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INDIAN INVESTOR AND THE LAW REGARDING DISCLOSURE

THE Companies Acts in India in the past were just copies of the corresponding enactments in the U.K. Some informed people opine that due to the far reaching changes brought about by the enactments in 1936 and thereafter, it can no longer be said to be a copy of the corresponding English Act. The purpose on the other hand is to highlight to the readers, especially the small investors, how miserably, investors in Indian companies have been left in the lurch. It would be useful to follow this up by a study of the factors which actually are responsible for this state of affairs being continued all these years and still continuing.

It will be universally accepted that the objective of a welfare state is to accelerate the pace of economic growth in the country. It will also be readily agreed that the corporate sector has a key role to play in that endeavour. This should be recognised as long as the mixed economy principle is the cardinal feature of government's economic policy. The sinews of the corporate sector are provided by the investing public—both big and small investors. It can also be recognised that investors can not be forced to make the investments in a democratic set up. The climate for investment should be created and the mean for creating the suitable climate is under the jurisdiction of the Government.

Apart from providing concessions in the matter of tax, what the investor is most interested in is, the protection from unscrupulous promoters. The purpose of this article is to bring to focus certain well laid out traps for the investors. These traps have been specifically left uncovered by the relevant legislations in the country. It would be possible to trace out as to who actually were responsible for these

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loopholes in law. It is time that the Government set in this direction with speed. However the small investors should take this up immediately as otherwise it leads to plunder of their hard earned savings in a moment. The matters which are dealt with here are limited to the raising of capital in the market. The Companies Act has number of provisions in respect of shareholders' protection which are not analysed here.

Students of company law can very well recollect the background of the Bubble Act of 1720 in U.K., and also its aftermath. It was reported that promotors and their agents were going from door to door to collect funds for joint stock companies, the investors taking their decisions on the basis of the oral picture presented by the caller at the door. The Government, though wedded to *laissez faire*, could not allow such methods of raising money from public. The Bubble Act was the result as the 'crown wanted to protect its citizen from being cheated'. The Government remained steadfast to this stand for more than a century after the passing of Bubble Act in 1720 banning formation of joint stock companies. The pressure of developing trade and commerce however underlined the necessity of formation of new forms of business organisations to operate huge commercial and industrial ventures. Thus in 1825 the Government on its own had to repeal the Bubble Act. At the same time, its zeal to protect the investing citizens had not dwindled. Therefore a way out of this dilemma was found by introducing more and more provisions in the company legislations regarding disclosure in writing of details about the company while raising capital.

Even then the menace of unscrupulous promoters haunted the investors. These written prospectuses whose copy had to be filed with the prescribed authority still could lure the investors to unprofitable ventures by painting rosy pictures. It is interesting to read a publication regarding the nature of these prospectuses, dating back to 1931. The following extract from the book would illustrate the plight of a small investor in those days : "Unfortunately the small investor has not easy access to financial authorities whose services are always at the command of large capitalists. The man of wealth can readily turn to his broker, his banker and to other professional financiers for advice and information. Moreover he frequently has the advantage of first hand knowledge of investment matters gained by intimate acquain-

tance with the financial side of industry. But although brokers and investment bankers nowadays pay more attention to small transactions, the large majority of those who can not claim to be rich men are not in a position to make easy reference to 'my broker' or 'my banker'. The result is that they rely upon breakfast table prospectus or newspaper advertisement for the practical introduction to the field of investment."

The menace of misleading prospectus, despite stern measures to regulate the issue and contents of prospectuses, was admitted by the Cohen Committee in England before the 1948 Act. To minimise the havoc, the role of informed press was emphasized. The Cohen Committee went to a considerable length in their recommendations in this regard. "Informed press comment should be a deterrent to misleading prospectuses but comment tends to be stifled by fear of proceedings for libel. The Law of libel is outside the scope of our enquiry but we think that if any reform were possible, which encouraged freedom of comment without opening the way to unjustified defamation, it would undoubtedly afford the additional weapon against the type of promoter who is averse to disclosure of all material facts." (Para 26 of the report)

Developing economies like ours can always enrich at the expense of the experience of already developed economies. After all we are passing through those phases which they have already passed through. It would be easy to avoid the pitfalls found from the history of developed economies. The above situation in U.K. in 1931 is almost similar to that faced by the Indian investors today. The Bhabha committee states in para 25 of its report : "The existing lacunae in the Indian Companies Act 1913 and the defects in its administration enabled some businessmen and financiers with no long and honourable traditions of service to community to misuse and sometimes to prevent the provisions of company law, to serve their private ends while the absence of any adequate and effective organisation for the administration of the Act rendered remedial action through suitable administrative measures extremely difficult."

