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# **SME EXCHANGES AT A CROSSROADS: MARKET MALPRACTICES AND THE REGULATORY RESPONSE OF 2024**

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## **ABSTRACT**

Recognizing the importance of increasing access to finance for small and medium enterprises, the Securities and Exchange Board of India had introduced a regulatory framework governing SME segment of capital markets in India. Since its operationalization, the SME Exchanges have gained significant traction in a short span of time, with record-breaking issuances in the recent years. However, this rapid growth has also gained the attention of the market regulator, SEBI especially with regard to allegations of market manipulation, financial misstatements, and post-listing volatility among SME-listed entities.

In response to these, SEBI recently introduced amendments to the SME framework with the intent to curb these malpractices, increase transparency and strengthen investor protection mechanism within this platform. These reforms seek to align SME IPO regulations more closely with Mainboard listing norms to ensure greater accountability, while maintaining accessibility for smaller business.

Even though these amendments have marked a significant step towards improving governance and fostering investor confidence, there are certain critical gaps that remain unaddressed. This article traces the recent surge in SME IPOs and subsequent regulatory actions against companies such as Varanium Cloud Ltd., Add-Shop E-Retail Ltd., and Trafiksol ITS Technologies Ltd for financial irregularities. Thereafter, it critically analyses the effectiveness of the new reforms in addressing concerns related to market manipulation, financial disclosure requirements and post-listing compliance. Finally, it highlights the remaining regulatory shortcomings that continue to undermine the long-term sustainability and credibility of SME Exchanges.

## Introduction

The SME platform was envisioned as a capital-raising avenue for small and medium enterprises, allowing them to access public markets with fewer regulatory burdens than mainboard listings. Over the past few years, SME IPOs have surged dramatically, reflecting both increased investor interest and a growing number of companies seeking public funding. According to official statistics *“Since, establishment of SME platforms, FY 2023-24 witnessed the highest number of SME public issue and highest SME fund raising with 196 IPOs tapping the market to mobilize more than Rs. 6000 crore. Also, in current FY 2024-25 already till Oct 15, 2024, more than Rs. 5700 crore has been raised through 159 SME IPOs.”*<sup>1</sup>

While these figures indicate the growing enthusiasm for SME stocks, they have also raised concerns about the sustainability of this momentum and the potential risks associated with it. Despite the robust listing gains observed in many IPOs, the post-listing performance of a significant proportion of these companies has been volatile. Official figures indicate that *“[w]hile the majority of companies have witnessed strong listing gains, approximately 20-30% have subsequently experienced price declines. Specifically, of the 224 companies listed on NSE and 91 companies listed on BSE over the past two fiscal years, 39 and 26 companies, respectively, have recorded substantial price drops post-listing.”*<sup>2</sup>

The heightened volatility of SME stocks has not gone unnoticed by regulators. SEBI Chairperson had also flagged concerns over potential market distortions, stating that there were “signs of manipulation” in the SME segment.<sup>3</sup> Her remarks have since fuelled market speculation, with some industry experts arguing that SEBI’s stance disproportionately targets SME companies rather than addressing broader systemic issues in the market.<sup>4</sup> On the other hand, the regulator acted swiftly and intensified surveillance of the SME stocks through

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<sup>1</sup> Securities and Exchange Board of India, “Review of SME Framework under SEBI (ICDR) Regulations, 2018, and Applicability of Corporate Governance Provisions under SEBI (LODR) Regulations, 2015 on SME Companies” (January, 2025)

<sup>2</sup> Sakshi Patil and Sourish Kundu, “SEBI Proposals to Ease Overheated SME IPO Market” *Vinod Kothari Consultants*, November 21, 2024 available at: <https://vinodkothari.com/2024/11/stringent-norms-proposed-to-burst-sme-ipo-bubble/> (last visited on March 2, 2025).

<sup>3</sup> Abhishek Sharma, “Qualification and Funding Concerns: SEBI’s New IPO Rules Spark Fear Among SMEs” *Business World*, May 23, 2024 available at: <https://www.businessworld.in/article/qualification-and-funding-concerns-sebis-new-ipo-rules-spark-fear-among-smes-520622> (last visited on March 2, 2025).

