# Safety Net Arrangements – Curse or Cure?

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## Introduction

The economic turmoil witnessed in the global economy over the past few years has left its mark on the Indian stock markets. While the country's growth continued at a decent pace (as compared to other developed nations), unfortunately invest-ors lost confidence in India due to a number of reasons, including (i) uncertainty of the political regime, (ii) unprecedented volatility in the stock markets and the value of the rupee, and (iii) a perception of systemic corruption.

The imperative of growth requires an increasing proportion of savings being channelized in a manner that would facilitate their deployment in the most productive uses. It is therefore a matter of concern that doubts often arise regarding the likely real returns on financial assets. Individuals tend to prefer physical assets like gold or real estate. The falling of gold prices has also played a major factor in diverting liquidity away from the capital markets. At present, thanks to political instability, performance of the equity markets, inflation, macroeconomic policies and general negative perception in the international markets about the country, the rupee has suffered record lows. Looking at it practically, the devaluation of the rupee could not have happened at a time worse than the present.

SEBI has been taking a number of steps to attract retail investors in the capital markets such as introduction of the equity savings scheme, incentives for mutual funds, separate plans for direct investment in existing as well as new schemes in mutual funds, expansion of asset classes that can be held in dematerialized form and so on. However, in order to mobilize savings into productive uses, retail investors must have a strong incentive to invest in financial assets such as shares and debentures. Perhaps it is with this well-intentioned purpose of safeguarding the retail investor that the concept of the safety net arrangement has been formulated by SEBI.

## Safety Net Arrangement – An Overview

A safety net arrangement is an arrangement provided by an issuer of shares, pursuant to which a person ("**Safety Net Provider**") offers to purchase the shares from the original retail individual investors ("**RIIs**") at their IPO issue price after the expiry of a particular period, in the event the price of such share has fallen below the IPO price. The basic intent of the safety net mechanism is to protect the investments of the RIIs in the IPOs from over pricing of such IPOs, and thereby encourage retail investment in the capital markets. A safety net mechanism is therefore like a money back scheme for the original RIIs in an IPO.

Interestingly, the concept of a safety net mechanism is not a new one. It was even included in Clause 8.18 of the erstwhile SEBI (Disclosure and Investor Protection) Guidelines, 2000 ("**DIP**"). This clause stated that any safety net scheme or buy-back arrangements of the shares proposed in any public issue shall be finalised by issuer with the lead merchant banker in advance and disclosed in the prospectus, and shall be made available only to all original resident individual allottees. Such buy back or safety net facility was required to be limited upto a maximum of thousand (1000) shares per allottee and the safety net mechanism was required to be valid at least for a period of six (6) months from the last date of despatch of securities. However, the provision of the safety net mechanism was optional and not mandatory.

MSP Steel & Power Limited ("**MSP**") and Usher Agro Limited ("**UAL**") provided a safety net mechanism to their retail investors in their IPOs in FY 2005 and FY 2006, respectively. In MSP's IPO, Microsec India Limited, the lead managers to the issue provided the safety net mechanism. Further the safety net mechanism was limited upto a maximum of 1000 shares per allottee at the issue price of `10 per share and was valid for a period of six (6) months from the last date of despatch of securities.

In UAL's IPO, IDBI Capital Market Services Limited, the lead managers to the issue provided the safety net mechanism. Further, the safety net mechanism was limited upto a maximum of 800 shares per allottee at the issue price of '15 per share and was valid for a period of six (6) months form the date of allotment of equity shares.

Currently, Regulation 44 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR**") provides for a safety-net arrangement for specified securities offered in any public issue in consultation with the merchant banker to the public issue. Such merchant banker is required to ascertain the financial capacity of the person offering the safety-net arrangement and ensure the disclosures specified in this regard in Part A of Schedule VIII of the ICDR. Any such arrangement is required to provide for an offer to purchase up to a maximum of one thousand (1000) specified securities per original resident retail individual allottee at the issue price within a period of six (6) months from the last date of despatch of security certificates or credit of demat account. However, even the ICDR does not provide for a mandatory safety net mechanism.

## SEBI Discussion Paper

SEBI observed while analyzing the price performance analysis of the scrips listed between 2008 and 2011 that most of the scrips were trading below their issue price after six (6) months of their listing on the stock exchanges and had fallen below 20% of their IPO issue price. In SEBI's view, this trend was hampering the RIIs' sentiments regarding the capital markets. In view of the same, SEBI issued a discussion paper 'Mandatory Safety Net Mechanism' dated Setpember 28, 2012 ("**Discussion Paper**"), which was made open for public comments.

