

**CHAPTER****3**

# **PROSPECTUS AND ALLOTMENT OF SECURITIES**



## **LEARNING OUTCOMES**

**At the end of this chapter, you will be able to:**

- ◆ Define prospectus
- ◆ Understand various types of prospectus
- ◆ Explain the procedure for issue of prospectus and other related concepts
- ◆ Know about the criminal and civil liability for mis-statements in prospectus and punishment for fraudulently inducing persons to invest money
- ◆ Understand the procedure for allotment of securities by companies
- ◆ Know the procedure of private placement of securities

## CHAPTER OVERVIEW



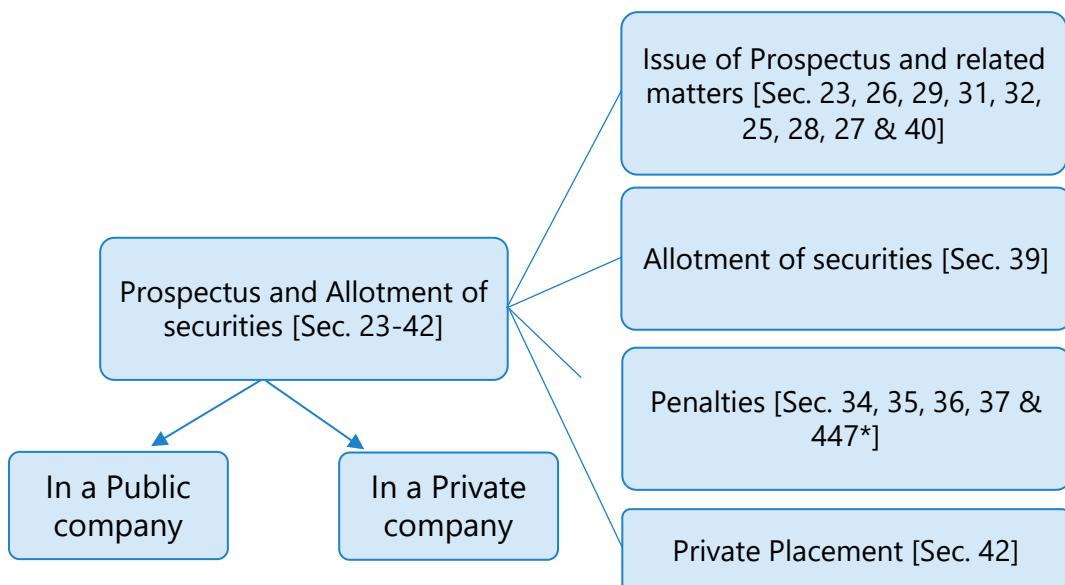
This chapter explains the provisions of Chapter III of the Companies Act, 2013 (hereinafter also referred to as "the Act" or "this Act"), consisting of sections 23 to 42 dealing with the prospectus and allotment of securities. Due to the inherent differences between the nature of public and private companies in addition to restrictions on the later, Chapter III of the Act contained the provisions for issue of securities under two distinct headings (parts):

**Part I** - Public offer (Section 23-41)

**Part II** - Private placement (Section 42).

The provisions contained in Part I and part II are supplemented by the Companies (Prospectus and Allotment of Securities) Rules, 2014.

Following diagram depicts the arrangement of relevant sections:



\* Section 447 contains provisions relating to 'punishment for fraud'.



## 1. INTRODUCTION

<b>Chapter III</b>	<b>Consists of sections 23 to 42 as well as the Companies (Prospectus and Allotment of Securities) Rules, 2014.</b>
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One of the advantages that a company has over other forms of business is its ability to raise capital, either from the public at large or from a set of identified persons. When the capital is raised from the public at large, it is done through a '**Public Offer**' and when it is raised from a selected group of identified persons it is carried out through a '**Private Placement**' of securities. Where the capital is raised from the public at large through 'Public Offer', an advertisement shall be issued in accordance with applicable provisions to protect the prospective investors from fraud. Securities are allotted against those applications that are received in full and in accordance with the advertisement issued. Such securities may be listed on an appropriate segment of a recognised stock exchange.

This chapter will explain the provisions relating to raising of capital i.e. issue of prospectus, allotment of securities, and other matters incidental thereto.



## 2. PUBLIC OFFER AND PRIVATE PLACEMENT [SECTION 23]

**As per Section 23 (1), a public company** may issue *securities*:

- a. To public through prospectus (herein referred to as "**public offer**") by complying with the provisions specified in Section 23 to Section 41 of the Act; or
- b. Through private placement by complying with the provisions specified in section 42 of the Act; or
- c. Through a rights issue or a bonus issue in accordance with the provisions of the Act and in case of a listed company or a company which intends to get its securities listed also with the provisions of the Securities and Exchange Board of India Act, 1992 and the rules and regulations made thereunder.

**Public offer** includes initial public offer (IPO) or further public offer (FPO) of securities to the public by a company, or an offer for sale of securities (OFS) to the public by an existing shareholder, through issue of a prospectus.

Students are advised to note; that Further Public Offer also known as Fellow-on Public Offer, whereas OFS is sometimes called deemed Public Offer.

As per **Section 23(2)**, a **private company** may issue securities:

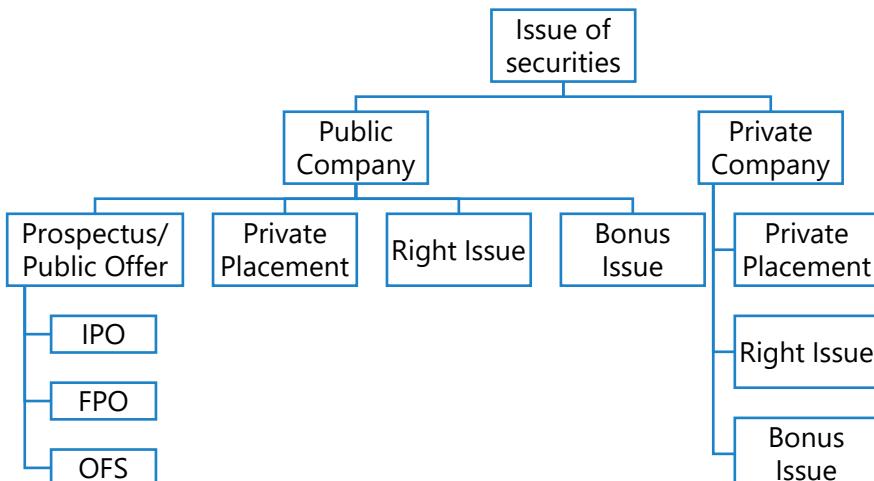
- a. By way of rights issue or bonus issue in accordance with the provisions of the Act; or
- b. Through private placement by complying with the provisions specified in section 42 of the Act.

**Summary** of modes (for issue of securities)

Mode of Issue	Public Company	Private Company
Public Offer (including IPO, FPO or OFS)	Yes	No
Private Placement	Yes	Yes
Rights issue / Bonus Issue	Yes	Yes
Compliance with SEBI rules & regulations	Yes*	No

\*For a listed company or a company proposed to be listed.

Various modes of issue of securities available to a public company or a private company are depicted in the following diagram for better understanding:



**Security is a wider term, not restricted to equity, preference, or debenture.****Meaning of Securities**

As per **section 2 (81)**, the term 'securities' means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956. The definition given thereunder provides, "Securities" include:

- (i) Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
- (ia) Derivative;
- (ib) Units or any other instrument issued by any collective investment scheme to the investors in such schemes;
- (ic) Security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
- (id) Units or any other such instrument issued to the investors under any mutual fund scheme.

**Explanation** - For the removal of doubts, it is hereby declared that "Securities" shall not include any unit linked insurance policy or scrips or any such instrument or unit, by whatever name called, which provides a combined benefit risk on the life of the persons and investment by such persons and issued by an insurer referred to in clause (9) of section 2 of the Insurance Act, 1938.

- (ie) Any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be;
- (ii) Government securities;
- (iia) Such other instruments as may be declared by the Central Government to be securities; and
- (iii) Rights or interests in securities.

To bring ease to doing business for corporates, sub-section 3 and 4 to section 23 of the Act were inserted.

Prior to the above amendments, Indian companies could access the overseas equity

markets only through depository receipts (e.g. American Depository Receipts (ADRs) or Global Depository Receipts (GDRs) or by listing their debt securities (such as, foreign currency convertible bonds, masala bonds, etc.) on foreign markets.

Since more and more businesses are going global & capital raised from across the border is cost effective, hence **section 23(3)** was inserted to open ways of **overseas direct listing** for notified class of public companies by allowing them to issue notified securities for the purpose of listing on permitted stock exchanges in permissible foreign jurisdictions or such other jurisdictions as may be prescribed.

**Note: How overseas direct listing is different from ADRs/GRDs?**

In a direct listing, a domestic company can enlist itself with the stock exchanges of other countries without an intermediary. Unlike American Depository Receipts (ADRs) and Global Depository Receipts (GDRs), the Indian company can directly offer their shares in foreign markets instead of giving them to a foreign depository bank. Direct listing excludes intermediaries, decreases the overall transaction cost, and increases transparency.

**Section 23(4)** of the Act empowers the Central Government to **exempt any class or classes of public companies** from complying with the provisions of Chapter III (Prospectus and Allotment of Securities), Chapter IV (Share Capital and Debentures), section 89 (Declaration in respect of a beneficial interest in any share), section 90 (Register of significant beneficial owners in a company) or section 127 (Punishment for failure to distribute dividends) of the Act, by issuing notification.

**Extract of section 23(3) and 23(4)**

*"(3) Such class of public companies may issue such class of securities for the purposes of listing on permitted stock exchanges in permissible foreign jurisdictions or such other jurisdictions, as may be prescribed.*

*(4) The Central Government may, by notification, exempt any class or classes of public companies referred to in sub-section (3) from any of the provisions of this Chapter, Chapter IV, section 89, section 90 or section 127 and a copy of every such notification shall, as soon as may be after it is issued, be laid before both Houses of Parliament."*

**Illustration (MCQ)**

*Which of following shall be considered as securities for purpose of section 23 of the Act;*

- (i) Unit linked insurance policy

- (ii) Actionable claim regarding mortgaged debt
- (iii) Securities issued by National Asset Reconstruction Ltd.

**Options**

- (a) (iii) only
- (b) Both (i) and (iii) only
- (c) Both (ii) and (iii) only
- (d) None of the (i), (ii), and (iii)

**Answer** – (c) (Refer section 2(h) of the Securities Contracts (Regulation) Act, 1956)



### 3. REGULATION OF ISSUE AND TRANSFER OF SECURITIES ETC. [SECTION 24]

**Securities and Exchange Board of India** is empowered to administer those provisions under chapter III and IV of the Act, which pertains to **issue & transfer of securities** and **non-payment of dividend**; by **listed companies** or those **companies which intend to get their securities listed on any recognised stock exchange in India**, by making regulations in this behalf.

**Additional Reading**

Being capital market regulator, the power is conferred upon Securities and Exchange Board of India under section 11, 11A, 11B and 11D of the Securities and Exchange Board of India Act 1992.

All other matters (including matters relating to prospectus, return of allotment, redemption of preference shares) specifically provided in this Act, shall be administered by the Central Government, Tribunal or the Registrar, as the case may be.

**Illustration (True/False)**

**Statement** – *The powers to administer the matters pertaining to redemption of preference share by listed company vested with the Securities and Exchange Board of India.*

**Answer** – False (Refer Section 24(1)(a))

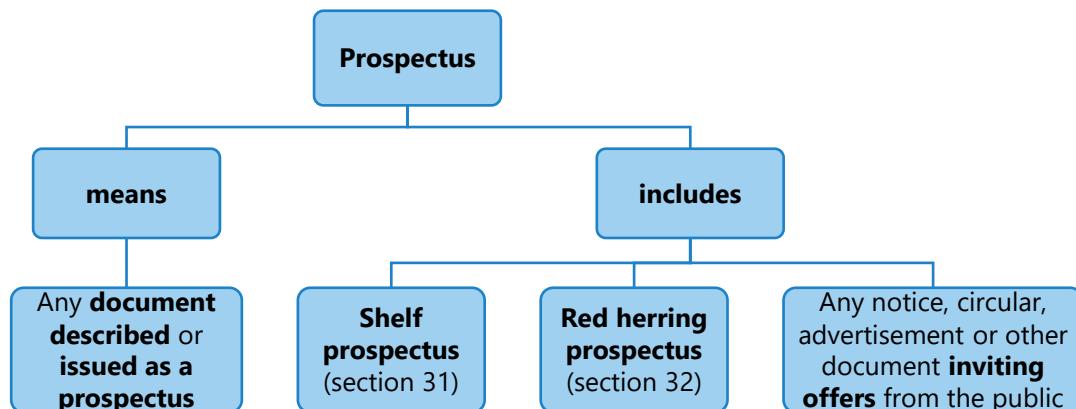


## 4. PROSPECTUS

### Meaning

As per the definition given in section 2 (70) of the Act, **Prospectus** means any **document described or issued as a prospectus**, and **includes** a **red herring prospectus** referred to in section 32, or **shelf prospectus** referred to in section 31, or **any notice, circular, advertisement or other document inviting offers** from the public for the **subscription or purchase** of any securities of a body corporate.