The prospectus provisions of the Companies Act, though intended to protect the investing public, are not fool-proof. Commenting on the provisions of the then English Companies Act, which were far reaching even in those days, the above author opined: "An honest

endevour appears to have been made in the Act to safeguard the interests of the investors and large number of clauses are concerned solely with the penalties which are attached to offences of either commission or omission on the part of the vendors promoters, directors, secretaries and liquidators. But the Act is not perfect and the money of the public may still be trapped by unscrupulous persons who successfully manage to keep within the four corners of the law."

The above was the comment of the author on the 1929 Act in England. Before the 1929 Act a company could evade the stringent provisions regarding prospectus by issuing the shares to an issue house and then make them issue to the public. "Before the 1929 Act (Sec. 38) was enacted, the rules as to prospectus did not apply in England to an offer for sale of shares made by a person to whom the company had sold the shares. (See Urquant *vs.* Stracey 18, 1929 NI 162).

The Act of 1929 has changed the position in this respect." (The Indian Companies Act by K. Venkoba Rao 3rd Edn. 1954).

As offer for sale through issue houses was therefore covered by 1929 Act. What the author mentioned above would have probably meant in 1931, is the salé of shares to the public by the existing shareholders, which can be termed as 'private placing'. This type of 'share hawking' by the holders of shares by means of advertisement in the press or by issue of pamphlets of information could be the obvious thing meant by that author. In England, though this business of 'share hawking' is not regulated by the Companies Act, is now governed by a separate legislation *viz.*, The Prevention of Fraud (Investments) Act. The Companies Act envisaged only sale of shares by a company either directly or indirectly. This loophole in law was perfectly plugged up in U.K. later by the above mentioned Prevention of Fraud (Investments) Act.

Private placing is not generally treated as a method of raising money from public L.C.B. Gower's. 'Modern company law' deals with three methods of raising money from the public, *i.e.*, Direct offer to the public; Offers for sale; and Placings. The difference between the second and third method is that in former a issuing house purchases the shares outright and then resells to the public whereas in latter the issuing house would be placing on behalf of the company the shares in the market. These are all covered by the company legislation in

India also. The sale of shares by existing shareholders through public advertisement is termed in India as 'offer for sale'. Strictly it is not 'offer for sale' if we derive the connotation from the English law. Such type of 'share hawking' can be termed as 'private placing'.

In any case, from the point of view of investors, protection should be afforded against unscrupulous company promotors as well as further speculative dealers in the market. Discussing the various methods of public issue of shares, a concise volume on English company law says: "the rules which we have just been discussing are concerned to control public issues of securities by companies. They are not concerned with subsequent dealings in those securities. The objects of Prevention of Fraud (Investments) Act 1958 are—to prevent dealings in securities by unauthorised person and to prevent investors from being invited to buy securities without the full information required by the Companies Act 1948 unless the seller is a professional man of good reputation." Thus private placings of shares can be made only through stock exchange, through licensed dealers or through issuing houses.

Many of the provisions of the Prevention of Fraud (Investments) Act are similar to the Securities Contracts (Regulation) Act 1957 in India. But whereas in India the purpose of the Act is to regulate the buying and selling of securities within the stock exchanges, there is nothing in the Act to prevent a person from publicly offering any share he or his principals may be holding. In the process of this offer if such a person makes any misleading or false statement, such statements do not attract the provisions of the Companies Act regarding 'prospectus'. The only provision under which such statements could be questioned is that of section 68 of the Companies Act which would be of practically no use to the small investor as would be evident on a mere reading of the section. The section reads as follows: "Any person who either by knowingly or recklessly making any statement promise or forecast which is false, deceptive or misleading, or by any dishonest concealment of materials facts, induces or attempt 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 shares or debentures; or

(*b*) any agreement the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of shares or debentures, or by reference to fluctuations in the values of shares or debentures;

shall be punishable with imprisonment for a term which may extend to five years or with fine which may extend to ten thousand rupees or with both."