<sup>4</sup> Moneycontrol, “We See Signs of Manipulation in the SME Segment, Says SEBI Chairperson” (*Moneycontrol*, March 11, 2024 available at: <https://www.moneycontrol.com/news/business/markets/we-see-signs-of-manipulation-in-the-sme-segment-says-sebi-chairperson-12436571.html> (last visited on March 2, 2025).

deploying advanced monitoring tools and initiating enforcement actions against companies suspected of engaging in fraudulent practices.<sup>5</sup> Misrepresentation of financial statements, diversion of IPO funds, and stock price manipulation had become recurring issues plaguing the Exchange. This raised concerns over the sustainability of SME exchanges, as their persistence could undermine investor confidence and potentially limit SME platforms' role as a legitimate fundraising avenue for small and medium enterprises.

## ONGOING CHALLENGES IN THE SME PLATFORM

One of the core challenges facing SME IPOs is their vulnerability to speculative trading and short-term price manipulation. Unlike mainboard IPOs, where institutional participation and stringent regulations moderate any kind of price fluctuations, SME IPOs are often dominated by retail investors seeking quick financial gains. The limited float of SME stocks amplifies this volatility, allowing a small group of investors to drive prices artificially higher.<sup>6</sup> This dynamic is further exacerbated by the low liquidity of SME stocks. While companies with a larger float and higher liquidity are less prone to price manipulation, smaller SME stocks often experience extreme price swings.

Retail investors, drawn in by the prospect of significant listing gains, often enter SME stocks without conducting adequate due diligence on the company's fundamentals. Many treat these stocks as short-term speculative bets rather than long-term investments, leading to increased market instability.<sup>7</sup> This phenomenon was evident in 2023 when, according to a report by wealth management platform Kuvera, *“[o]ut of 179 SME IPOs listed that year, a fourth of the them eventually underperformed. The median return after listing to date on the junior exchanges of the NSE and the BSE has been 47 per cent for investors. This is a full 1500 basis*

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<sup>5</sup> Neha Joshi and Dipti Sharma, “SEBI Flags Inflated Valuations and Shady Tactics in SME Market”, *Mint*, Aug. 29, 2024, available at: <https://www.livemint.com/market/stock-market-news/sebi-amfi-sme-ipos-price-manipulations-front-running-axis-quant-mutual-funds-stock-market-sme-platform-11724847433114.html> (last visited on Apr. 14, 2025).

<sup>6</sup> Abhishek Sharma and Satyam Mishra, “India's SME IPOs: A Bubble Ready to Burst”, *Business World*, Oct. 09, 2024, available at: <https://www.businessworld.in/article/indias-sme-ipos-a-bubble-ready-to-burst-535653#:~:text=Recently%2C%20renowned%20investor%20Vijay%20Kedia,soaring%20valuations%20and%20market%20exuberance> (last visited on Apr. 14, 2025).

<sup>7</sup> Dhanya Nagasundaram, “SME IPO Frenzy: What's Driving Retail Investors' Big Bets Despite Potential Market Risks? Experts Decode”, *Mint*, Aug. 28, 2024, available at: <https://www.livemint.com/market/ipo/sme-ipo-frenzy-whats-driving-retail-investors-big-bets-despite-potential-market-risks-experts-decode-1172477793991.html> (last visited on Apr. 14, 2025).

*points more than that on the main board (32 per cent).*”<sup>8</sup> This data suggests that while SME IPOs can be highly rewarding, they also carry significantly higher risks due to speculative trading and inflated valuations.

The rapid surge in demand for SME IPOs, fuelled by speculative interest rather than genuine business potential, creates liquidity risks. Many SME stocks have witnessed an initial price boom due to oversubscription but have struggled to sustain trading activity thereafter. This has resulted in sharp price volatility and, in some cases, a liquidity trap where investors find it difficult to exit their positions without incurring significant loss.<sup>9</sup> This cycle of reduced liquidity and heightened volatility have eroded investor confidence, and reinforced the perception that SME exchanges are prone to speculation rather than long-term value creation.