The definition of prospectus has two limbs (*means* part and *includes* part) with four elements in totality, these four constituents can be appreciated through diagram presented below:



Out of four constituents of prospectus definition, first three are quite clear; but the fourth one i.e. **document inviting offer from the public** (considered as **deemed prospectus** or **prospectus by implication**) need to be decoded further that too in context to section 25 and landmark judicial pronouncements (elaborated later).

Other elements are also explained/elaborated at relevant place in this chapter.

### DEEMED PROSPECTUS [SECTION 25] - THE DOCUMENTS CONTAINING OFFER OF SECURITIES FOR SALE

#### Deemed Prospectus

**Sub-section 1** provides, where a company allots or agrees to allot any of its securities with a **view** that those securities (all or any part thereof) being **offered for sale to the public**, any document by which the offer is made; shall **deemed to be a prospectus** (issued by the company) for all purposes.

All the enactments and rules of law containing provisions pertaining to prospectus, matters to be stated, liability for misstatement shall apply to such deemed prospectus; subject to section 25(3) and 25(4).

The purpose of deeming provision is to protect gullible investors from various fraudulent practices.

### **Presumption of view (intent to offer securities for sale to public) under sub-section 1**

As per **sub-section 2**, the allotment is **presumed** to have been made with a **view of offering them to the public** where **either** of following conditions fulfilled:

- a. Securities are offered to the public **within six months of allotment**, or
- b. Where the **full consideration has not been received** by the company at the date of offer to the public.

It means, in case if any of above two conditions met; then issuing document shall deemed to be Prospectus under sub-section 1.

Sub-section 1 and 2 to section 25 are not exhaustive in nature, there may be certain other situations when issuing document may construe as deemed prospectus.

*SEBI v Kunnamkulam Paper Mills Ltd*<sup>9</sup>

Where a rights issue is made to existing members with a right to renounce in favour of others, if the number of such others exceeds fifty, it also becomes a deemed prospectus.

### **Requirements in case of Deemed Prospectus**

#### **Matters to be stated additionally**

As per **Sub-section 3**, following **matters need to be stated** (in the deemed prospectus i.e. the document through which offer of securities to public is made under sub-section 1) **in addition to those required under section 26**;

- a. A statement of the **net amount received** or **to be received** as consideration for the securities to which the offer relates.
- b. The **time** and **place** at which the underlying contract for allotment may be inspected.

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<sup>9</sup> (2013)178 Comp Cas 371 (Ker)

- c. The **persons making the offer** were named in the prospectus **as directors** of the company.

### **Signing of deemed prospectus (on behalf of company)**

Further, as per **Sub-section 4**, it is sufficient, if the document (**deemed prospectus** i.e. through which offer of securities to public is made under sub-section 1) on behalf of the company is signed by its two directors.

#### **Illustration (True/False)**

**Statement** – *The matters specified under section 25(3) need to be stated in substitution of matters stated under section 26.*

**Answer** – False [Section 25(3) provides three matters that need to be stated in addition to matters required to be stated in prospectus under section 26.]

Additional Reading – For better understanding only

Since the provisions of the Act relating to prospectus and the penal provisions are attracted only when the prospectus (including deemed prospectus) has been **issued**. "Issued" means issued to the **public**.

Hence In context of 'Invitation to Public' 'Inviting offer from the Public' or 'Offer of securities for sale to Public' two valid questions arise here:

#### **1. What constitute as 'Public'? Does only 'Public at large' constitute as Public?**

The term public is not restricted to the public at large. It includes any section of the public, it is immaterial howsoever such section is selected.

Public connotes persons not personally known to the promoter as distinguished from his own friends, relatives, connections and acquaintances.

*Re, South of England Natural Gas and Petroleum Co. Ltd*<sup>10</sup>

**Facts** – 3000 copies of a document which was offered for subscription of shares in a company and which was headed "For Private Circulation only," circulated to the members of certain number of gas companies only.

**Legal Question** – Was this a prospectus? Should it contain the particulars required by the Act?

**Decision** – It was decided that though the offer was only to limited class, it was not less than an offer to the public in any sense, because **those persons from limited**

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<sup>10</sup> (1911) 1 Ch. 573 | 104 LT 378

**class were nonetheless the public.** Hence, the distribution of a document entitled, "For Private Circulation only" offering the company shares was an offer to the public and their document was a prospectus. Therefore, it must contain the particulars required by the Act.

## **2. Whether a single private communication tantamount to issue; can it be construed to a prospectus to attract the provisions of the Act?**

The term "issue" is **not satisfied by a single private communication**. There must be some measure of publicity, however modest. A **private communication** is not thus open and **does not construe to be a prospectus**, hence not attracting the provisions of the Act.

*Nash v. Lynde*<sup>11</sup>

**Facts** – Nash applied for certain shares in a company on the basis of a document sent to him by Lynde, the managing director of the company. The document was marked 'strictly private and confidential'. The document did not contain all the material facts required by the Act to be disclosed. Nash filed a suit for compensation for loss suffered by him by reason of the Omissions.

**Decision** – Suit was dismissed.

**Viscount Summer's** landmark dictum in this case is worth to consider here as basis of above answer. "The public in the definition is of course a general word, no particular number are prescribed. Anything from two to infinity may serve, perhaps even one if he is intended to be the first of a series of subscribers but made further proceedings needless by himself subscribing the whole. The point is that the offer is such as to be opened to anyone who brings his money and applies in due form, whether the prospectus was addressed to him on behalf of the company or not. A private communication is not thus open and does not construe to be a prospectus."

### **Illustration (Q&A)**

*Company's prospectus was given to a solicitor of the company and he forwarded it to one of his clients despite it was marked strictly private, who applied for share based upon same. Later filed suit for damages. Will this communication amount to an issue to the public and whether the provisions of the Act are attracted?*

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<sup>11</sup> (1929) AC 158 | 140 LT 146 (HL)

**Answer -** No, this did not amount to an issue to the public and accordingly the provisions of the Act relating to liability for omissions, etc. not attracted here. (Refer *Nash v. Lynde*<sup>12</sup>)

### MATTERS TO BE STATED IN PROSPECTUS [SECTION 26] – CONTENTS & REQUIREMENTS AS TO PROSPECTUS

#### Requirements as regards to date, sign, and contents to be included [Sub-section 1]

Prospectus shall be **dated** and **signed** and shall **state such information** and set out such **reports on financial information** as may be specified by the **Securities and Exchange Board of India** (SEBI) in consultation with the Central Government.

Proviso to sub-section 1 says the regulations made by SEBI in respect of such financial information or reports on financial information shall apply until the SEBI specifies the information and reports on financial information u/s 26(1).

A declaration shall be made **affirming the compliance** of the provisions of this Act (the Companies Act 2013).

A statement shall also include to the effect that **nothing** in the prospectus **is contrary** to the provisions of:

- a. The Companies Act, 2013
- b. Securities Contract (Regulation) Act, 1956
- c. Securities and Exchange Board of India Act, 1992
- d. Rules and Regulations made under above three statutes.

#### The provisions of Section 26(1) shall not apply [Sub-section 2]

- a. If prospectus issued to **existing** members or debenture-holders of a company;
- b. If prospectus issued relating to shares or debentures which are in all respects **uniform** with shares or debentures previously issued and for the time being dealt in or quoted on a recognised stock exchange.

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<sup>12</sup> (1929) AC 158 | 140 LT 146 (HL)

### Date of publication of prospectus [Explanation to Sub-section 3]

The date indicated in the prospectus shall be **deemed** to be the date of its publication.

### Filing of signed copy with Registrar [Sub-section 4]

A prospectus shall not be issued unless a **signed copy** of such prospectus has been **delivered to the Registrar for filing**.

Such copy shall be signed by **every** person who is named as either director or proposed director in such prospectus. Duly authorised attorney can sign in representative capacity.

**Example** – Ms. Sarika, executive director of leading Fintech Company has to fly to Davos to attend World Economic Forum meet.

While company secretary of the company intended to file a copy of prospectus with registrar upcoming, Ms. Sarika authorised in writing, Mr. Gautam for signing of such copy on her behalf.

Date of filing copy of prospectus with registrar is important in context of concept of **validity of prospectus for issue**, discussed under section 26(8).

### Conditions in regard to Experts' statement [Sub-section 5]

A prospectus issued under section 26(1) **shall not** include a statement purporting to be made by an **expert**, if any of following condition met:

- a. If he is engaged or interested in the formation or promotion or management of the company, **or**
- b. If the expert has not given written consent to the issue of the prospectus, **or**
- c. If he has withdrawn the consent before the delivery of a copy of the prospectus to the Registrar for filing.

A **statement to that effect** (non-existence of conditions, if expert's statement is included) shall also be included in the prospectus.

Purpose of sub-section 5 is to ensure independence of expert to protect the financial interest of prospective investor who may invest in company after relaying

upon the statement of such expert.

Expert as per section 2(38) of the Act, **includes** an engineer, a valuer, a Chartered Accountant, a Company Secretary, a Cost Accountant and any other person who has the power or authority to issue a certificate in pursuance of any law for the time being in force.

### Disclosure on the face of prospectus [Sub-section 6]

Prospectus issued under sub-section (1) shall, on the face of it, state/specify:

- a. That a copy has been delivered for filing to the Registrar under sub-section (4);
- b. Documents required by this section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents.

### Validity of Prospectus for issue [Sub-section 8]<sup>5</sup>

A prospectus is considered to be valid for issue, only if **90 days** has not been lapsed from the date on which a copy thereof is delivered to the Registrar under section 25(4).

The date of issue is important for many reasons, one of them being the value of securities keeps changing.

If 90 days have expired after filling of prospectus, it is better to send a fresh copy of prospectus to registrar under section 26(4); to avoid the penalties imposed under section 26(9).

### Penalty [Sub-section 9]

If a prospectus is issued in contravention of the provisions of section 26 the **company and every person who is knowingly a party to the issue of such prospectus** shall be punishable with **fine of ₹ 50,000 to ₹ 3,00,000**.

**Example -** The Board of Directors of a Pharmaceutical Limited has allotted shares to the public by issuing a prospectus that is not filed with the Registrar of Companies.

<sup>5</sup> Sub- section 7 has been Omitted by the Companies (Amendment) Act, 2019, w.e.f. 15-8-2019.

In this regard, it is to be noted that a public company can issue securities to the public only by issuing a prospectus, under section 23(1)(a) of the Act.

Further section 26(4) requires that no prospectus shall be issued unless, a duly signed copy of the prospectus forwarded to Registrar for filing.

In the given case, the company has issued the prospectus in violation of the provisions of section 26. Hence, company as well as the person who is knowingly a party to this, will be punishable with penalty under section 26 (9) of the Act.

#### Illustration (True/False)

**Statement** – *The copy of prospectus submitted with registrar for filing need to be duly signed by majority of directors.*

**Answer** – False

Under section 26(4) of the Act, the copy of prospectus submitted with registrar for filing shall be signed by every person who is named as either director or proposed director in such prospectus. Duly authorised attorney can sign in representative capacity.

### VARIATION IN TERMS OF CONTRACT OR OBJECTS STATED IN PROSPECTUS [SECTION 27]

Sub-section 1 provides, the terms of a **contract** referred to in the prospectus or **objects** for which the prospectus has been issued **can be varied**, but **only with the authority** of the company given by it in **general meeting** by way of **special resolution**.