It would be evident that only person who would claim relief under this section will have to prove the intentions of the party who had made the false statement.

Compared to the above situation in India, in U.K., "It is an offence for an unlicensed person to invite public to buy or sell shares and the offence is punishable with two years imprisonment or a fine of £ 500 or both (Section 14)" [Prevention of Fraud (Investments) Act 1956] "If in addition the circular or other information given in the course of the dealing is misleading, false or deceptive or contains reckless statement or forecasts there is a further offence punishable with seven years' imprisonment (Sec. 13)". These provisions of the Act under reference were there in the Prevention of Fraud (Investments) Act 1939 which was redrafted in 1956.

The Securities Contract (Regulations) Act in India does not extend its scope to prevention of fraud on investments as it is in U.K. under the Prevention of Fraud (Investments) Act. The preamble to the Securities Contract (Regulations) Act 1956 states:

"An Act to prevent undesirable transactions in securities by regulating the business of dealing therein by prohibiting options and by providing for certain other matters connected therewith."

It is understandable why the Act should limit its scope to option dealings alone. This requires rethinking.

If our legislators had been closely observing the English legislations and if they had been serious in taking lessons from developed economies as U.K., what actually prevented them from introducing such a measure either in the Securities Contract Regulations Act or the Companies Act? They could not have considered Indian investing public better informed and discriminative to assess the statements which may be made or omissions which may be committed in private placings. Even the provisions regarding false and misleading state-

ments in such private offers for sale were written into law, in section 68 of the Companies Act, only in 1956.

Here then is a new open field for those who want to make quick money. They can also pass on portions of it to underwriters and brokers as commission. It can be done in an organised manner by a group of underwriters or financiers. Operations of this type do not get recorded anywhere either with the Registrar of Joint stock companies or with the Controller of Capital Issues. However a written clarification from the Office of the Controller of Capital Issues states: "If the amount involved in the offer of sale exceeds Rs. 25 lakhs the person who makes the offer has to obtain the permission of the Controller of Capital Issues." It is not clear how far this formality is being observed as will be explained later.

Statistics are not readily available regarding private placings in India in the past. However it should be admitted that the facility afforded has not been fully exploited. So far so good. But the field is still open. On a random basis when the offers of this type were studied in this country the following 4 cases came to my notice:—

1. Offer of 2,50,000 equity shares of the Ratnakar Shipping Company Limited, Calcutta by the Sutlej Cotton Mills Limited, Amritsar. Both the companies were under the same management but situated at two different places with different political environments. The offer was made in October 1968.

2. Offer by the Central Bank of India Limited on behalf of certain shareholders of 22,000 fully paid equity shares of Rs. 100 each at Rs. 170 each of the Motor Industries Company limited, Bangalore in January 1969.

3. Offer by M/s. Anand Dasgupta & Sagar, Solicitors and Advocates, Calcutta on behalf of certain shareholders of 2,94,000 equity shares of Rs. 10 each of the Electrical Manufacturing Company limited, Calcutta in August 1969.

4. Offer by M/s. Chithra & Co., Stock brokers of 1,40,000 equity shares of Rs. 10 at Rs. 14 each of the Engine Valves Limited, Madras on behalf of certain shareholders in December 1969.

All the above private placings were purported to be made to comply with the listing requirements of the Stock Exchange. They had all issued a pamphlet of information along with the application forms. One of the offers was even underwritten by the Unit Trust of

India. However none of these pamphlets of information had been filed with the Registrar of Joint stock companies as it is the case with prospectuses; there was no mention whether permission from Controller of Capital Issues was sought or obtained; none of them contained the particulars as set out in detail in schedule II of the Companies Act 1956 for prospectuses; none of them contained the Auditor's report regarding the working results and financial position. However atleast two of the placings (2 and 4) were ever subscribed and the shares were admitted in the stock exchanges mentioned in the pamphlet. Placing No. 1 was fully underwritten. Those who get the shares under offers (1), (2) and (4) were of course benefited as the share values did go up. In the case of No. (2) the market went up to Rs. 480 as against Rs. 170 the price at which it was offered to the public. Offer (3) was not as briskly subscribed as the others. The shares were also not admitted for trading in the stock exchange for nearly a year.