Moreover, certain promoters have also resorted to deceptive tactics such as inflating the financial performance of the company followed by corporate actions like bonus issues, stock splits, and preferential allotments. These moves allow the promoters to offload their shares at inflated prices, leaving the retail investors at a disadvantage.

Hence, the convergence of convergence of price manipulation, liquidity constraints and, speculative trading, have raised significant concerns about the sustainability of the SME platform. Therefore, unless stronger governance mechanisms and investor protection safeguards are introduced, these challenges could continue to hinder the ability of the platform to facilitate capital formation for emerging enterprises.

Given these persistent challenges in the SME platform, this project provides a comprehensive analysis of the ongoing problems plaguing the SME exchange. It delves into major fraudulent practices that have eroded investor confidence, examining key case studies such as Varanium Cloud Ltd., Add-Shop E-Retail Ltd., and Trafiksol ITS Technologies Ltd. The study further evaluates SEBI’s 2024 amendments, assessing their impact on transparency, governance, and fund utilization while identifying critical gaps that remain unaddressed. By analyzing both regulatory advancements and persisting loopholes, this research aims to provide insights into

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<sup>8</sup> Abhishek Sharma, “Qualification and Funding Concerns: SEBI’s New IPO Rules Spark Fear Among SMEs”, *Business World*, May 23, 2024, available at: <https://www.businessworld.in/article/qualification-and-funding-concerns-sebis-new-ipo-rules-spark-fear-among-smes-520622> (last visited on Apr. 14, 2025).

<sup>9</sup> *Id.*

the future of SME exchanges and the necessary steps to ensure their credibility and sustainability.

## **Fraudulent Practices That Prompted SEBI's Action**

### **I. Varanium Cloud Ltd**

Varanium Cloud Ltd. is an SME-listed entity operating in the digital learning and cloud services sector.<sup>10</sup> The company successfully raised Rs. 40.39 crore in its Initial Public Offering ("IPO") in September 2022, listing on the NSE's SME platform. Promoted by Harshawardhan H. Sabale, the company projected itself as a high-growth technology company with ambitious expansion plans. However, SEBI's investigation uncovered a sophisticated web of financial misstatements, misuse of IPO proceeds, and manipulative practices orchestrated by the company and its promoter.<sup>11</sup>

Post its IPO, the company prompted to take several corporate actions to create an impression of a strong financial health to attract retail investors. It announced a bonus issue, stock split, and rights issue, generating a false sense of expansion. It made misleading corporate announcements claiming entry into new markets and acquisitions worth thousands of crores, none of which materialized. On the other hand, the number of public shareholders surged from approximately 1,000 in September 2022 to over 10,000 by December 2023, driven by heavy retail participation based on these misleading statements.<sup>12</sup>

SEBI's interim order revealed that the company had engaged in multiple fraudulent activities that violated securities laws. The most serious offense was the diversion of IPO proceeds, with nearly 60% of the funds misused.<sup>13</sup> A substantial portion was routed into BM Traders, an entity found to have no legitimate business operations. BM Traders, officially registered as a wholesaler of fruits and vegetables, had negligible declared income and operated from a residential address with no actual business activity.<sup>14</sup> The end use of these diverted funds

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<sup>10</sup> Interim Order in the matter of Varanium Cloud Ltd. WTM/ASB/CFD/CFD-SEC-1/30328/2024-25.

<sup>11</sup> Moneylife Digital Team, "SEBI Prohibits Varanium Cloud MD from Securities Markets as Investigation Persists", *Moneylife*, Oct. 22, 2024, available at: <https://www.moneylife.in/article/sebi-prohibits-varanium-cloud-md-from-securities-markets-as-investigation-persists/75434.html> (last visited on Apr. 14, 2025).

<sup>12</sup> Interim Order (n 10) para 160.

<sup>13</sup> *Id.* para. 42.

<sup>14</sup> *Id.* para. 46.

remains unknown, raising concerns about fund siphoning.