First proviso to sub-section 1 requires that prescribed details of the **notice** which has to be given to the shareholders are to be **published in newspapers** (one in English and one in vernacular language) circulating in the city where the registered office of the company is situated **indicating clearly the justification for such variation**.

The second proviso to sub-section (1) also prescribes that **such company is not to use any amount raised** by it through the prospectus for **buying, trading or otherwise dealing in equity shares of any other listed company**.

Sub-section (2) provides that the **dissenting shareholders** (i.e. those who did not agree to the variation) are to be given an **exit offer** by promoters or controlling shareholders at such **exit price** and in such **manner and conditions** as may be **specified by SEBI** by making regulations for this purpose.

**Example** – Ind-swift pharma limited after issue of prospectus, willing to make variation in object of issue of prospectus (due to change in industry brought by covid-19 among other dynamics of pharma industry). What is your piece of advice to Ind-swift pharma limited?

In given case, Ind-swift should authorise the changes through special resolution passed at general meeting and copy of notice that is given to shareholder for such variation shall be published in newspaper along with justification of variation.

If any shareholder shows dissent then exit option shall be provided in accordance with guideline issued in this regards by SEBI.

Once funds are raised through a given prospectus, the principle of "doctrine of ultra vires" (*mutatis mutandis*) comes into play i.e., the company has to use the funds strictly in accordance with the prospectus.

But if in any case variation need to made, then such deviations are required to be pre-approved by the investors and 'recall option' needs to be given to the dissenting investors. Deviation regarding use of proceeds of issue for buying, trading or otherwise dealing in equity shares of any other listed company is not permitted in any case.

### Procedural Aspects

Rule 7 of the Companies (Prospectus and Allotment of Securities) Rules, 2014

Sub-rule 1, provides for **Special Resolution to be passed through Postal Ballot and Contents to be included in Notice.**

**Further** sub-rule 2, provides the advertisement of the notice (for getting the resolution passed) shall be in Form PAS-1 and such advertisement shall be published simultaneously with dispatch of Postal Ballot Notices to Shareholders.

According to sub-rule 3, the notice shall also be placed on the **website** of the company, if any.

### Illustration (MCQ)

*In case of variation in terms of contract or objects in prospectus, which of the followings statement are not true:*

- (i) Ordinary resolution shall be passed at general meeting

- (ii) Notice given to shareholder shall also be published in two newspapers
- (iii) Amount so raised can be invested only in equity share of prescribed class of companies.

### **Options**

- (a) (i) only
- (b) Both (i) and (ii) only
- (c) Both (i) and (iii) only
- (d) Both (ii) and (iii) only

**Answer** – (c)

## **OFFER OF SALE OF SHARES BY CERTAIN MEMBERS OF COMPANY [SECTION 28]**

Sub-section 1 provides that, **member** or members of a company, in **consultation with board of directors**, may **offer whole or part** of their holding of **shares** to the **public**, in accordance with the provisions of the law for the time being in force.

Further sub-section 2 provides that the document by which the offer of sale to the public is made shall be **treated as prospectus issued by company**. Hence, all provisions apply accordingly.

At last sub-section 3 highlights the members' responsibility in the matter of sale under sub-section 1. It provides, the members whether individual or bodies corporate or both, whose shares are proposed to be offered to the public, **shall collectively to authorise the company** to take all actions on their behalf for **carrying out the transaction**. They also have to **reimburse** the company for **all expenses** made by it on this matter.

### **Procedural Aspects**

Rule 8 of the Companies (Prospectus and Allotment of Securities) Rules, 2014

According to Rule 8 (1) the provisions of section 23 to 41 of this Act and rules made thereunder shall be applicable to an **offer of sale** referred to in section 28 except for the provisions relating to:

- a. minimum subscription
- b. minimum application value

- c. any statement to be made by the Board of directors in respect of the utilization of money; and
- d. information which cannot be compiled or gathered by the offer or, with detailed justifications for not being able to comply with such provisions.

Further, Rule 8 (2) requires that the prospectus issued under section 28 shall disclose the name of the person or persons or entity bearing the cost of making the offer of sale along with reasons.

#### **Illustration (Q&A)**

*In case of Super-Fix-it Limited, some of members of a company offer part of their holding of shares to the public (in consultation with board of directors), wherein company took all actions on their behalf for carrying out the transaction.*

*Company incur the expense of ₹ 3.2 lakh for carrying out such transactions, can company recover the amount so incurred in full from such members?*

**Answer** – Yes, members who offer whole or part of their holding of shares to the public, in consultation with board of directors, shall authorise the company to take all actions on their behalf for carrying out the transaction, and bound to reimburse the company for all expenses made by it on this matter [Refer section 28(3)].

#### **PUBLIC OFFER OF SECURITIES TO BE IN DEMATERIALISED FORM [SECTION 29]**

Sub-section 1 has overriding effect to any other provision of this Act. It provides that **every company making a public offer** and **such other class or classes of companies as may be prescribed**, have to **issue** their securities only in dematerialised form by complying with the provisions of the Depositories Act, 1996 and regulations made under it.

Sub-section 1A (inserted in 2019), provides that in case of **prescribed class/classes of unlisted companies**, the securities shall be **held or transferred** only in dematerialised form by complying with the provisions of the Depositories Act, 1996 and regulations made under it.

Further sub-section 2 provides, **any other company** may;

- a. Convert its securities into dematerialised form;

- b. Issue its securities in physical form in accordance with the provisions of this Act;
- c. Issue its securities in dematerialised form in accordance with the provisions of the Depositories Act, 1996 and the regulations made thereunder.

Rule 9 (Dematerialisation of securities) and 9A (Issue of securities in dematerialised form by unlisted public companies; of *Companies (Prospectus and Allotment of Securities) Rules, 2014*) is relevant for procedural aspects pertaining to Public Offer of Securities to be in Dematerialised Form.

### ADVERTISEMENT OF PROSPECTUS [SECTION 30]

Where an advertisement of any prospectus of a company is published in any manner, it shall be necessary to specify therein the contents of its memorandum as regards the following:

- a. Objects,
- b. Liability of members and the amount of share capital of the company,
- c. Names of the signatories to the memorandum,
- d. Number of shares subscribed for by the signatories, and
- e. Capital structure of the company.

### SHELF PROSPECTUS [SECTION 31]

#### Meaning of Shelf Prospectus [explanation to section 31]

The expression "shelf prospectus" means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in **one or more issues over a certain period** without the issue of a further prospectus.

#### Need of Shelf Prospectus

A company is required to issue a prospectus each time it accesses the capital market. It leads to unnecessary repetition for a company which makes **more than one offer of securities** in a year to mobile funds from the public. A way out is shelf prospectus which **remains valid (on the shelf) for a specified time period** during which offers for securities may be made by a company to the public without going through the arduous exercise of issuing fresh prospectus every time.

### Filing of shelf prospectus with the Registrar [Sub-section 1]

Shelf prospectus may be filed with the Registrar **at the stage of first offer of securities**, by class or classes of companies as the Securities and Exchange Board of India may provide by regulations in this behalf.

It has to indicate a period not exceeding one year as the **period of validity** of such shelf prospectus.

The period of validity is to commence **from the date of opening of the first offer** of securities under such prospectus.

In respect of any **second or subsequent offer** of such securities issued **during the period of validity** of such prospectus, **no further prospectus is required**.

### Filing of 'Information Memorandum' with the Shelf Prospectus [Sub-section 2]

A company filing a shelf prospectus **shall be required** to file an information memorandum with the Registrar within the prescribed time, prior to the issue of a second or subsequent offer of securities under the shelf prospectus containing;

- a. All material facts relating to new charges created,
- b. Changes in the financial position of the company as have occurred between the first offer of securities or the previous offer of securities and the succeeding offer of securities, and
- c. Such other changes as may be prescribed,

**Proviso to Sub-section 2, provides a safeguard (in case of changes) to applicants who made payment in advance.** It is provided that where a company or any other person has received applications for the allotment of securities along with advance payments of subscription before the making of any such change, the company or other person shall intimate the changes to such applicants and if they express a desire to withdraw their application, the company or other person shall **refund all the monies** received as subscription **within fifteen days** thereof.

#### Procedural Aspects

Rule 10 of the Companies (Prospectus and Allotment of Securities) Rules, 2014

The information memorandum shall be prepared in Form PAS-2.

It shall be filed with the Registrar **along with the fee** as provided in the **Companies (Registration Offices and Fees) Rules, 2014** within **one month prior to the issue of a second or subsequent offer** of securities under the shelf prospectus.

**Information Memorandum together with Shelf Prospectus is deemed Prospectus [Sub-section 3]**

Where an information memorandum is filed, every time an offer of securities is made under sub-section (2), such memorandum together with the shelf prospectus shall be deemed to be a prospectus.

**Illustration (MCQ)**

*An applicant who made application for allotment along with advance payment of subscription, if he expresses a desire to withdraw his application after changes reported in information memorandum came to his knowledge. The company;*

**Options**

- a. *May refund the monies at discretion of Board of Directors*
- b. *Shall refund the monies after deducting the administrative charges within fifteen days*
- c. *Shall refund all the monies received as subscription within fifteen days*
- d. *Shall refund the monies after deducting the administrative charges within 30 days*

**Answer** – c [Refer proviso to section 31(2). It is provided that where a company or any other person has received applications for the allotment of securities along with advance payments of subscription before the making of any such change, the company or other person shall intimate the changes to such applicants and if they express a desire to withdraw their application, the company or other person shall **refund all the monies** received as subscription **within fifteen days** thereof].

**RED HERRING PROSPECTUS [SECTION 32]****Meaning of Red Herring Prospectus (explanation to section 32)**

The expression "red herring" means a prospectus which **does not include complete particulars** of the **quantum or price** of the securities.

**Need of Red Herring Prospectus**

Developments taking place in the financial markets from time to time allow innovative methods of raising funds so as **to avail the most of favourable market conditions**. Timing the issue and book building of issue are facilitated by the

concept of red herring prospectus whereby the **price per security and number of securities are left open** to be decided post closure of the issue.

#### **Timing of issue the Red Herring Prospectus [Sub-section 1]**

A company proposing to make an offer of securities may issue a red herring prospectus **prior to the issue of a prospectus**.

#### **Filing of Red Herring Prospectus with the registrar [Sub-section 2]**

A company proposing to issue a red herring prospectus shall file it with the Registrar **at least three days prior** to the **opening of the subscription** list and the offer.

#### **Obligations under Red Herring Prospectus vis-à-vis Prospectus [Sub-section 3]**

A red herring prospectus shall carry the **same obligations** as are applicable to a **prospectus** and any **variation** between the red herring prospectus and a prospectus **shall be highlighted as variations in the prospectus**.

#### **Filing with Registrar and SEBI upon closing of Offer [Sub-section 4]**

**Upon the closing of the offer** of securities under this section, the prospectus stating therein the **total capital raised**, whether by way of debt or share capital, and the **closing price** of the securities and **any other details as are not included in the red herring prospectus** shall be filed with the Registrar and the Securities and Exchange Board.

**Book Building** is actually a price discovery method. In this method, the company doesn't fix up a particular price for the shares, but instead gives a **price range**.

An underwriter builds a book by accepting orders from fund managers, indicating the number of shares they desire and the price they are willing to pay.

### **CONCEPT OF ABRIDGED PROSPECTUS - ISSUE OF APPLICATION FORMS FOR SECURITIES [SECTION 33]**

#### **Meaning of Abridged Prospectus [Section 2(1)]**

Abridged Prospectus means a memorandum containing such **salient features of a prospectus** as may be specified by the Securities and Exchange Board by making regulations in this behalf.

### Need of Abridged Prospectus

In fact, 'Abridged Prospectus' is a summarized form of actual prospectus, containing the salient features of a prospectus to **cut the cost involved in the publication** of large number of prospectus which has to accompany the application forms for shares or debentures in case of public offer.

### Abridged Prospectus accompany the application form [Sub-section 1]

Section 33(1) provides that every application form for shares or debentures has to be accompanied with the abridged prospectus.

Proviso to sub-section 1 provides exceptions, when the requirement of abridged prospectus does not apply;

- a. When application form is issued in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to shares or debentures;
- b. In relation to shares or debentures which were not offered to the public; or
- c. Where offer is made only to existing members of the company

### Right to receive prospectus [Sub-section 2]

Sub-section 2 provides that a prospectus (full prospectus) is to be made available to any person who request for it before the closing of the subscription list and the offer.

