

Discussion paper on developing a market for
Small and Medium Enterprises in India

1. Background

The Small and Medium Enterprises (SMEs) play a catalytic role in the development process of most economies as they constitute a major part of the industrial activity in these economies. This is reflected in the form of their increasing number and rising proportion in the overall product manufacturing, employment, technical innovations and promotion of entrepreneurial skills.

The contribution of SMEs in the development of Indian economy has been significant, both in terms of contribution to GDP and creation of employment opportunities. They contribute around 20% of GDP and are the largest generator of employment (approximately 25 million). In India, SME sector is the second largest employer, after agriculture. With the Indian economy growing at more than 9 per cent and size of the economy crossing the \$1 trillion mark, the need of SMEs to raise capital is becoming increasingly critical.

2. Industry Concerns

Discussions were held with various market participants and industry representatives to seek their comments / suggestions on the subject. During the course of the discussions, certain areas of concern on the subject were expressed by them, which are as under -

- The cost of raising capital for SMEs is quite high.
- The current means of financing for SMEs are not adequate as they do not have easy access to funds from Angel Investors, VCs and PE players.
- Most costs of compliance in raising capital under the existing guidelines are fixed. As a result, the costs become burdensome for smaller issues (SMEs).
- The SMEs should be provided a framework that would enable them to raise capital quickly and at a low cost.

- Owing to small size and less affordability, the eligibility conditions, listing requirements, corporate governance norms and disclosure standards may need to be suitably relaxed for SMEs.

3. Need for a separate dedicated SME stock exchange

In view of the aforesaid concerns raised by the market participants / industry representatives, there is a felt need for developing a dedicated stock exchange for the SME sector so that SMEs can access capital markets easily, quickly and at lower costs. Such dedicated SME exchange is expected to provide better, focused and cost effective service to the SME sector.

The need for having a separate exchange / platform for SMEs was also discussed during the 32nd Annual Conference of IOSCO held in April 2007 in Mumbai and it was felt that the same would be necessary for the focused development of the SME sector.

Efforts had already been made in the past for catering to the needs of small companies. Towards this end, OTCEI was set up in 1989 and the INDO NEXT Platform of the BSE was launched in 2005. However, both these experiments failed to achieve the desired results.

4. International experience

Internationally also countries have provided for a separate exchange / trading platform to facilitate listing of securities of growth companies / new economy companies / small and medium companies. Some of the cases in point are the Alternative Investment Market (AIM), London, the Growth Enterprises Market (GEM), Hong Kong and MOTHERS, JAPAN. Out of these, the GEM is a separate dedicated stock exchange whereas the AIM and the MOTHERS are trading platforms of their respective main stock exchanges.

AIM provides for ease of entry and less onerous disclosure requirements but appropriate level of regulation for smaller companies. It also provides faster admission process and no pre-vetting by regulator.

GEM operates on the philosophy of "buyers beware" and "let the market decide" based on a strong disclosure regime. Here the rules and requirements are designed to foster a culture of self compliance by the listed issuers in the discharge of their responsibilities.

In the case of MOTHERS, the emerging companies applying there must have the potential for high growth though there are no specific numerical criteria for determining growth potential. Further, the applicant company is mandated to make a public offering of at least 500 trading units. At the time of listing, it should have at least 2,000 trading units and the market capitalization of its listed shares should be more than 1 Billion Yen. The applicant must also have a continuous business record of not less than 1 year dating back from the day on which it makes listing application.

5. Issues for consideration

In view of the aforesaid concerns raised by the industry representatives / market participants, it may be necessary to have a fresh look on the listing norms and continuous disclosure requirements for the SME sector. Accordingly, SEBI is in the process of framing a suitable policy with regard to the above. In this regard, public comments are sought on certain important issues, mentioned below –

Issues relevant to the Primary Markets

- a) In order to have only informed, financially sound and well-researched investors, it may be desirable to fix a minimum investment size, say Rs. 5 lakhs, at the time of the IPO.
- b) To facilitate retail participation in SMEs for investors having high-risk appetite, specific allocation through mutual funds may be permitted.
- c) For being eligible to participate in the SME exchange, a company may have a maximum post-issue capital of Rs. 25 Crores.
- d) Specialized Merchant Bankers may be licensed for exclusively catering to the needs of the SME segment.

- e) There may not be any requirement of vetting of the offer document by SEBI since the intended investors are expected to make informed and calculated investments.
- f) As per the existing DIP Guidelines, the issuer company is required to have net tangible assets of at least Rs. 3 Crores in each of the preceding 3 full years, a track record of distributable profits for at least 3 out of immediately preceding 5 years and a net worth of at least Rs. 1 Crore in each of the preceding 3 years. These may be relaxed completely for SMEs.
- g) There may not be any restriction on the number of investors as long as they are informed investors.
- h) Price discovery may be made through fixed price mechanism or through the book building process.
- i) Underwriting may be made mandatory and it may be also mandated that the merchant bankers for the IPO, be required to compulsorily fully underwrite the issue.
- j) The merchant bankers/underwriters in the IPO may be compulsorily required to be market makers for the company.
- k) The issue should be through electronic applications only, eliminating all costs associated with paper printing and processing.

Issues relevant to the Secondary Markets

- a) In order to ensure that the relaxed criterion for SMEs does not result in retail investors being drawn in, a minimum trading lot of Rs. 5 lakhs to be prescribed.
- b) Trading system may either be order driven or quote driven. In this regard, the settlement may either be on rolling, trade for trade or call auction basis. Flexibility may be given to the exchange concerned.

Continuous Listing Requirements

- a) Reporting of results by the companies listed on the SME exchange may be made on a half yearly basis instead of quarterly basis. Further, they may be required to file only unaudited results.

- b) A simplified and abridged version of the annual report may be prepared by the company and the requirement of sending full annual reports to all the shareholders may be dispensed with. Instead, the companies may post their annual reports on their web-sites or of the exchange. Physical copies of the same may be provided to the shareholders only on specific request.
- c) The companies listed on the SME exchange may migrate to the bigger exchanges as and when they meet the listing requirements of the bigger exchanges.

Comments / suggestions are invited on the above proposal. In addition to the above, suggestions may be made on any other important policy issues as well.

The same may be sent before June 6, 2008 to Mr. Bhartendra Kumar Gupta, Assistant General Manager, Market Regulation Department, SEBI at the following address -

Market Regulation Department - Division of SRO Administration
SEBI Bhavan, 2nd Floor, A-Wing
Plot No. C4-A, "G" Block
Bandra Kurla complex
Mumbai-400 051

The comments / suggestions may also be e-mailed to bhartendrakg@sebi.gov.in.