Fabricated financial statements and misleading public announcements were another major violation. SEBI found an 833% increase in shareholders' funds and a 984% rise in revenue from operations within just one year.<sup>15</sup> These figures were later discovered to be fictitious. Transactions recorded in financial statements lacked supporting documentation, and the company's bank statements did not reflect any legitimate cash flow movements. The announcements regarding Edge Data Centers and a Rs. 2,683 crore acquisition of Fastway Transmissions were found to be baseless, as no substantial business activity was ever conducted.<sup>16</sup>

The company also engaged in price manipulation and an orchestrated promoter exit. Promoters offloaded their shares at inflated prices, making significant profits at the expense of retail investors. Their stocks witnessed a sharp decline post-exit, causing major losses to public shareholders. Another critical issue was the failure to provide financial documentation and lapses in auditor oversight. The company failed to submit financial documents related to its US-based subsidiary, including auditor reports and employee details. SEBI flagged the role of statutory auditor AK Kochhar & Associates, referring the matter to the National Financial Reporting Authority ("NFRA") for further scrutiny.

Thereafter, SEBI held Varanium Cloud and its promoter accountable for financial misstatements exercising its powers under Sections 11, 11(4), and 11B(1) read with Section 19 of the SEBI Act, 1992. SEBI banned Varanium Cloud and Mr. Sabale from participating in the securities market. Additionally, Mr. Sabale was also restricted from serving as a director or key managerial personnel in any listed company until further orders.

This case highlighted the impact fraudulent practices can have in distorting the complete IPO market. The company had exploited the regulatory gaps, manipulated its financial statements and eventually misled retail investors to inflate its stock price. Sebi's timely intervention underscore the necessity for stricter supervision in SME listings especially in regard to fund utilization, corporate disclosures and auditor accountability.

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<sup>15</sup> *Id.* para. 49.

<sup>16</sup> *Id.* para. 141.

## II. Add-Shop E-Retail Ltd

Add-Shop E-Retail Ltd. (“ASERL”) is a company engaged in the marketing and distribution of organic and ayurvedic products. It came under regulatory scrutiny for widespread financial fraud. The investigation had exposed a series of fabricated sales, circular transactions, and related-party dealings that misrepresented the company’s revenue and overall profitability.<sup>17</sup>

The investigation had revealed that between the period FY 2020-21 and FY 2022-23, over 46% of ASERL’s reported sales were fictitious.<sup>18</sup> The company had engaged in a pattern of circular transactions primarily with two entities—White Organic Agro Ltd. (WOAL) and Dada Organics Ltd. (DOL). These transactions created an illusion of robust revenue growth thereby, misleading investors and regulators. Further, payments were also recycled through multiple accounts, making it appear as though ASERL was generating genuine sales when, in reality, no actual exchange of goods or services were taking place.<sup>19</sup> SEBI also found that ASERL had failed to maintain any real stock of goods, reinforcing the conclusion that all its reported sales were fraudulent in nature.<sup>20</sup>

The financial misrepresentation had also impacted the company’s stock price. The stocks witnessed a meteoric rise from ₹32.30 in April 2020 to a peak of ₹275.20 in January 2022.<sup>21</sup> This was primarily driven by the artificially inflated revenue figures. On the other hand, investigation revealed while the company was reporting increased revenue, its promoters were engaged in systematically offloading its shares.<sup>22</sup> This indicated that promoters used the inflated figures as a strategy to boost share prices before selling their holdings at artificially high valuations. Once these fictitious revenue figures were cut off, the stock prices plummeted and left retail investors at a loss.

Further, the company had also engaged in unapproved related-party transactions (“RPTs”). For instance, significant volume of business dealings was conducted without proper disclosure or regulatory authority, thereby violating corporate governance norms.<sup>23</sup> Most of these

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<sup>17</sup> Interim Order cum Show Cause Notice in the matter of Add-Shop E-Retail Limited and White Organics Agro Limited WTM/ASB/CFID/CFID-SEC6/30323/2024-25

<sup>18</sup> *Id.* para. 41.

<sup>19</sup> *Id.* para. 23.

<sup>20</sup> *Id.* para. 22.

<sup>21</sup> *Id.* para. 42.

<sup>22</sup> *Id.* para. 57.