In the meantime when a reference as made to the issuers for the return of the money, they declined their responsibility for any statements, on the plea that they were only agents. A similar issue by the company itself would have attracted the provisions of Section 73 of the Companies Act. The company would have had to return the money if stock exchange quotation was not obtained. It is interesting to study further the circumstances under which the offer No. 3 was made, the company was hit by an indefinite strike at the time the offer was made. This fact was conveniently omitted in the pamphlet. Moreover immediately before the public offer the company had issued substantial number of Bonus shares. The summary of the Balance sheet produced in the pamphlet was that of the Balance sheet before the issue of Bonus shares. It showed substantial reserves whereas actually they had been distributed as Bonus shares. The sales of the company for the year had been adversely affected due to the strike and therefore no profits could have been expected. It can therefore be reasonably concluded that he private offer was an effort to convert the Bonus shares into cash when the shareholders were not sure of the dividend for he year. The scapegoat for this was the investing public. All this has been within the four corners of law.

When the matter was referred to the Company law Board for their intervention regarding:

(1) concealment of the strike situation in the factory;

(2) failure to get stock exchange quotation as stated in the terms of issue of the shares;

(3) the issue of bonus shares and their immediate resale to cash the reserve from out of public money instead of from the resources of the company;

the Board expressed its inability to interfere as it perhaps found all this within the bounds of law.

In addition to the exemption from the stringent provisions of Companies Act, private placings also enjoy the exemption under the Capital Issue Control Rules. No permission need be obtained or exemption sought for placings upto Rs. 25 lakhs. Even in respect of placings above this sum it is doubtful whether permission had been obtained or not. Moreover it can not be said whether capital issue control is to protect investors from unscrupulous promoters and speculators. In the U.K. the main emphasis of Government policy as set out in the memorandum of guidance to the Capital Issues Committee is on:—

"(1) the increase of capacity needed to overcome shortage of basic materials;

(2) projects likely to substantially increase exports to hard currency markets or to bring about marked and direct savings in imports from hard currency sources;

(3) the development of technical advances and new practices and research and development projects contributing to industrial progress; and

(4) projects which will yield marked and immediate reduction in costs."

The above policy guidance shows that the objective of Treasury consent has more to do with monetary economics at the national level than with investor protection. The general objectives of Capital Issues Control in India also can be taken to be the same as in U.K. Therefore nothing could be expected by the investor from that quarter.

Another vexed problem faced by the investors is the listing of shares in the stock exchange. Invariably the public issues are made with a statement that application has been made or will be made for quotation in the stock exchange. Section 73 of the Companies Act seeks to regulate the linking up of a proposal for stock exchange quo-

tation with the public issue of shares. If a company offers the shares on the condition that application has been made or will be made, the investor applies in the hope that the listing would be granted. If the listing is not granted within the time prescribed, the moneys received have to be returned according to the section. Normally companies take 2 to 3 months to send letters of allotment regret. It is ununderstandable why the listing decision should not be taken within this period. Invariably the announcemert regarding listing comes long after the allotments. The company however can commence business under section 149 of the Companies Act if a declaration is made by the secretary. If the stock exchange had not communicated its refusal, before the allotment, it does not mean they have accepted the shares for listing. If it is refused later on, the provisions of Section 73 (regarding return of money) cannot be honoured as the money would have been already applied. If however in order to avoid public inconvenience a stock exchage decides to admit the shares the standards for admission may be lowered. That by itself is doing away with a safeguard on which an investor depends. The practice in this regard therefore has to be regulated. Permission to commence business, even if the stock exchange has not decided about the listing, is due to the permissive clause contained in Secton 149 of the Companies Act. The section states that—

"(1) Where a company having a share capital has issued a prospectus inviting the public to subscribe for its shares, the company shall not commence the business or exercise any borrowing powers unless

(*a*) ....

