authority to impose penalties on the defaulting parties for non-disclosure of material information to an extent of Rupees 1 crore/-. The regulator uses its discretion to decide whether the omission of a certain fact from the prospectus can constitute non-disclosure and whether the same was malicious or bona fide. The regulator also has the discretion to decide the materiality of certain information towards the ongoing transaction. The key highlight is that the regulator takes key interest in Investor protection and holds companies accountable for their misconduct or mischiefs. Therefore some may think SEBI has ample discretionary powers and that the companies tend to get scrutinized by SEBI for the smallest of mishaps, thus increasing our faith in the Indian market regulator. But on the other hand such wide discretionary powers in one body's hand could render lots of companies helpless as they need to maintain all records however unnecessary.

¹¹ Hindustan Steel Ltd vs State Of Orissa, 1970 AIR 253