### Penalty [Sub-section 3]

A company who makes any default in complying with the provisions of section 33, shall be liable to a penalty of **fifty thousand rupees for each default**.



## 5. MIS-STATEMENTS IN PROSPECTUS

A contract of shares in a company is a contract of ***Uberrimae fides*** (Latin), which means '**utmost good faith**'. The legal doctrine of *Uberrimae fides* provides that all parties to contract must deal in good faith, making a full declaration of all material facts. The intending purchasers of shares are entitled to true and correct disclosures of all the facts in the prospectus.

Hence, a prospectus must make all statements with **scrupulous accuracy** and not state facts which are not strictly correct. Neither any information which the law requires to be disclosed to the public be concealed or omitted to be stated from the prospectus nor should the information given be false and misleading.

Mis- statements in prospectus is a serious offence which attracts the provisions of section 34 (criminal liability) and / or section 35 (civil liability) of the Act. In this section we will learn about misleading prospectus, remedies for misrepresentation in the prospectus.

### **WHAT CONSTRUE AS MIS-STATEMENT AND MISLEADING PROSPECTUS**

A prospectus is said to be misleading, **if it includes any mis- statement**. In common parlance, mis-statement is the act of stating **anything that is false** (or not accurate). A statement become false statement, if it produces a **wrong impression of actual facts**. It could either be due to **commission or omission or both**.

As per section 34, a statement included in a prospectus shall be deemed to be untrue:

- a. if the statement is misleading in the form and context in which it is included: or
- b. where any inclusion or omission of any matter is likely to mislead

**Some of landmark judicial pronouncements** - only for reference and better understanding

#### **Mislead through false Statement (prima-facie of facts) - Henderson v. Lacon<sup>21</sup>**

It was stated in the prospectus, 'the directors and their friends have subscribed a large portion of the capital and they now offer to the public the remaining shares.' Whereas, in actually each of director had subscribed only 10 shares. It was held that such a statement is misleading one.

#### **Misled by hiding truth through superficial statement - Rex v. Kylsant<sup>22</sup>**

In the prospectus, it is stated that the company had regularly paid dividends, in actual, company has been incurring substantial losses during all those years. Company used to write back some of the past provisions to the credit of the profit and loss account. It was held that the prospectus did not disclose the true picture of the company.

<sup>21</sup> C 16/276/H211 (1865 - Cause number: 1865 H211)

<sup>22</sup> Harvard Law Review Vol. 45, No. 6 (Apr., 1932), pp. 1078-1083 (available at <https://doi.org/10.2307/1332145>)

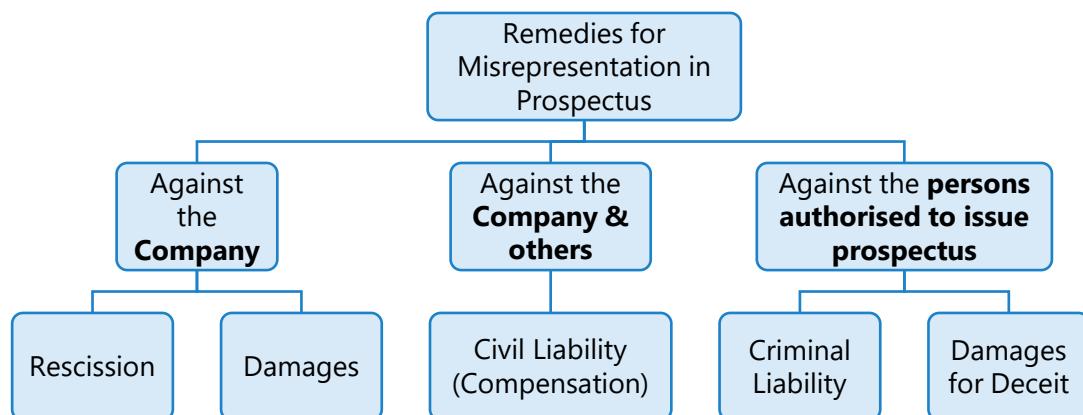
### Misled through ambiguous statement - Smith v. Chadwick<sup>23</sup>

The prospectus of a manufacturing company contain, 'the present value of turnover is £1million sterling per annum,' the statement was true only if production capacity is considered but untrue if it meant the present production level (capacity in utilisation). It was held that, such a statement which director knew may bear multiple meaning out of which any can be false to their knowledge, considered to be furnishing of misleading statement.

### EFFECT OF MISLEADING PROSPECTUS – REMEDIES OF MISREPRESENTATION

The fear of heavy liability and criminal sanctions have controlled the directors' tendency of "using extravagant terms and flattering description".

But if the prospectus contains a misleading or false statement or omits to disclose a material fact which amounts to misrepresentation, the aggrieved shareholder has the remedies. The law allows the following remedies for misrepresentation:



Remedy of Rescission, Damages and Deceit are not specified under this Act, they are available under the Indian Contract Act 1872 read with relevant provisions of Specific Relief Act 1963. Whereas Criminal and Civil Liability is provided under section 34 and 35 respectively of this Act.

Since remedies specified above are alternative courses, hence all of these remedies are not available simultaneously, whereas appropriate combination of these can be claimed.

<sup>23</sup> HL 18 Feb 1884

**To illustrate**, claim for compensation under section 35 (civil liability) of this Act (being special statute where jurisdictional power is vested in NCLT) shall not be moved simultaneously with claim for Damages (under general provisions).

## RIGHT OF RESCISSION

### When to seek rescission?

A person who has purchased shares from the company on the basis of the prospectus containing untrue and misleading statement of material facts is entitled to apply to the court for the rescission of the contract, under the relevant provisions of the Indian Contract Act 1872.

### Effect of rescission

The agreement to take up shares is voidable at the option of the subscriber to the shares, it will remain valid unless he actually rescinds it.

If the court accepts his application for the repudiation of the contract, company will remove his name from the register of members and return his money with interest and other incidental cost.

Entitlement to compensation for any damages which he sustained through the non-fulfilment of the contract arises under section 75 of the Indian Contract Act 1872.

### Exceptions – When right of rescission is not available?

- a. Right to rescind allotment of shares will not be available to the subsequent purchasers of shares from the market.
- b. A subscriber to the Memorandum of Association cannot also seek any relief, as the company cannot be considered to be in existence at the time when he appended his signatures to the Memorandum of Association. He cannot be said to have been influenced by any statement in the prospectus.

### Illustration (Q&A)

*All the statements contained in a prospectus issued by a company were literally true. It was also stated in the prospectus that the company had paid dividends for a number of years but there was no disclosure regarding the fact that the dividends were paid out of realised capital profits and not out of trading profits. An allottee of shares wants to avoid the contract on the ground that the prospectus was false in material particulars.*

**Answer** – The non-disclosure of the fact that dividends were paid out of capital profits is a concealment of material fact as a company is normally required to distribute dividend only from trading or revenue profits and under exceptional circumstances it can pay dividend out of capital profits. Hence, a material misrepresentation has been made.

Accordingly, in the given case the allottee can avoid the contract of allotment of shares.

### RIGHT OF ACTION FOR DAMAGES

#### When to evoke?

In the cases where mis-statement amounts to fraud, aggrieved investor also gets a right of action for damages against the company. This right is available even after the company has gone into liquidation.

#### Pre-requisite to claim for damages

- a. Misrepresentation (fraudulent) was there in the prospectus and it is of material fact
- b. Person is intended to act upon it
- c. Person suffered the damages as consequences of acting upon such fraudulent misrepresentation.

### CIVIL LIABILITY FOR MIS-STATEMENTS IN PROSPECTUS [SECTION 35]

#### Offence under section 35

Loss or damage to subscriber of securities, as a consequence of acting on basis of inclusion or omission of any matter in the prospectus; which is misleading the subscriber/s.

#### Who shall be held liable?

- a. Company; and
- b. Every person who is/has;
  - i. A **director** of the company at the time of the issue of the prospectus;
  - ii. **Authorised himself** to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

- iii. A **promoter** of the company;
- iv. **Authorised** the **issue of the prospectus**; and
- v. An **expert** referred to in sub-section (5) of section 26,

### **Liability for an offence under section 35**

A person found guilty under section 35, in addition to any punishment under section 36, a company and every other person shall also be **liable to pay compensation** to every person who has sustained loss or damage.

### **Exception to liability for guilty/offence under section 35 [Sub-section 2]**

Sub-section 2, provides the instances when a person shall not be held guilty under section 35 of this Act, if he proves:

- a. He **withdrew his consent** to be a director of company and prospectus issued without his consent and authority.
- b. He has given reasonable public notice to effect, that **prospectus was issued without his knowledge and consent**.
- c. He made the statement on the **authority of an expert** whom he believed to be competent and that the expert had given his consent and had not withdrawn it.
- d. He had **reasonable ground** for **believing the statement to be true** and that he did believe it to be true up to the time of allotment.
- e. The statement was a **correct copy of some extract** from an official document and that he had in fact believed.

### **Personal Liability when intend to defraud [Sub-section 3]**

Every person referred under sub-section 1 shall be **personally responsible, without any limitation of liability**;

- For **all or any of the losses or damages** that may have been incurred by any person who **subscribed to the securities** on the basis of such prospectus;

Where it is proved that a prospectus has been issued with **intent to defraud** the applicants for the securities of a company or any other person or for any fraudulent purpose.

**Illustration (Q&A)**

A prospectus issued by a company contained certain mis-statements. On becoming aware of the fact regarding mis-statements in the prospectus, one of the experts Anilesh who had earlier given his consent, forthwith gave a reasonable public notice stating that the prospectus was issued without his knowledge and consent. Is it possible for Anilesh to escape liability for mis-statement in the prospectus?

**Answer** – Section 35 (2) of the Companies Act, 2013 states that no person shall be liable under Sub-section (1) if he proves that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

The case of Anilesh is covered under the above exception provided by Sub-section (2) and therefore, he will escape liability for mis-statement in the prospectus.

**CRIMINAL LIABILITY FOR MIS-STATEMENTS IN PROSPECTUS [SECTION 34]****Offence under section 34?**

Where a prospectus is issued, circulated or distributed that includes;

- a. Any statement which is **untrue** or **misleading** in form or context in which it is included or
- b. Where any **inclusion** or **omission** of any matter is likely to mislead.

**Who shall be held liable?**

Every **person who authorises** the **issue of such prospectus**

**Liability for an offence under section 34**

Such persons found guilty under section 34 shall be liable for punishment under **section 447** of this Act.

**Exception to liability for guilty/offence under section 34 [Proviso to section 34]**

Proviso to section 34 provides the instances when a person shall not be held guilty under section 34 of this Act, if he proves that:

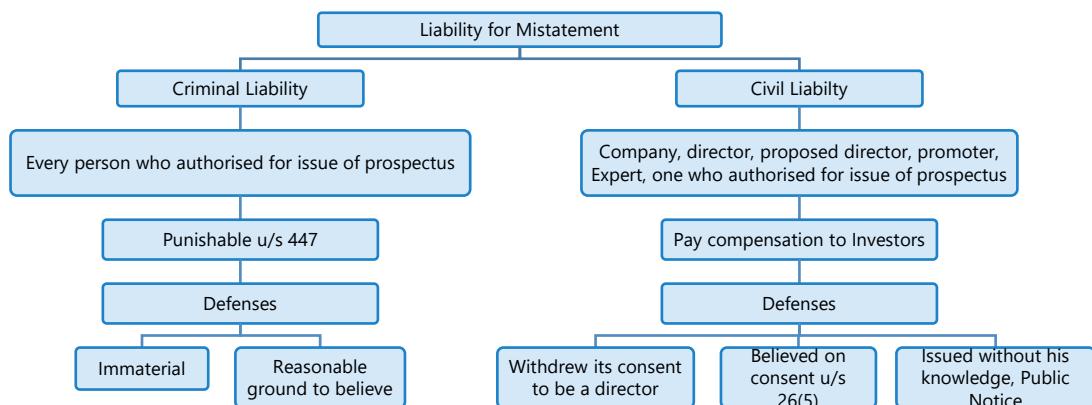
- a. Such mis-statement or omission was immaterial, or

- b. He had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

**Note**

- a. Loss from mis-statement is not essential, to hold a person guilty under section 34.
- b. Liability for offence under section 34, is strict liability, hence it is immaterial where the omission is intentional or unintentional, in both case person will be held guilty under section 34 and liable for punishment under section 447 of this Act.

