

Make the problem vanish

The probe on 'vanishing companies' is futile. Give it a quiet burial and instead redraw the rules so that it doesn't happen again

Companies turn sick, lenders turn sick, but promoters rarely do. Make them pay up if issue funds are misused

Prithvi Haldea

One of the scars of the capital market excesses of the nineties is the 'vanishing companies' scam. Between 1992 and 1996, 4,057 public issues raised Rs 54,250 crore. However, soon most of these companies stopped communicating with shareholders, and their shares were either not traded or traded at very low prices. A decade on, no substantive action has been taken against the offenders.

The issue wasn't about 'vanishing companies', it was about vanishing funds -- companies don't disappear, the funds that they raise do. Now, how does one prevent that from happening again? The regulator has suggested, among other things, IPO grading. It won't work, as grading is a subjective, one-time scrutiny of a company. Many more checks and balances that focus on meaningful monitoring, disclosures and redress are required.

Checks and...

Monitor end-use of issue funds. The use of issue funds should be closely tracked in all cases of large issuances. It can begin with issues of above Rs 50 crore made between 2002-03 and 2006-07; cases of misuse should be made public and action taken against promoters.

This responsibility can be assigned to the regulator or the principal stock exchange, or even the credit rating agencies that are now doing IPO grading. Of late, when a company files an IPO application with the NSE, exchange officials visit its offices and plants to get a sense of its physical presence and verify its claims. Extend this further. Officials should visit the plants and offices of companies making a public issue once in six months, for at least three years after the issue; and they should put up their findings on their website.

Make disclosures more meaningful. Disclosures on utilisation of issue funds in annual reports are meaningless, as the format is not detailed and demanding enough to identify misuse.

Disclosures can even get better at more public forums. For instance, issues above Rs 500 crore have to appoint a monitoring agency, but the monitoring agency doesn't share its findings with the public. Therefore, all issuers should be asked to make detailed quarterly disclosures on fund use to stock exchanges for public dissemination in a detailed and meaningful format.

Provide exit option in case of change in issue objects. If a company changes its issue objects within a year of its issue, it should provide an exit option to small investors. In the past, companies diverted public issue funds to their subsidiaries/associate companies and siphoned it off, or utilised it for speculative purposes. They even put it in projects different from those for which the funds had been raised.

However, they couldn't be charged with "misusing issue funds", as they were changed their objects, with shareholders' approval. Small investors, who are sidelined from all such general body meetings, need to be given an exit option, through a promoter buyback, in case of a change in utilisation of issue funds.

...balances

Allow class-action suits. It has been difficult to file cases against fraudulent companies because the Indian Penal Code requires FIRs to be filed by aggrieved individuals, who cannot be represented by the government or investor associations. Given their wide dispersion, small amounts involved and the efforts required, this is not feasible. We need to provide for class-action suits.

In India, companies become sick, lenders become sick, but promoters almost never do. A law should be introduced to make promoters personally liable for the misuse of issue funds. Further, the money so recovered should be used to compensate small investors affected.

Track money trails. PAN is now mandatory for all capital market transactions. This should be extended to all bank accounts, as the number of undisclosed bank accounts is huge. In addition, the director identification number (DIN) should be made mandatory for all promoters for all their capital market and bank transactions, and income tax returns. This will reduce the incidence of using undisclosed bank accounts and help establish audit trails.

Take action against erring auditors. In most developed markets, accounting firms are not only under the regulatory scanner, they are also punished heavily for being a party to fraudulent accounting disclosures. However, in India, while we have seen large accounting frauds, hardly any audit firms have been punished. Maybe, we should establish an Accounting Oversight Board on the lines of the US.

Cover all kinds of companies. These rules should apply to listed companies as well as those selling sundry financial products

like plantation schemes, fixed deposits and timeshares.

We need to move on. Let's give the never-ending and seemingly inconsequential probe of 'vanishing' companies a quiet burial and save public resources. If at all, investigate 10-15 large cases of vanishing funds, mete out exemplary punishment and compensate investors. Further the government should appoints an agency or a bank to buy shares of these dud companies from investors at zero value. Investors can at least book losses and offset them against current capital gains. And maybe, get rid of bitter memories.