(*b*) ....

(*c*) no money is or may become liable to be repaid to applicants for any shares or debentures which have been offered for public subscription by reason of any failure to apply for or obtain permission for the shares or debenture to be dealt in on any recognised stock exchange; and

(*d*) there has been filed with the Registrar a duly verified declarration by one of the directors or the secretary, in the prescribed form that clauses (*a*), (*b*) and (*c*) of this sub-section, have been complied with."

The above is the exact reproduction of Section 109 of the English

Companies Act 1948. The English Act did not implement fully the views of the Cohen Committee. The views of the Cohen Committee were as follows :

> "We have already referred in para 23, to the unfortunate results to the subscriber in cases where permission to deal is refused after the allotment of the shares and securities. We think that the hands of the stock exchange would be strengthened and the mischief mitigated by requiring the company in any case when the prospectus contains a statement that application has been or will be made for permission to deal to make that application not later than two days after the issue of the prospectus and if permission to deal is definitely refused within 21 days of the closing of the lists to cancel allotments and return subscription moneys. If this latter suggestion is adopted it would be advisable to require a statutory declaration that such permission has been granted or has not been refused before the expiration of that period as condition precedent to the commencement of business. Such an alteration of the law will not afford complete protection to the investor as stock exchange committees may decide to defer, not to refuse permission." (Para 28)

At the same time the Committee also considered the possibility of the stock exchange deferring the decision and preferring to wait till the results of a year are known and in the mean time the company could not start business and the money would have to be returned thus preventing the establishment of a useful business enterprises. The committee ultimately recommended that a certificate of commencement of business could be obtained on a declaration by the secretary or a director that the application has not been refused by the stock exchange. It did not specify any remedy for the investor in case listing is refused later on. The result was section 109 of the Companies Act in U.K. with some changes in the recommendations. The section was copied out in the Companies Act 1956 in India as section 149. The net result of section 149(1)(c) would be that business can be commenced even though no reply has been received from the stock exchange and if the moneys have been spent in the mean time and if the listing refused, the investor should lose or at the most the officer who has

made the declaration can be made to pay a penalty. But that does not lead the investor anywhere. This whole question of stock exchange listing and commencement of business keeping in view the protection to investors requires a thorough re-examination.

The peculiar situation in India in the corporate sector is the lack of mass base. This base has not been built nor efforts made to build it up. Those who come forward to participate in this process of economic development do not get adequate protection from unscrupulous promoters. Added to this is the poor literacy percentage of the population. Many investors cannot understand the prospectuses issued as the language of communication is only English. The message does not reach the rural areas. No facilities for remittance of the application money in rural areas is available. Subscriptions are collected in only important metropolitan cities. The investors in the cities also do not bother much to go through critically the prospectus. It is also regrettable to mention here that the stock brokers who collect addresses of potential investors from different sources do not choose to send the application forms and prospectus if the issues are popular. If the issues are not quite popular, they send the application form to addresses collected. Invariably they would be accompanied by a personal letter from the broker commending the issue, but without a copy of the prospectus. It is violation of company law to supply application forms without a prospectus [Sec. 56(3)] and is a punishable offence. But who can prove it and how? Then what is the use of the provision? Again they have reason for it. The brokerage allowed is just ½% of the issue price whereas the postage in sending a bulky prospectus will itself eat away more than 50% of this brokerage. Cannot the Government do something about it?

The system of issue houses which is prevalent in U.K. is absent in India. The public can to a certain extent assess the worthwhileness of the issue on the basis of the Issue houses who undertake the issue. In India only recently the National and Grindlays Bank Limited started a merchant banking division and has managed some of the good issues after its inception. However the system has not developed on a large scale.

Thus when :

1. Prospectuses containing all sorts of statements unscrutinised

by Governmental authorities are put in circulation;

2. there are no reputable issue houses to manage the issues;
3. it is possible to by-pass the prospectus provisions of the Companies Act by issuing the shares to a limited few and after 6 months make them offer on their own for sale to the public;
4. there is no guarantee of stock exchange listing for the shares when transferability of shares is the essence of the joint stock company form of business enterprise;

the Indian investor is miserably on dangerous cross roads full of rash and negligent traffic.