**Summary of section 34 and 35.**



**Illustration (Q&A)**

An allottee of shares in a company brought action against a director in respect of false statements made in the prospectus. The director contended that the statements were prepared by the promoters and he simply relied on them. Is the director liable under the circumstances?

**Answer** – Yes, the Director shall be held liable for the false statements made in the prospectus under sections 34 and 35 of the Companies Act, 2013. Whereas section 34 imposes a criminal punishment on every person who authorises the issue of such prospectus, section 35 more particularly includes a director of the company in the imposition of liability for such mis-statements.

Certain situations when a director will not incur any liability for mis-statements in a prospectus are covered under exceptions provided by Section 35 (2) but no such

exception specifies that relying on the statements prepared by the promoters of the company is a valid ground for a director to escape liability for mis-statement.

### DAMAGES FOR DECEIT

#### When remedy of damages for deceit is available?

Persons responsible for the issue of prospectus can also be held liable in an action for deceit, under general law as provided by section 19 of the Indian Contract Act, 1872.

This remedy shall be available even where the remedy by way of rescission as against the company is lost either through latches or negligence or even if the company goes into liquidation.

#### Prerequisite to claim damages for deceit is available

- a. There was a fraudulent mis-statement related to some existing material facts.
- b. He is original allottee and had seen the prospectus.
- c. He has been actually deceived.

#### Peek v. Gurney

Gurney issued a fraudulent prospectus on behalf of a company. No shares were purchased by Peek at that time. Several months afterwards, Peek purchased 2,000 shares of the company from the stock exchange. He brought an action against the directors for deceit (on the basis of prospectus). Court held, the directors were not liable as the shares were not purchased on the basis of prospectus.



## 6. PUNISHMENT FOR FRAUDULENTLY INDUCING PERSONS TO INVEST MONEY [SECTION 36]

Any person who, either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into:

- a. any agreement for, or with a view to, acquiring, disposing of, subscribing for, or underwriting securities; or

- b. any agreement, the purpose or the pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities; or
- c. any agreement for, or with a view to obtaining credit facilities from any bank or financial institution,

shall be liable for action under section 447.

**Example** – A huge sums of money were collected under a document described as "project overview" by NRIs but shares not allotted in the proposed joint venture company instead the money was diverted to some off-shore companies controlled by the accused persons. *Prima-facie* offence under section 36 made-out.



## 7. ACTION BY AFFECTED PERSONS [SECTION 37]

A suit may be filed or any other action may be taken under section 34 or section 35 or section 36 by:

- a. Any person,
- b. Group of persons or
- c. Any association of persons

If **affected** by any **misleading statement** or the **inclusion or omission** of any matter in the **prospectus**.

### Illustration

*M applies for equity shares of a company on the basis of a prospectus which contains mis-statement. The shares are allotted to him, who afterwards transfers them to N. Whether N can bring an action for a rescission on the ground of mis-statement under section 37 of the Companies Act, 2013?*

**Answer** – No. N cannot bring an action for rescission of the contract for buying shares from M on the ground of mis-statement made in the prospectus. Section 37 of the Companies Act, 2013 does not become applicable in such a situation.

It is noteworthy that according to Section 37, a suit may be filed or any other action may be taken under section 34 or section 35 or section 36 only by any person, group of persons or any association of persons affected by any misleading statement or the inclusion or omission of any matter in the prospectus. Therefore, only M is eligible to file a suit.

**Section 37 has paved way for class action**

Class action suit is for a group of people filing a suit against a defendant who has caused common harm to the entire group or class. This is not like a common litigation method where one defendant files a case against another defendant while both the parties are available in court. In the case of class action suit, the class or the group of people filing the case need not be present in the court and can be represented by one petitioner. The benefit of these type of suits is that if several people have been injured by one defendant, each of the injured person need not to file a case separately but all the people can file one single case together against the defendant.



## **8. PUNISHMENT FOR PERSONATION FOR ACQUISITION, ETC., OF SECURITIES [SECTION 38]**

The purpose of the section is to prevent allotment of shares in fictitious names.

Sub-section 1 provides, any person shall be liable for punishment under section 447, if:

- a. He makes or abets the making of an application in a fictitious name to a company for acquiring, or subscribing for, its securities; or
- b. He makes or abets the making of multiple applications in different names or different combinations of his name or surname for acquiring or subscribing for its securities; or
- c. otherwise induces, directly or indirectly a company to allot or register any transfer of any securities to him or to any other person in a fictitious name.

Sub-section 2, provides that every company which issues a prospectus is required to reproduce prominently the provisions of the sub- section (1) in the prospectus and every form of application for securities.

**Note:**

A person who gets shares allotted in a fictitious name becomes liable as a shareholder. Thus, where a person carried on business under an assumed name and took shares in that name, his trustee in bankruptcy of the said person, could not avoid liability.

Sub-section 3 provides, where a person has been convicted under the section, the court may order disgorgement of any gain made by such person. The order may also include seizure and disposal of securities which may be found in his possession.

The amount received through disgorgement or disposal of securities under sub-section (3), is to be credited to the Investor Education and Protection Fund. [Sub section (4)]



## 9. PUNISHMENT FOR FRAUD [SECTION 447]

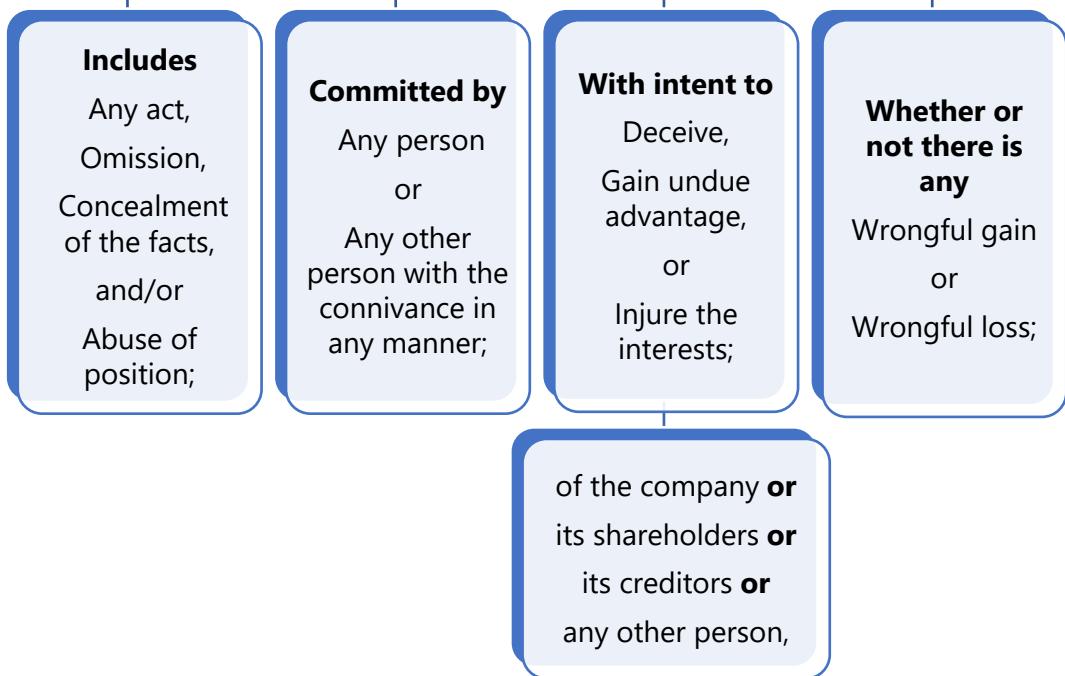
Amount and nature of fraud	Fine			Imprisonment	
	Minimum	Maximum		Minimum	Maximum
Fraud involving less than 10 lakh rupees or 1% of turnover, whichever is lower ( <i>public interest not involved</i> )	-	Up to ₹ 50 lakh	or/and	-	Up to 5 years
Fraud involving at least 10 lakh rupees or 1% of turnover, whichever is lower ( <i>public interest not involved</i> )	Equal to amount of fraud	3 times of amount of fraud	and	6 Months	10 Years
Fraud in question involves public interest	Equal to amount of fraud	3 times of amount of fraud	and	3 Years	10 Years

Section 447 provides three explanations, read as:

- (i) "fraud" in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.

- (ii) "wrongful gain" means the **gain by unlawful means** of **property** to which the person gaining **is not legally entitled**.
- (iii) "wrongful loss" means the **loss by unlawful means** of **property** to which the person losing **is legally entitled**.

**Fraud**, in relation to affairs of a company or body corporate



### Illustration

Mr. Raju one of prospective investor under section 37 of this Act, sue the persons who authorise the issue of prospectus for the fraudulent misstatements they made in the prospectus. Mr. Raju also filed a complaint under section 420 of the IPC, 1860 and section 447 of this Act.

Mr. Angad one of the authorised persons, plead that Mr. Raju did not took any share, hence he has not borne any sort of loss, therefore he cannot seek the remedies, for what he is asking for and they are not punishable under section 447, because fraud is not committed against Mr. Raju. Whether the persons who authorised the issue of prospectus punishable under section 447?

**Answer**

In this case, the persons who authorised the issue of prospectus shall be punishable under section 447 for the fraudulent misstatement, despite the fact that Mr. Raju had not borne any loss. Because wrongful gain or loss is not essential constituent of fraud under section 447.



## **10. ALLOTMENT OF SECURITIES BY COMPANY [SECTION 39]**

### **MEANING OF ALLOTMENT**

Offers for shares are made on application forms supplied by the company. When an application is accepted, it is an allotment

Hence, in general sense 'allotment' is neither more nor less than the acceptance by the company of the offer to take shares.

In technical context, it is an appropriation out of the previously unappropriated capital of a company.

### **Note**

Where forfeited shares are re-issued, it is not the same thing as an allotment.

A valid allotment has to comply with the requirements of the Act and principles of the law of contract relating to acceptance of offers.

Section 39 of the Act and *the Companies (Prospectus and Allotment of Securities) Rules, 2014* contains provisions in respect of allotment of securities when there is a public offer.

### **MINIMUM SUBSCRIPTION IS A MUST [SUB-SECTION 1]**

The first requisite of a valid allotment is that of minimum subscription.

Hence, when shares are offered to the public, the amount of minimum subscription has to be stated in the prospectus.

No shares can be allotted unless:

- a. At least so much amount (which is stated as minimum subscription) has been subscribed and

- b.** The sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument from the subscribers or investors at the time of making application.

**Note:**

As per the regulation 45(1) of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018<sup>28</sup>, the minimum subscription is 90% of the entire issue.

Any means by which money can be remitted may be used, but remittances must be cleared and actual cash received by the company before proceeding to allotment. An application for shares, if not accompanied by any such payment, does not constitute a valid offer.

### QUANTUM OF AMOUNT PAYABLE ON APPLICATION [SUB-SECTION 2]

The amount payable on application **shall not be less than:**

- a.** 5% of the nominal amount of the security **or**
- b.** Such other percentage or amount, as may be **specified by the Securities and Exchange Board** by making regulations in this behalf.

Here, it is important to note that as per the regulation 47(4) of the <sup>29</sup>Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, the minimum sum payable on application per specified security shall be **at least twenty five percent of the issue price**.

Further, proviso to regulation 47(4) provides that in case of an offer for sale, the full issue price for each specified security shall be payable at the time of application.

**Example** - If listed company offer the shares with nominal value of ₹ 10 then application money shall be at least ₹ 2.5 and if nominal value is ₹ 100 then shall be at least ₹ 25.

<sup>28</sup> SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 are not a part of syllabus at Intermediate Level. However, it is necessary to build the understanding of the students.

<sup>29</sup> SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 are not a part of syllabus at Intermediate Level. However, it is necessary to build the understanding of the students.

### CONSEQUENCES IF MINIMUM AMOUNT IS NOT SUBSCRIBED [SUB-SECTION 3]– RETURN OF APPLICATION MONEY

If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of **30 days** (or any other period as prescribed by SEBI) from the date of issue of the prospectus, the amount received from applicants shall be returned.

#### Time period for return of application money

As per rule 11(1) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, such refund shall be made within a period of **15 days** from the closure of such issue.

#### Default in return of application money

As per rule 11(1) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, in case of default in refund within that period, **directors and other officers** responsible for default shall be **jointly and severally** liable to repay that money with interest at the rate of **15% pa**.