**Significant Provisions of the Discussion Paper**

*Mandatory safety net mechanism in all IPOs*

The ICDR does not mandatorily require the issuer to provide for the safety net mechanism, but the Discussion Paper proposes to impose a mandatory safety net mechanism in all the IPOs. If the sole intention of SEBI is to control over pricing of IPOs, then the same can be achieved by introducing more checks and balances on the promoters and the intermediaries, strict disclosures norms and transparency in pricing methodology. This may prove far more beneficial in reducing the risks of IPO mispricing and keeping intact the flavor of equity capital markets. The mandatory implementation of the safety net mechanism will fundamentally change the inherent risk element of equity markets and RIIs may not take informed decisions before investing in IPOs.

*The primary safety net obligation would rest with the promoter of the issuer company;*

The ICDR provides that the issuer has to provide the safety net mechanism in consultation with the lead merchant banker, who has to certify the ability of the safety net provider with respect to honoring its safety net mechanism commitments. During the DIP regime, the lead merchant bankers were the Safety Net Providers in the IPOs of MSP and UAL and there were no direct obligations created on the promoters. Creating such an obligation on the promoters could have the effect of discouraging them from accessing the capital markets to raise funds.

*Safety net mechanism shall trigger when the price of the shares depreciate by more than 20% from the issue price. The price of the shares shall be calculated as the volume-weighted average market price of such shares for a period of three (3) months from the date of listing on a particular index;*

As stated earlier, there is no specific safety net trigger stated in the ICDR for the safety net mechanism. However, the Discussion Paper suggests that any depreciation of the share price beyond 20% of the IPO issue price calculated as per the volume-weighted average market price for a period of three (3) months from the date of listing on a particular market index, shall trigger the safety net mechanism. This may not be the accurate way of calculating the depreciation of the share price, as it is possible that the shares price can fluctuate after the period of three (3) months which starts from the date of listing of shares, and the safety net mechanism has to be offered for a minimum of six (6) months from the date of despatch of the securities. Further, it is also possible that share prices could fall as a result of factors outside the control of the issuer and its promoters, such as acts of God, terrorism and macro economic conditions.

*Safety Net Mechanism is only available to RIIs, who had made application for up to* '*50,000; and* RIIs who had applied for shares up to '50,000 in the IPO, are eligible for safety net mechanism. There is a possibility that a large number of RIIs may not even qualify under this eligibility criterion, thus defeating the basic purpose of protecting RIIs in the IPOs.

*Any acquisition of the shares under the safety net mechanism is exempt from the provisions of SEBI (SAST) Regulation, 2011.*

The acquisition of shares under the safety net mechanism has been exempted from the provisions of SEBI (SAST) Regulation, 2011. However, the triggering of the safety net mechanism could result in a breach of the minimum public shareholding in the issuer as required under SEBI Contracts (Regulations) Rules, 1957 ("**SCRR**"). This would result in the incurring of additional expenses for the issuer company and the promoter to achieve the minimum public shareholding under the SCRR.

**Reaction to the Discussion Paper**

The Discussion Paper prompted many negative reactions from investment bankers, companies which are in the process of accessing the capital markets through the IPO route and other market participants. The general view was that the equity markets have an inherent risk element and the money return policies such as safety net mechanisms will eliminate the element of risk from the investment decisions of the retail investors, thereby diluting the true nature of the equity capital markets and discouraging promoters from accessing the capital markets. The mandatory safety net mechanism has been envisaged considering the post-listing price performance of IPOs in India to reinforce investor confidence and rationalize IPO pricing. However, as stated above, one has to keep in mind that the price of equity shares can also fluctuate beyond the control and foresight of the lead merchant bankers and promoters.

**Post - Discussion Paper**

In the post Discussion Paper period, SEBI has been actively recommending that issuer companies and / or their promoters provide a safety net mechanism in their IPOs. As a result, companies such as Just Dial Limited ("**Just Dial**") and ACB (India) Limited ("**ACB**") have offered a safety net mechanism in their IPOs.

***Salient features of the safety net mechanisms in the Just Dial and ACB IPOs:***

*In the Just Dial IPO, the promoters are the Safety Net Providers and in the ACB IPO, the promoters and the* *selling shareholders are the Safety Net Providers.*

The ICDR has not placed any particular responsibility on the promoter or the lead merchant bankers to bear the burden of Safety Net Provider in IPOs. Interestingly, in the erstwhile DIP regime it can be observed that the lead merchant bankers undertook the role of Safety Net Providers. But post the Discussion Paper, it can be observed that the promoters and other investors have taken the responsibility providing the safety net mechanism (in the Just Dial IPO and the ACB IPO).