Commencing upon the main features of the company law in U.K. on investor protection, L.C.B. Gower an eminent authority on Modern Company Law observes :

"Three main conclusions on investor protection will occur to any reader of this chapter.

The first is that England has pinned its faith on a philosophy of disclosure rather than supervision....

The second main feature therefore of our system is the apparent inadequacy of the arrangment to check the truth of the information disclosed....

In England however we leave this to private enterprise; to the stock exchanges and more especially the issuing houses which satisfy themselves on this score;

This leads to the third and final point; the extent to which English company law relies on private agencies and extra legal techniques. Some state intervention there has certainly been; Treasury consent under the Borrowings Act; prospectus provisions under the Companies Act and the licensing of dealers under the Prevention of Fraud Act."

We in India have miserably failed in aping the British example. We have left it to the private enterprise without checking the contents of the prospectus for truth; we have failed to develope reputable issues houses and we have failed to regulate open public offers for sale by all and sundry persons. Even the capitalist United States has made adequate provision for protection of investors. The Securities Exchange Commission estalished as early as in 1934 has been entrusted with the task of scrutinising the veracity of statements made in prospectuses issued in inter-state commerce. The S.E.C. is even entitled

to stop the company from collecting the money after the prospectus has been issued. This is applicable to anyone who makes a public sale of shares whether it be the issue by the company or by a issue house or a private placing. The following passage from an American author on S.E.C. Accounting practice and procedure is relevant: "The preparation of a registration statement is a complicated technical process. The S.E.C.'s job is to examine the registration statement to see that full and accurate disclosure to made of all pertinent information relating to the company's business, its securities, its financial position and its earnings and the underwriting arrangement so that the prospective investor may have a basis for deciding whether to purchase the securities. Under the law, it is the seller (not the buyer) who must beware because the commission's responsibility is to protect the public --not the issuer or the underwriters of the securities".

"If all the facts regarding a security are not truthfully told in the registration statement or if important information is omitted, the commission may require the registration statement to be appropriately amended. If the amendment does not cure the deficiencies the commission may exercise the 'stop-order' or 'refusal order' powers to prevent the registration statement from becoming effective and the securities from being sold until the deficiencies are cured. If the stop order is issued after the registration statement has become effective the order prevents further sales of the securities by the issuer or underwriter."

If so much caution is taken in a country of enlightened and literate investors, there is no reason why such steps like these should be delayed indefinitely in this country. It is worthy of mention here that recommendations on this pattern had been made by the Bhabha committee in 1954 and even prior to that by the Planning Commission. The Bhabha committee observes:

"The requirements of section 93 about disclosue of information in a prospectus are often more honoured in the breach than in their observance.

The interests of the public demand that they should be protected against being induced to part with their capital by those who indulge in the practice of issuing irregular prospectus. Under our proposals, greater and fuller information is to be made available. It is therefore all the more necessary that some responsible authority should scrutinise the statutory information required to be disclosed in the pros-

pectus before it is registered and issued. The need for such scrutiny has been recognised by several witnesses. In certain countries *e.g.*, the United States of America and Canada, prospectuses are subjected to preliminary serutiny at the hands of appropriate authorities. In a matter like this prevention of mischief should be the main objective. When a company approaches the Controller of Capital Issues for sanction to the issue of its capital, it is required to submit relevant information relating to the formation. It should not be therefore difficult for the Controller of Capital Issues to scrutinise the contents of a prospectus and to certify whether it discloses all the information required to be disclosed in it by the Act. This should not cause any avoidable delay. If our recommendation is accepted all issues of capital to the public including those which at present enjoy exemption will have to be brought within the purview of the Controller of Capital Issues. This is also recommended by the First Five Year Plan (Para 69).

The present miserable situation in India regarding protection available to investors does not fit into contemporary trends in Governmental policies. A complete rethinking on this aspect of investor protection is essential. This should be done speedily. Simultaneously small investors should join hands to accelerate this process of change. Now is the time as the new company law may be taking its shape.