#### Source for return of application money

According to Rule 11 (2), the application money to be refunded shall be credited only to the bank account from which the subscription was remitted.

Section 40(3) and Rule 11(2) of the Companies (Prospectus and Allotment of Securities) Rules, 2014 are confirming provisions regarding **return of application money**, in case where allotment is not done.

### RETURN OF ALLOTMENT [SUB-SECTION 4]

Whenever a **company having a share capital** makes any allotment of securities, it shall file with the Registrar a return of allotment in manner as prescribed in the Companies (Prospectus and Allotment of Securities) Rules, 2014.

#### Time Limit for filing Return of Allotment

According to Rule 12 (1) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, the company shall file a return of allotment with Registrar in Form PAS-3 within 30 days along with the fee as specified in the Companies (Registration Offices and Fees) Rules, 2014.

### Attachments to Form PAS-3

According to Rule 12 (2) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, lists of following particulars (duly certified by the signatory of the Form PAS-3 for completeness and correctness) shall accompany:

- a. A list of allottees stating their names, address, occupation, if any, and
- b. Number of securities allotted to each of the allottees.

### Additional attachments to Form PAS-3 – In case share issued for consideration other than cash.

Rule 12 (3) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, provides, in the case of securities (not being bonus shares) allotted as fully or partly paid up for **consideration other than cash**, then following documents shall also be attached;

- a. A copy of the contract, duly stamped, pursuant to which the securities have been allotted
- b. Any contract of sale if relating to a property or an asset, or a contract for services or other consideration.

Further Rule 12 (4) states that where a contract referred above is not reduced to writing, the company shall furnish complete particulars of the contract stamped with the same stamp duty as would have been payable if the contract had been reduced to writing and same shall deemed to be an instrument within the meaning of the Indian Stamp Act, 1899.

Rule 12 (5), requires a report of a registered valuer in respect of valuation of the consideration if either of rule 12(3) or 12(4) applicable.

### Attachments to Form PAS-3 – In case share issued in pursuance of Section 62(1)(c)

Rule 12 (7) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, states that in case the shares have been issued in pursuance of clause (c) of sub-section (1) of section 62 by a **company other than a listed company** whose equity shares or convertible preference shares are listed on any recognised stock exchange, there shall be attached to Form PAS-3, the **valuation report of the registered valuer**.

### PUNISHMENT FOR DEFAULT [SUB-SECTION 5]

In case of any default under sub-section (3) or sub-section (4), the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less.

#### Illustration

*After having received 80% of the minimum subscription as stated in the prospectus, Raksha Detective Instruments Limited, before finalisation of the allotment, withdrew 50% of the said amount from the bank for the purchase of certain assets. Thereafter, it started allotting the shares to the subscribers. Rashmi, one of the subscribers, was allotted 1000 equity shares. She, however, refused to accept the allotment on the ground that such allotment was violative of the provisions of the Companies Act, 2013.*

#### Answer

According to the above example, Raksha Detective Instruments Limited has received only 80% of the minimum subscription as stated in the prospectus. Since minimum amount has not been received in full, the allotment is in contravention of section 39 (1) of the Companies Act, 2013 which prohibits a company from making any allotment of securities until it has received the amount of minimum subscription stated in the prospectus. Further, under section 39 (3), such company is required to refund the application money received (*i.e.* 80% of the minimum subscription) to the applicants.

Therefore, in the present case, Rashmi is within her rights to refuse the allotment of shares which has been illegally made by the company.



## 11. SECURITIES TO BE DEALT WITH IN STOCK EXCHANGES [SECTION 40]

### FILING OF AN APPLICATION WITH RECOGNISED STOCK EXCHANGE [SUB-SECTION 1]

Before making public offer, every company shall make an application to one or more recognised stock exchange or exchanges and obtain permission for the securities to be dealt with in such stock exchange or exchanges.

**PROSPECTUS TO STATE NAME OF STOCK EXCHANGE [SUB-SECTION 2]**

Name or names of the stock exchange in which the securities shall be dealt with, must be stated in the prospectus.

**MAINTAINING OF SEPARATE BANK ACCOUNT [SUB-SECTION 3]**

All monies received on application from the public for subscription to the securities shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than:

- a. For **adjustment against allotment of securities** where the securities have been permitted to be dealt with in the stock exchange or stock exchanges specified in the prospectus; or
- b. For the **repayment of monies within the time specified** by the Securities and Exchange Board, received from applicants in pursuance of the prospectus, where the company is for any other reason unable to allot securities.

**Note:** Section 40(3) and Rule 11(2) of the Companies (Prospectus and Allotment of Securities) Rules, 2014 are confirming provisions regarding **return of application money**; in case where allotment is not done.

Rule 11(2) of the Companies (Prospectus and Allotment of Securities) Rules, 2014 is already discussed before in the chapter.

**CONDITION PURPORTING TO WAIVE COMPLIANCE SHALL BE VOID [SUB-SECTION 4]**

Any condition purporting to require or bind any applicant for securities to waive compliance with any of the requirements of this section shall be void.

**DEFAULT IN COMPLYING WITH PROVISIONS [SUB-SECTION 5]**

If a default is made in complying with the provisions of this section, the company shall be punishable with a fine which shall not be less than five lakh rupees but which may extend to fifty lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees.

Penalty provisions provided under sub-section 5 can be summarized as:

Defaulter	Minimum Fine	Maximum Fine
Company	5,00,000	50,00,000
Defaulting Officer	50,000	3,00,000

### PAYMENT OF COMMISSION [SUB-SECTION 6]

A company may pay commission to any person in connection with the subscription to its securities subject to rule 13 of the Companies (Prospectus and Allotment of Securities) Rules, 2014.

**Note-** No commission shall be paid to any underwriter on securities, which are not offered to the public for subscription.

#### Authorisation and Source

The payment of such commission shall be authorized in the company's **Articles of Association**. The commission may be paid out of:

- a. proceeds of the issue, or
- b. the profit of the company, or
- c. both

#### Rate of commission

Security	Rate
Shares	<p><b>Should not exceed;</b>            5% of the price at which the shares are issued  <b>Or</b>            Any less rate/amount authorised by articles</p>
Debentures	<p><b>Should not exceed;</b>            2.5% of the price at which the debentures are issued  <b>Or</b>            Any less rate/amount authorised by articles</p>

**Hence students are advised to note;**

Maximum rate of commission can be 5% and 2.5% in case of shares and debentures respectively subject to rate authorised by article.

**Example** – Ind-swift Pharma Labs Limited issued the shares to raise capital. Article of Ind-swift authorised payment of commission at rate of 2%. Since rate of commission **should not exceed** 5% of the price at which the shares are issued **or** any less rate/amount authorised by articles Hence, cap for payment of commission under section 40(6) of the Act is 2%.

**Disclosure of the particulars in prospectus regarding underwriting**

The prospectus of the company shall disclose the following particulars:

- a. the name of the underwriters;
- b. the rate and amount of the commission payable to the underwriter; and
- c. the number of securities which is to be underwritten or subscribed by the underwriter absolutely or conditionally.

**Copy of payment of commission to be delivered to Registrar**

A copy of the contract for the payment of commission is delivered to the Registrar at the time of delivery of the prospectus for filling.

**Illustration Q&A**

*The Board of Directors of a company decide to pay 5% of the issue price of shares as underwriting commission to the underwriters. However, the Articles of Association of the company permit only 3% commission. The Board of Directors further decide to pay the commission out of the proceeds of the share capital. Are the decisions taken by the Board of Directors valid under the Companies Act, 2013?*

**Answer** – Under Rule 13 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 the rate of commission paid or agreed to be paid shall not exceed, in case of shares, five percent (5%) of the price at which the shares are issued or a rate authorised by the articles, whichever is less.

The same rule allows the commission to be paid out of proceeds of the issue or the profit of the company or both.

Therefore, the decision of the Board of Directors to pay 5% commission to the underwriters is invalid since the same cannot exceed the rate which is permitted by the Articles. However, the decision to pay commission out of the proceeds of the share issue is valid provided it is paid at the rate authorised by the Articles.



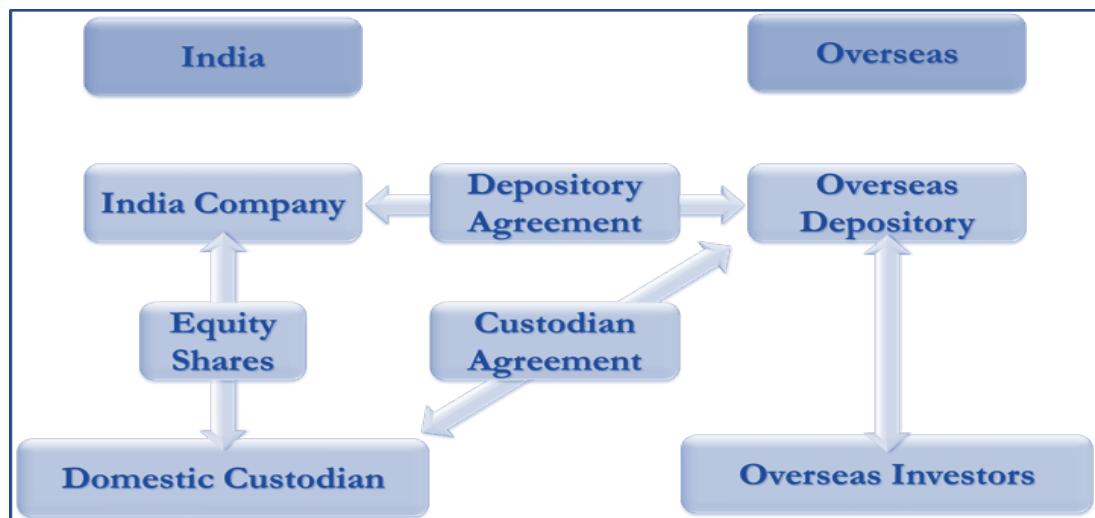
## 12. GLOBAL DEPOSITORY RECEIPT [SECTION 41]

A global depository receipt is a general name for a depository receipt where a certificate issued by a depository bank, which purchases shares of foreign companies, creates a security on a local exchange backed by those shares.

GDR as per section 2(44) of this Act means any instrument in the form of a depository receipt, by whatever name called , created by a foreign depository outside India & authorized by a company making an issue of such depository receipts.

Section 41 provides, company may issue depository receipts in any foreign country after passing a **special resolution** in its general meeting and subject to such conditions as may be prescribed in the Companies (Issue of Global Depository Receipts) Rules, 2014.

### HOW GDR OPERATES?



## MANNER AND FORM OF DEPOSITORY RECEIPTS

The depository receipts can be issued by way of public offering or private placement or in any other manner prevalent in the concerned jurisdiction and may be listed or traded on the listing or trading platform in the concerned jurisdiction.

The depository receipts may be issued against issue of new shares or may be sponsored against shares held by shareholders of the company in accordance with such conditions as the Central Government or Reserve Bank of India may prescribe or specify from time to time.

The underlying shares shall be allotted in the name of the overseas depository bank and against such shares, the depository receipts shall be issued by the overseas depository bank.

## VOTING RIGHT

A holder of depository receipts may become a member of the company and shall be entitled to vote as such only on conversion of the depository receipts into underlying shares after following the procedure provided in the Scheme and the provisions of this Act.

Until the conversion of depository receipts, the overseas depository shall be entitled to vote on behalf of the holders of depository receipts in accordance with the provisions of the agreement entered into between the depository, holders of depository receipts and the company in this regard.



## 13. PRIVATE PLACEMENT [SECTION 42]

Provisions relating to the 'private placement' are contained in Part II of Chapter III of the Act, which consist of only one section i.e. section 42 – Issue of shares on private placement basis.

A company may make private placement of securities subject to provisions of section 42 of this Act in supplement with those stated under rule 14 of the Companies (Prospectus and Allotment of securities) Rules, 2014.

### MEANING OF PRIVATE PLACEMENT [EXPLANATION I TO SECTION 42(3)]

Private placement means any **offer or invitation** to subscribe or issue of securities **to a select group of persons** by a company (other than by way of public offer) through private placement offer-cum-application, which satisfies the conditions specified in section 42.

**OFFER TO BE MADE ONLY TO A SELECT GROUP OF PERSONS [SUB-SECTION 2]**

A private placement shall be made only to a select group of not more than **two hundred (200) persons** in a financial year, who have been identified by the Board, after passing as special resolution in this regard.