<sup>23</sup> *Id.* para. 137.

transactions were executed on the same day and caused funds to be transferred in a circular manner between related entities thereby reinforcing its fraudulent nature. The regulator had also found lapses on the part of the company's auditors. This had been referred to the NFRA for further investigation.

Based on these findings, SEBI barred ASERL, along with its promoter and management, from accessing the capital markets. The directors were also prohibited from holding any managerial position in any listed company. ASERL's conduct went beyond mere regulatory lapses since it had actively deceived investors by artificially inflating sales figures and engaging in dubious RPTs, thereby distorting the market perceptions about themselves.

Hence, the case highlighted the necessity of having rigorous regulatory oversight over company's operations to avoid fabricated sales and unauthorised RPTs. The ease with which ASERL was able to manipulate financial records over multiple years signals the need for further regulatory tightening, particularly in regard to RPTs, SME market listings, and audit governance to prevent future fraudulent schemes.

### **III. Trafiksol ITS Technologies Ltd**

Trafiksol ITS Technologies Ltd. is a Noida-based company specializing in intelligent transportation systems and automation solutions for traffic and toll management projects. It became the first company in India to have its IPO cancelled by SEBI.<sup>24</sup> The case had exposed significant regulatory lapses and fraudulent practices that ultimately led to SEBI directing the company to refund the money paid by investors.

The company's IPO was highly successful, being oversubscribed 345.65 times and raising Rs. 44.87 crore.<sup>25</sup> However, just a day before its scheduled listing, SEBI and BSE received a complaint from the Small Investors' Welfare Association (SIREN) that raised suspicion about the credentials of a third-party vendor (TPV) involved in one of the IPO's key objectives—the purchase of software valued at Rs. 17.70 crore.<sup>26</sup>

The regulator promptly issued an interim order to halt the listing and initiated an investigation.

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<sup>24</sup> Order in the matter of Tranfiksol ITS Technologies Ltd. WTM/AB/CFD/CFD-SEC-1/31023/2024-25

<sup>25</sup> *Id.* para. 4.

<sup>26</sup> *Id.* para. 5.



The investigation revealed serious financial irregularities, primarily centered around three major issues: firstly, the intent to divert funds through misleading IPO objectives, secondly, misstatement of financial statements in the prospectus and thirdly, concealment of material facts from the investors. The TPV engaged by Trafiksol was a shell entity with no substantial financial standing or operational capability. In fact, the vendor's office was found locked during an inspection and most of the financial statements were fabricated and signed just one day before submission to the BSE.<sup>27</sup> The chartered accountant responsible for signing the vendor's financial statements had also admitted that they were prepared in haste and presented to him on the same day they were filed thereby, raising further suspicions about their legitimacy.

Further, SEBI also found discrepancies in the backgrounds of the TPV's directors. Their profiles appeared tailored to fit Trafiksol's needs, and one of them had actively avoided the regulator's summons. There were also suspicious transactions linking Trafiksol's Managing Director, Jitendra Das, to individuals behind the vendor entity. SEBI had obtained call data records confirming their association thereby, strengthening allegations of collusion. Trafiksol had even attempted to mislead the authorities by defending the vendor's credentials. The company had also failed to disclose crucial details about its dealings with this vendor in its IPO prospectus.

Trafiksol defended itself by arguing that it had merely forwarded the vendor's documents to BSE without verifying their authenticity.<sup>28</sup> However, SEBI rejected this stating that the promoters were aware that the vendor's profile was fraudulent. SEBI emphasized that the company had an obligation to conduct proper due diligence before including a vendor's credentials in its IPO documents. Thereafter, invoking its powers under Sections 11(1), 11(4), and 11B of the SEBI Act, 1992, along with Regulation 296 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, SEBI ordered cancellation of Trafiksol's IPO and directed refund to investors who had been allotted shares within one week with BSE overseeing the process.<sup>29</sup> The shares allotted in the IPO were transferred to a separate demat account and subsequently cancelled.

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<sup>27</sup> *Id.* para. 35.

<sup>28</sup> *Id.* para. 43.

<sup>29</sup> *Id.* para. 48.