In the ACB IPO, interestingly, a private equity investor who is also a selling shareholder is one of the Safety Net Providers along with the promoters of ACB. Generally, private equity investors use IPOs as an exit from the company. However, in this case, if the safety net mechanism is triggered, it would result in a private equity investor who is seeking an exit from the company once again becoming a shareholder of the company. In future deals, this could have the effect of opening a Pandora's box of negotiations between issuer companies, their promoters and private equity investors, with respect to who would actually be the provider of the safety net mechanism. In a primary fund raise, this becomes a problem since it may entail bringing new money into the company since the proceeds of the IPO cannot be used to implement the safety net mechanism.

*Only the shares allotted in the IPO will qualify for the safety net mechanism and any secondary market purchase will be adjusted accordingly.*

Any purchase of shares from the secondary market will be adjusted towards any subsequent sale by the RII. Accordingly the shares eligible for the safety net mechanism shall be the lowest number of shares held by the RIIs at any point in time during the safety net period, allotted in the IPOs. This process of calculating the number of shares is referred to as the LIFO method (last in first out) in the offer document filed by Just Dial with SEBI.

*The completion of the safety net period will trigger the safety net mechanism, provided the safety net trigger price is lower than the IPO issue price of the shares*

In the Just Dial IPO and the ACB IPO, the safety net mechanism gets triggered on the completion of the safety net mechanism period (i.e., 180 days from the date of listing of the shares), if the safety net trigger price is lower than the price at which the shares were allotted to the RIIs.

The safety net trigger price will be calculated by the volume–weighted average market price of the equity shares during the sixty (60) trading days preceding the relevant date, where the relevant date shall be the last day of the safety net mechanism period.

For the purposes of calculating the safety net trigger price, the volume–weighted average market price will be calculated by multiplying the number of equity shares traded on the relevant stock exchanges with price of each Equity Shares and dividing this amount by the total number of equity shares traded on the relevant stock exchange.

*Deposit of security amounts from the issue proceeds, equivalent to the liability arising from the safety net mechanism in an escrow account for ensuring that the obligation of the safety net mechanism are fulfilled.*

This escrow account mechanism removes any uncertainty in relation to fulfillment of the obligations by the Safety Net Provider. It also ensures that in the event of any of the safety net provider is unable to honour its safety net mechanism commitments, then the amount in the escrow accounts enables the merchant banker to fulfill the same.

It can be observed that in the Just Dial IPO, 100% of the amount required for fulfilling the safety net obligation of the safety net providers was required to be credited to an escrow account directly from the proceeds of the IPO and in the ACB IPO, 75% of the retail portion of the issue is required to be deposited in an escrow account.

**Conclusion**

Investors should be educated in how to make an investment decision after analyzing the disclosures made by a company in relation to its business and past performance as well as attendant risk factors. This will result in a more sophisticated investor base being created over time. The imposition of a safety net mechanism will only have a detrimental effect on this long term goal, as investors are likely to adopt an attitude of apathy towards disclosures by a company, as they are simply not incentivized to take the level of care in making an investment decision, as they would otherwise have.

Another factor that necessarily must be considered is the impact of these requirements on private equity investors. Private equity investors even now are finding it difficult to obtain exits, with uncertainty around the enforceability of put options under Indian laws. If they are now asked to take the risk of stock prices not performing satisfactorily after an IPO, effectively, another exit route is being hampered. In an environment where Indian companies are starved for liquidity, private equity investments should be encouraged, rather than discouraged.

To conclude, SEBI needs to reconsider its position on making the safety net mechanism a mandatory feature of IPOs by Indian companies. The determination of whether a valuation of a company is fair should be left to the market to decide – it may not be appropriate for SEBI to substitute its judgment for what should essentially be purely a commercial decision of whether or not to invest in a particular company. This is the essence of investment in equity – that investors must take the potential risk of a loss in their investment if they desire to obtain the potential reward of the upside in the stock price. Also, the manner in which the safety net mechanism has been implemented post the Discussion Paper has been inconsistent and uncertain. In an environment that is already rife with ambiguity, imposing such harsh requirements in a manner that is not uniform will only have a detrimental effect.