**Note:**

1. These select group of persons is referred to as "identified persons"
2. While computing threshold limit of 200, following shall be excluded;
  - a. qualified institutional buyers and,
  - b. employees of the company being offered securities under a scheme of employees stock option under section 62(1)(b)
3. As per Explanation II to sub-section 3, the term "**qualified institutional buyer**" means the qualified institutional buyer as defined in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009.
4. Section 42(2) originally contains '**fifty (50) or such higher number as may be prescribed**'. Since Rule 14 (2) of the Companies (Prospectus and Allotment of Securities) Rules, 2014 (as amended through Companies (Prospectus and Allotment of Securities) Second Amendment Rules, 2018) prescribed '**an offer or invitation to subscribe securities under private placement shall not be made to persons more than two hundred (200) in the aggregate in a financial year**', hence limit of identified persons under section 42(2) shall be read as **two hundred (200)**.
5. The aforesaid restrictions would be reckoned individually for each kind of security that is equity share, preference share or debenture.
6. Non-banking financial companies (NBFCs) which are registered with the Reserve Bank of India; and housing finance companies (HFCs) which are registered with the National Housing Bank; if they are complying with any regulations made by the Reserve Bank of India or the National Housing Bank in respect of offer or invitation to be issued on private placement basis, then need not to comply with rule 14(2) stated above.

**PRIVATE PLACEMENT SHALL BE DEEMED TO BE AN OFFER TO THE PUBLIC  
[EXPLANATION III TO SECTION 42(3) READ WITH SUB-SECTION 11 TO  
SECTION 42]**

As per explanation III to section 42(3), if a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities **to more than 200 identified persons**, whether the payment for the securities has been received or not or whether the company intends to list its securities or not on any recognised stock exchange in or outside India, the same shall be deemed to be an offer to the public and provisions contained in section 23 to 41 shall apply.

Further section 42(11) provides, in such case all the provisions of this Act and the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 shall be applicable.

Though penalty under sub-section 9 and 10 to section 42 of this Act, still can be imposed.

**MANNER OF ISSUING PRIVATE PLACEMENT OFFER AND APPLICATION [SUB-SECTION 3]**

A company making private placement **shall issue private placement offer and application to identified persons** (whose names and addresses are recorded by the company) in the form and manner prescribed below.

**Note:** Private placement offer and application shall not carry any right of renunciation.

**Resolution for the Private Placement Offers**

Rule 14 (1) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, requires prior approval of the shareholders of the company, by a **special resolution** for **each** of the **private placement offers** or **invitations**. The explanatory statement annexed to the notice for shareholders' approval, must disclose the following:

- a. Particulars of the offer including date of passing of Board resolution;
- b. Kinds of securities offered and the price at which security is being offered;
- c. Basis or justification for the price (including premium, if any) at which the offer or invitation is being made;

- d. Name and address of valuer who performed valuation;
- e. Amount which the company intends to raise by way of such securities;
- f. Material terms of raising such securities, proposed time schedule, purposes or objects of offer, contribution being made by the promoters or directors either as part of the offer or separately in furtherance of objects; principle terms of assets charged as securities.

**Students are advised to take note of certain exceptions above rule**

**Board resolution** under section 179(3)(c)<sup>30</sup> shall be adequate in case of offer or invitation for **non-convertible debentures**, where the proposed amount to be raised **does not exceed** the limit as specified in **section 180(1)(c)**. But if amount is above the said limit, it shall be sufficient if the company passes a **previous special resolution only once in a year** for all the offers or invitations for such debentures during the year.

Even for issue of securities to QIBs, it shall be sufficient to pass a **previous special resolution only once in a year** for all the offers or invitations for all the allotments to such buyers during the year.

**Filing of Resolution with Registrar**

Copy of resolutions passed above shall be moved to registrar **prior** to issue of **private placement offer cum application letter**.

**Note:** Vide Companies (Prospectus and Allotment of Securities) Amendment Rules, 2022 the principal rules of 2014 further amended to insert a proviso to Rule 14(1) which deals with Private Placement.

The proviso states that when a company makes an offer or invitation to subscribe to securities, no offer or invitation of any securities shall be made to a body corporate incorporated in, or a national of, a country which shares a land border with India, unless such body corporate or the national, as the case may be, have obtained Government approval under the FEMA<sup>31</sup> Rules, 2019 and attached the same with the private placement offer cum application letter.

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<sup>30</sup> Section 179(3) and section 180 of the Companies Act, 2013, does not form part of syllabus at Intermediate level.

<sup>31</sup> FEM (Non-debt Instruments) Rules, 2019

This means that companies will now have to obtain government approval under the FEMA Rules before inviting subscription to securities or offering securities to any entity from a country that shares a land border with India i.e. China, Bhutan, Nepal, Pakistan, Bangladesh, and Myanmar.

### Applicable Application Form

Rule 14 (4) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, provides a **private placement offer cum application letter** shall be;

- a. Issued in form **PAS-4**
- b. **Serially numbered**
- c. Addressed **specifically** to the person to whom the offer is made
- d. Sent either in **writing** or in **electronic mode**
- e. Sent within **thirty days** of recording the name of such person pursuant to section 42 (3).

#### Note:

1. No person other than the person so addressed in offer-cum-application letter, allowed to apply through such application form.
2. Any application not conforming to this condition shall be treated as invalid.

### Maintaining Complete Records

Rule 14(4) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, requires the company to maintain a complete record of private placement offers in Form PAS-5.

### MANNER OF SUBSCRIBING TO THE PRIVATE PLACEMENT ISSUE [SUB-SECTION 4]

Person who is identified and provided with private placement application cum letter, if willing to subscribe securities in the private placement, then may apply in through same letter along with subscription money.

#### Note:

1. Subscription money shall be paid either by cheque or demand draft or other banking channel, but not by cash.

2. Rule 14(5) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, Payment shall be made from the bank account of the person subscribing to such securities and the company shall keep the record of the bank account from where such payment for subscription has been received.
3. First proviso to rule 14(5) stated above, provides that; in case of joint holders, monies payable on subscription to securities shall be paid from the bank account of the person whose name appears first in the application.
4. Company shall not utilise monies raised through private placement unless allotment is made and the return of allotment is filed with the Registrar in accordance with sub-section (8) of Section 42.

#### Illustration Q&A

*Ruhi and her brother Sohit were offered jointly 1000 equity shares of ₹ 100 each by Soumya Software Private Limited under the issue of shares on private placement basis. Offer-cum-application letter addressed to both containing their names as "Ms. Ruhi, Mr. Sohit". From whose account the company is required to take subscription money for 1000 equity shares?*

**Answer** – According to the first Proviso of Rule 14(5) of the Companies (Prospectus and Allotment of Securities) Rules, 2014, monies payable on subscription to securities to be held by joint holders shall be paid from the bank account of the person whose name appears first in the application. Since Ruhi's name appears first in the application, therefore the subscription of ₹ 1,00,000 shall be payable by her from her account. It is obligatory for the company to ensure that the money is paid from her bank account and not from the bank account of her brother Sohit.

#### LIMIT ON FRESH OFFER [SUB-SECTION 5]

No fresh offer or invitation under this section shall be made unless the allotments with respect to any offer or invitation made earlier have been completed or that offer or invitation has been withdrawn or abandoned by the company.

Proviso to sub-section 5 read as, subject to the maximum number of identified persons (i.e. 200), a company may, at any time, make more than one issue of securities to such class of identified persons as may be prescribed.

**TIME LIMIT FOR ALLOTMENT OF SECURITIES [SUB-SECTION 6]**

A company making an offer or invitation under this section shall allot its securities within **sixty days** from the date of receipt of the application money.

1. If company fails to make allotment within 60 days, then repayment of the application money to the subscribers shall be made within **fifteen days** from the expiry of sixty days
2. If the company further fails to repay the application money within the 60 days, then it shall be liable to repay that money with **interest at the rate of twelve percent** per annum from the expiry of the sixtieth day.

It is provided that the monies received on application under this section shall be kept in a **separate bank account** in a scheduled bank and shall not be utilised for any purpose other than:

- a. For adjustment against allotment of securities; **or**
- b. For the repayment of monies where the company is unable to allot securities.

**PROHIBITION ON PUBLIC ADVERTISEMENT [SUB-SECTION 7]**

No company shall release any public advertisements or utilise any media, marketing or distribution channels or agents to inform the public at large about issue under section 42.

**FILING OF RETURN OF ALLOTMENT [SUB-SECTION 8]**

Section 42(8) read with Rule 14 (6) of the Companies (Prospectus and Allotment of Securities) Rules, 2014 provides, a return of allotment in form PAS-3 (along-with the fee as provided in the Companies (Registration Offices and Fees) Rules, 2014) shall be filed with the Registrar within **fifteen days** from the date of the allotment under section 42, with a complete list of all the allottees containing;

- a. the full name, address, Permanent Account Number and E-mail ID of such security holder;
- b. the class of security held;
- c. the date of allotment of security;
- d. the number of securities held, nominal value and amount paid on such securities, and particulars of consideration received if the securities were issued for consideration other than cash.

### **DEFAULT IN FILING THE RETURN OF ALLOTMENT [SUB-SECTION 9]**

For defaults in filing the return of allotment, the company, its promoters and directors shall be liable to a penalty for each default of one thousand rupees for each day during which such default continues but not exceeding twenty-five lakh rupees.

**Example** – An allotment of security under private placement (section 42) was completed on 9<sup>th</sup> November 2023. Return of allotment in Form PAS-3 filed on 28<sup>th</sup> November 2023. Therefore, a penalty of ₹ 4000 shall be imposed on company, its promoter and directors.

### **PUNISHMENT FOR CONTRAVENING THE PRIVATE PLACEMENT PROVISIONS [SUB-SECTION 10]**

For making offer or accepting money in contravention to section 42, liability will be:

Liable	Nature of penalty	Description
Promoters and Directors	Fine	Amount raised through the private placement <b>or</b> two crore rupees, whichever is <b>lower</b>
Company	Refund	All monies along-with interest (as specified in sub-section 6) to subscribers within a period of <b>thirty days</b> of the order

## **SUMMARY**

- ◆ Securities can be offered to public at large (public offer) or through private placement. However, a private company is prohibited from resorting to public offer.
- ◆ SEBI has power to deal with matters relating to listed or proposed to be listed securities. Central Government (through MCA represented by Regional Directors and ROCs) has power to deal with matters relating to unlisted securities.
- ◆ Prospectus, deemed prospectus, abridged prospectus, red-herring prospectus, shelf prospectus, information memorandum need to comply with

the minimum information requirements as prescribed in the Companies Act, 2013 and the applicable Rules.

- ◆ Existing holders of securities could offload their stake through required compliances for an offer for sale of securities to the public (OFS route).
- ◆ Fraudulent omission or commission in the prospectus attracts civil as well as criminal liability.
- ◆ Issue of securities (shares, debentures or hybrid securities) through public offer is to be made only in demat form by the companies which are not exempted.
- ◆ Provision related to timelines, pre-requisites for allotment and listing wherever applicable needs to strictly adhered to avoid any penal provision.
- ◆ Private placements have somewhat diluted disclosure requirements as public exposure is not there.