This order set a strong precedent for future companies looking to raise funds through public issues especially with regard to having robust due diligence in IPO disclosures. While alternative measures, such as setting aside the disputed Rs. 17 crore or appointing a monitoring agency, were considered, SEBI determined that an outright cancellation was necessary to uphold the integrity of the capital markets. Further, Trafiksol has been barred from re-entering the market until SEBI's ongoing proceedings are concluded. This case reinforces the need for stringent compliance with disclosure norms and due diligence requirements, ensuring that investor interests are safeguarded against fraudulent activities.<sup>30</sup>

## SEBI 2024 AMENDMENTS

In response to these malpractices in the SME platform, SEBI introduced the 2024 amendments to the SEBI (ICDR) Regulations, 2018, and SEBI (LODR) Regulations, 2015. These changes were initially proposed in a consultation paper<sup>31</sup> dated November 19, 2024, which introduced stricter eligibility criteria for SME IPOs and more stringent disclosure requirements. Some of these proposals were ultimately approved during SEBI's Board Meeting on December 18, 2024. These reforms aim to curb fraudulent activities, strengthen investor protection, and uphold market integrity. The key amendments and their implications are discussed below: -

### 1. Alignment of Allotment Methodology for Non-institutional Investors ("NIIs")

The shift from a proportionate allotment system to a draw-of-lots method for NIIs marked a significant regulatory change aimed at addressing the market inefficiencies in SME IPOs.<sup>32</sup> Previously, the proportionate system enabled large investors to artificially inflate demand and distort subscription levels and price discovery mechanisms.<sup>33</sup> Hence, the introduction of a draw-of-lots system represented an effort to curb such practices and align the SME IPOs with the allocation methodology followed in the mainboard IPOs.

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<sup>30</sup> Singhania & Co., "SEBI Cancels SME IPO and Orders Refund of Investor Money", *LinkedIn*, Dec. 04, 2024, available at: <https://www.linkedin.com/pulse/sebi-cancels-sme-ipo-orders-refund-investor-money-singhania-12ppc/> (last visited on Apr. 14, 2025).

<sup>31</sup> "SEBI Floats Consultation Paper to Revamp SME IPO Framework", *Inc42*, Nov. 19, 2024, available at: <https://inc42.com/buzz/sebi-floats-consultation-paper-to-revamp-sme-ipo-framework/#:~:text=The%20paper%20suggests%20sweeping%20changes,of%20the%20total%20issue%20size> (last visited on Apr. 14, 2025).

<sup>32</sup> SEBI, "208th Board Meeting Press Release No. 36/2024", available at: [https://www.sebi.gov.in/media-and-notifications/press-releases/dec-2024/sebi-board-meeting\\_90042.html](https://www.sebi.gov.in/media-and-notifications/press-releases/dec-2024/sebi-board-meeting_90042.html) (last visited on Apr. 14, 2025).

<sup>33</sup> "SEBI Overhauls SME IPO Rules: Tighter Scrutiny, Investor Protection Enhanced", *Groww*, Feb. 21, 2025, available at: <https://groww.in/blog/sebi-overhauls-sme-ipo-rules> (last visited on Apr. 14, 2025).

A key aspect of the reform is the introduction of a two-tier structure within the NII category. One-third of the allocation is now reserved for smaller investors applying within the ₹2 lakh to ₹10 lakh range, while the remaining two-thirds are designated for those investing more than ₹10 lakh. This segmentation seeks to level the playing field by ensuring that smaller investors receive a fairer opportunity. By limiting the ability of large investors to manipulate subscription levels, SEBI aims to promote price stability and reduce the speculative frenzy witnessed in SME IPOs.

This amendment further strengthens regulatory consistency across market segments. The draw-of-lots method, which is already used for retail investors in mainboard IPOs, is expected to instil greater confidence in SME offerings by preventing undue concentration of shares in the hands of a few dominant players. However, while this shift curtails excessive leverage<sup>34</sup>, it also reduces the predictability of allotments for well-capitalized investors who may now be less incentivized to participate actively in SME IPOs. Further, this does not necessarily address the core liquidity concerns of the SME Exchange. A disproportionate preference for larger ticket sizes could lead to a concentration of holdings in fewer hands, potentially increasing volatility and discouraging long-term retail engagement. The long-term impact on SME fundraising remains to be seen, as a potential decline in NII participation could affect overall subscription levels. Nonetheless, the reform reflects SEBI's broader objective of fostering a more transparent and equitable IPO process, particularly for smaller investors who have historically been overshadowed in the allocation process.

## **2. Restriction on Offer for Sale**

The new amendment introduces a cap on the Offer for Sale ("OFS") component, ensuring that IPOs primarily serve as a means of fundraising for business growth rather than an early exit strategy for promoters.<sup>35</sup> Under the new rules, the OFS portion cannot exceed 20% of the issue size, and individual selling shareholders are restricted from offloading more than 50% of their pre-issue shareholding. This measure aims to prevent excessive promoter dilution, which can

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<sup>34</sup> SEBI, "Consultation Paper on Review of SME Segment Framework Under SEBI (ICDR) Regulations, 2018, and Applicability of Corporate Governance Provisions Under SEBI (LODR) Regulations, 2015 on SME Companies to Strengthen Pre-Listing and Post-Listing SME Provisions" (2025)

<sup>35</sup> SEBI (n 32) para 2.2

weaken long-term leadership stability and investor confidence.<sup>36</sup>

### 3. Increase in Lock-in Period on Minimum Promoter Contribution

Additionally, the amendments introduce a phased lock-in period for promoter holdings exceeding the mandatory Minimum Promoter Contribution (“MPC”). Previously, promoters could exit immediately after the MPC lock-in period, raising concerns about their long-term commitment to the company. Now, any promoter holdings beyond the MPC must be released in phases: 50% after one year and the remaining 50% after two years.<sup>37</sup> This staggered release structure ensures that promoters retain a vested interest in the company’s performance post-listing, reinforcing market confidence and promoting stability in SME IPOs.<sup>38</sup> This change addresses concerns over promoters cashing out quickly, which has historically led to volatility in SME stocks post-listing. By preventing a sudden large-scale offloading of shares, SEBI aims to enhance investor confidence and stabilize stock prices.

However, a potential downside is that this requirement may discourage some promoters from listing their companies, particularly those who view IPOs as an immediate liquidity event. Moreover, while a phased release promotes stability, it does not entirely eliminate the risk of price manipulation by promoters who might still attempt to offload shares in coordinated batches after each lock-in period expires. Therefore, while the amendment strengthens corporate governance, its effectiveness will depend on how strictly it is monitored and enforced.

### 4. Reduction in General Corporate Purpose Limit

The amendment also tightens regulations on how SME IPO proceeds can be utilized, ensuring that funds raised serve the intended purpose of business growth and operational expansion. One of the significant changes is the reduction in the maximum allocation for General Corporate Purposes (“GCP”) from 25% to 15% of the issue size or ₹10 crore, whichever is lower.<sup>39</sup> Previously, companies had greater flexibility in using IPO proceeds for broad, undefined

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<sup>36</sup> “Summary of Changes Introduced by SEBI W.R.T. SME IPO on 18th Dec, 2024”, *Transique*, Dec. 18, 2024, available at: [https://www.transiqueadvisors.com/SME\\_IPO\\_SEBI\\_Changes.pdf](https://www.transiqueadvisors.com/SME_IPO_SEBI_Changes.pdf) (last visited on Apr. 14, 2025).

<sup>37</sup> *Supra* note 32, para. 2.3.

<sup>38</sup> *Supra* note 34, p.no. 13.