## TEST YOUR KNOWLEDGE

### Multiple Choice Questions

1. *Modern Furniture Limited, issued a document containing offer of securities for sale that is considered as deemed prospectus under section 25, which requires such document must contains certain matters/disclosures in addition to those required under section 26. Which of following are correct requirements;*
  - i. *A statement of the net amount received or to be received as consideration for the securities to which the offer relates*
  - ii. *The persons making the offer were named in the prospectus as promoters of the company.*
  - iii. *The time and place at which the underlying contract for allotment may be inspected.*
  - (a) *i or ii only*
  - (b) *i or iii only*
  - (c) *ii or iii only*
  - (d) *All of i, ii and iii*

2. *Section 40 of the Companies Act, 2013 requires every company shall make an application to one or more recognised stock exchange or exchanges before making public offer. Madhav Casting Limited filed an application to three exchanges for the securities to be dealt with in such stock exchanges, it received permission from couple of them and proceed with public issue. There will be:*
- (a) *No penalty, as application has been filed*
  - (b) *Penalty on Madhav Casting Limited ranging from ₹ 5 lakh to ₹ 50 lakh*
  - (c) *Penalty on Madhav Casting Limited ranging from ₹ 5 lakh to ₹ 50 lakh and every officer of the company who is in default ranging from ₹ 50 thousand to ₹ 3 lakh*
  - (d) *Penalty on Madhav Casting Limited ranging from ₹ 5 lakh to ₹ 50 lakh and every officer of the company who is in default ranging from ₹ 50 thousand to ₹ 3 lakh and/or Imprisonment upto one year.*
3. *Rig exploration and refinery limited (RERL) decided to raise capital through issue of a shelf prospectus. Company secretary explains the requirement to board that RERL shall be required to file an information memorandum with the Registrar within \_\_\_\_\_, prior to the issue of a second or subsequent offer of securities under the shelf prospectus.*
- (a) *15 days*
  - (b) *21 days*
  - (c) *30 days*
  - (d) *1 month*
4. *Modern Furniture decided to raise capital by issue for which prospectus need to be issued. The copy of prospectus submitted with registrar for filling need to be duly signed by:*
- (a) *Any two directors including managing directors*
  - (b) *Majority of directors*
  - (c) *Majority of directors including proposed directors*
  - (d) *Every director or proposed director*

## Descriptive Questions

1. Explain various instances which make the allotment of securities as irregular allotment under the Companies Act, 2013.
2. What is a Shelf-Prospectus? State the important provisions relating to the issuance of Shelf-Prospectus under the provisions of the Companies Act, 2013 and the Companies (Prospectus and Allotment of securities) Rules, 2014.
3. The Board of Directors of Chandra Mechanical Toys Limited proposes to issue a prospectus inviting offers from the public for subscribing to the equity shares of the Company. State the reports which shall be included in the prospectus for the purposes of providing financial information under the provisions of the Companies Act, 2013.
4. Unique Builders Limited decides to pay 2.5 percent of the value of debentures as underwriting commission to the underwriters but the Articles of the company authorize only 2.0 percent underwriting commission on debentures. The company further decides to pay the underwriting commission in the form of flats. Examine the validity of the above arrangements under the provisions of the Companies Act, 2013.
5. PQR Bakers Limited wants to raise funds for its upcoming project. Accordingly, it has issued private placement offer letters for issuing equity shares to 55 persons, of which four are qualified institutional buyers and remaining are individuals. Before the completion of allotment of equity shares under this offer letter, company issued another private placement offer letter to another 155 persons in their individual names for issue of its debentures.

Being a public company is it possible for PQR Bakers Limited to issue securities under a private placement offer? By doing so, whether the company is in compliance with provisions relating to private placement or should these offers be treated as public offers? What if the offer for debentures is given after allotment of equity shares but within the same financial year?

6. How does the Companies Act, 2013 regulate and restrict the following matters in respect of a company going for public issue of shares:
  - (i) Minimum Amount stated in the Prospectus; and
  - (ii) Application Money payable on shares.

7. Examine the validity of the following statement with reference to the provisions of the Companies Act, 2013.

*The Articles of Association of X Limited contained a provision that the underwriting commission may be paid up to 4% of the issue price of the shares. However, the Board of Directors have decided to pay the underwriting commission of 5% to Deal & Co., the underwriters."*

## ANSWERS

### Answer to MCQ based Questions

1.	<b>(b)</b> i or iii only
2.	<b>(c)</b> Penalty on Madhav Casting Limited ranging from ₹ 5 lakh to ₹ 50 lakh and every officer of the company who is in default ranging from ₹ 50 thousand to ₹ 3 lakh.
3.	<b>(d)</b> 1 month
4.	<b>(d)</b> Every director or proposed director

### Answer to Descriptive Questions

1. **Irregular allotment:** The Companies Act, 2013 does not specifically provide for the term "Irregular Allotment" of securities. Hence, we have to examine the requirements of a proper issue of securities and consider the consequences of non-fulfillment of those requirements.

In broad terms, an allotment of shares is deemed to be irregular when it has been made by a company in violation of Sections 23, 26, 39 or 40. Irregular allotment therefore arises in the following instances:

- Where a company does not issue a prospectus in a public offer as required by section 23; or
- Where the prospectus issued by the company does not include any of the matters required to be included therein under section 26 (1), or the information given is misleading, faulty and incorrect; or
- Where the prospectus has not been filed with the Registrar for filing under section 26 (4); or

4. The minimum subscription as specified in the prospectus has not been received in terms of section 39; or
  5. The minimum amount receivable on application is less than 25% of the nominal value of the securities offered or lower than the amount prescribed by SEBI in this behalf; or
  6. In case of a public issue, approval for listing has not been obtained from one or more of the recognized stock exchanges under section 40 of the Companies Act, 2013.
2. As per **explanation to section 31**, the expression "shelf prospectus" means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in **one or more issues over a certain period** without the issue of a further prospectus.

A company is required to issue a prospectus each time it accesses the capital market. It leads to unnecessary repetition for a company which makes **more than one offer of securities** in a year to mobile funds from the public. A way out is shelf prospectus which **remains valid (on the shelf) a specified time period** during which offers for securities may be made by a company to the public without going through the arduous exercise of issuing fresh prospectus every time.

### 1. **Filing of shelf prospectus with the Registrar**

Shelf prospectus may be filed with the Registrar at the stage of first offer of securities, by class or classes of companies as the Securities and Exchange Board may provide by regulations in this behalf.

It has to indicate a period not exceeding one year as the period of validity of such shelf prospectus.

The period of validity is to commence from the date of opening of the first offer of securities under such prospectus.

In respect of any second or subsequent offer of such securities issued during the period of validity of such prospectus, no further prospectus is required.

**2. Filing of 'Information Memorandum' with the Shelf Prospectus**

A company filing a shelf prospectus **shall be required** to file an information memorandum with the Registrar within the prescribed time, prior to the issue of a second or subsequent offer of securities under the shelf prospectus containing;

- a. All material facts relating to new charges created,
- b. Changes in the financial position of the company as have occurred between the first offer of securities or the previous offer of securities and the succeeding offer of securities, and
- c. Such other changes as may be prescribed,

The information memorandum shall be prepared in Form PAS-2 and filed with the Registrar along with the fee as provided in the Companies (Registration Offices and Fees) Rules, 2014 within one month prior to the issue of a second or subsequent offer of securities under the shelf prospectus.

**3. Safeguard (in case of changes) to applicants who made payment in advance.**

It is provided that where a company or any other person has received applications for the allotment of securities along with advance payments of subscription before the making of any such change, the company or other person shall intimate the changes to such applicants and if they express a desire to withdraw their application, the company or other person shall **refund all the monies** received as subscription **within fifteen days** thereof.

**4. Information Memorandum together with Shelf Prospectus is deemed Prospectus**

Where an information memorandum is filed, every time an offer of securities is made under sub-section (2), such memorandum together with the shelf prospectus shall be deemed to be a prospectus.

3. As per section 26(1) of the Companies Act, 2013, every prospectus issued by or on behalf of a public company either with reference to its formation or subsequently, or by or on behalf of any person who is or has been engaged

or interested in the formation of a public company, shall be dated and signed and shall state such information and set out such reports on financial information as may be specified by the Securities and Exchange Board in consultation with the Central Government.

It is provided that until the Securities and Exchange Board specifies the information and reports on financial information under this sub-section, the regulations made by the Securities and Exchange Board under the Securities and Exchange Board of India Act, 1992, in respect of such financial information or reports on financial information shall apply.

According to clause (c) of Section 26 (1), the prospectus shall make a declaration about the compliance of the provisions of the Companies Act, 2013 and a statement to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 and the rules and regulations made thereunder.

Accordingly, the Board of Directors of Chandra Mechanical Toys Limited which proposes to issue the prospectus shall provide such reports on financial information as may be specified by the Securities and Exchange Board in consultation with the Central Government to comply with the above stated provisions and make a declaration about such compliance.

4. Section 40 (6) of the Companies Act 2013, provides that a company may pay commission to any person in connection with the subscription to its securities, subject to a number of conditions which are prescribed under the *Companies (Prospectus and Allotment of Securities) Rules, 2014*. In relation to the case given, the conditions applicable under the above Rules are as under:
  - (a) The payment of such commission shall be authorized in the company's articles of association;
  - (b) The commission may be paid out of proceeds of the issue or the profit of the company or both;
  - (c) The rate of commission in case of debentures, shall not exceed two and a half per cent (2.5%) of the price at which the debentures are issued, or as specified in the company's articles, whichever is less.

Thus, the underwriting commission in case of debentures is limited to 2.5%.

In view of the above, the decision of Unique Builders Limited to pay underwriting commission exceeding 2% as prescribed in the Articles, is invalid.

The company may pay the underwriting commission in the form of flats since there is no prohibition on payment of underwriting commission in kind. Further, in case of *Booth v New Africander Gold Mining Co.*, it was held that underwriting commission may be paid in cash or in kind or in lump sum or by way of a percentage.

5. According to section 42 of the Companies Act, 2013 any private or public company may make private placement through issue of a private placement offer letter.

However, the offer shall be made to the persons not exceeding fifty or such higher number as may be prescribed, in a financial year. For counting number of persons, Qualified Institutional Buyers (QIBs) and employees of the company being offered securities under a scheme of employees' stock option will not be considered.

Further, Rule 14 (2) of the *Companies (Prospectus and Allotment of Securities) Rules, 2014* prescribes maximum of 200 persons who can be offered securities under the private placement in a financial year, though this limit should be counted separately for each type of security.

It is to be noted that if a company makes an offer or invitation to more than the prescribed number of persons, it shall be deemed to be an offer to the public and accordingly, it shall be governed by the provisions relating to prospectus.

Also, a company is not permitted to make fresh offer under this section if the allotment with respect to any offer made earlier has not been completed or otherwise, that offer has been withdrawn or abandoned by the company. This provision is applicable even if the issue is of different kind of security.

Any offer or invitation not in compliance with the provisions of this section shall be treated as a public offer and all provisions will apply accordingly.

In the given case PQR Bakers Limited, though a public company but the private placement provisions allow even a public company to raise funds through this route. The company has given offer to 55 persons out of which

4 are qualified institutional buyers and hence, the offer is given effectively to only 51 persons which is well within the limit of 200 persons. From this point of view, the company complies the private placement provisions.

However, as per the question, the company has given another private placement offer of debentures before completing the allotment in respect of first offer and therefore, the second offer does not comply with the provisions of section 42. Hence, the offers given by the company will be treated as public offer.

In case the company gives offer for debentures in the same financial year after allotment of equity shares is complete then both the offers can well be treated as private placement offers.

6. The Companies Act, 2013 by virtue of the provisions as contained in Section 39 (1) and (2) regulates and restricts the minimum amount stated in the prospectus and the application money payable in a public issue of shares as under:

#### **Minimum amount stated in a prospectus**

No Allotment shall be made of any securities of a company offered to the public for subscription; unless; -

- (i) the amount stated in the prospectus as the minimum amount has been subscribed; and
- (ii) the sums payable on application for such amount has been paid to and received by the company.

#### **Application money**

Section 39 (2) provides that the amount payable on application on each security shall not be less than 5% of the nominal amount of such security or such amount as SEBI may prescribe by making any regulations in this behalf.

Further section 39 (3) provides that if the stated minimum amount is not received by the company within 30 days of the date of issue of the prospectus or such time as prescribed by SEBI, the company will be required to refund the application money received within such time and manner as may be prescribed.

Rule 11 (1) of *the Companies (Prospectus and Allotment of Securities) Rules, 2014* mentions that if the stated minimum amount has not been subscribed and the sum payable on application is not received within the period specified therein, then the application money shall be repaid within a period of fifteen days from the closure of the issue and if any such money is not so repaid within such period, the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at the rate of fifteen percent per annum.

In case of any default, the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less.

7. Section 40 (6) of the Companies Act 2013, provides that a company may pay commission to any person in connection with the subscription to its securities, subject to the conditions prescribed under the *Companies (Prospectus and Allotment of Securities) Rules, 2014*. Rule 13 states that the rate of commission paid or agreed to be paid shall not exceed, in case of shares, five percent (5%) of the price at which the shares are issued or a rate authorised by the articles, whichever is less.

In the given problem, the Articles of X Ltd. have prescribed 4% underwriting commission but the directors decided to pay 5% underwriting commission.

Therefore, the decision of the Board of Directors to pay 5% underwriting commission to the underwriters (*i.e.* Deal & Co.), is invalid.