<sup>39</sup> *Supra* note 32, para. 2.5.

corporate expenses, sometimes even earmarking up to 35% of the raised capital for unidentified acquisitions. The revised cap ensures that a larger portion of funds is channelled into specific, pre-identified business activities, reducing the risk of funds being diverted toward discretionary or less productive expenditures.<sup>40</sup>

## 5. Public Access to Draft Red Herring Prospectus

SEBI also increased transparency measures to strengthen investor confidence in SME IPOs. A key reform is the mandatory 21-day public review period for Draft Red Herring Prospectuses (“DRHPs”), ensuring greater scrutiny before an IPO proceeds. Under this requirement, companies filing for an IPO must make their DRHPs publicly accessible and proceed to invite comments from investors, analysts, and other stakeholders.<sup>41</sup> Similar to Main Board IPOs, this would include hosting the DRHP on stock exchange and lead manager websites, along with making public announcements in English, Hindi, and regional newspapers inviting comments. Ultimately, this ensures greater transparency and public participation in the IPO process. Further, SEBI has also mandated inclusion of a QR code, allowing easy digital access to everyone. This amendment marks a significant departure from the previous system, where the draft prospectus did not undergo any such structured public consultation process thereby limiting investor engagement and external evaluation.<sup>42</sup>

## 6. Extending RPT Provisions to SME-Listed Entities

The amendment has also strengthened the regulatory framework governing RPTs in SME-listed entities by aligning their governance norms with those applicable to Main Board-listed companies. Previously, SME IPOs lacked the stringent regulatory oversight imposed on larger listed entities. The new amendments extend Main Board RPT regulations to SME-listed companies, ensuring greater scrutiny and transparency in transactions involving promoters, subsidiaries, and related entities.<sup>43</sup> A key aspect of this reform is the introduction of a threshold for materiality—any RPT amounting to 10% of the company’s annual consolidated turnover or ₹50 crore, whichever is lower, will now be classified as a material transaction.<sup>44</sup> This change

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<sup>40</sup> *Supra* note 34, p.no. 14.

<sup>41</sup> *Supra* note 32, para. 2.7.

<sup>42</sup> *Supra* note 34, p. no. 24.

<sup>43</sup> *Id.* p. no. 28.

<sup>44</sup> *Supra* note 32, para. 2.9.

ensures that significant financial dealings with related parties undergo enhanced disclosure and approval processes, reducing the risk of fund misappropriation or conflicts of interest.

## **7. Restrictions on Using SME Issue Proceeds for Promoter Loan Repayment**

The amendment has also restricted SME IPO proceeds from being used to repay loans taken from promoters, promoter groups, or related parties.<sup>45</sup> Previously, there were no such limitations, allowing companies to allocate IPO funds toward repaying debts owed to insiders. This practice often raised concerns about the potential misuse of public funds, as it enabled promoters to use IPO proceeds for financial restructuring rather than genuine business expansion. By explicitly prohibiting such repayment, SEBI has ensured that funds raised through public offerings are utilized for productive purposes like scaling operations, investing in innovation, or fulfilling growth-oriented objectives.<sup>46</sup> Hence, this amendment strengthens investor confidence, preventing the diversion of IPO proceeds for the benefit of promoters rather than the company itself.

## **8. Compliance for Further Issues without Migration**

Additionally, SEBI has also introduced a provision allowing SMEs to raise additional capital beyond ₹25 crore without mandatorily migrating to the Main Board, provided they comply with SEBI (LODR) Regulations, 2015, applicable to Main Board-listed entities.<sup>47</sup> Earlier, SMEs exceeding this threshold were required to transition to the Main Board, thereby limiting their ability to raise funds while remaining on the SME platform. Now, enterprises that do not meet the eligibility criteria for migration can still enhance their capital base, subject to adherence to stricter regulatory requirements, including corporate governance norms and quarterly financial disclosures.<sup>48</sup> This change offers greater flexibility for SMEs to scale their operations while ensuring transparency and accountability in fund utilization.<sup>49</sup>

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<sup>45</sup> *Supra* note 32, para. 2.6.

<sup>46</sup> *Supra* note 34, p. no. 21.

<sup>47</sup> *Supra* note 32, para. 2.8.

<sup>48</sup> Dhananjay Walke, 'Adapting to Change: SEBI's New SME Framework and Its Impact on IPO Platforms' (*LinkedIn*, 19 December 2024) <<https://www.linkedin.com/pulse/adapting-change-sebis-new-sme-framework-its-impact-ipo-walke-vippf/>> accessed 2 March 2025.

<sup>49</sup> *Supra* note 34, p. no. 20.

## 9. Minimum Operating Profit

Further, this amendment introduces a minimum operating profit (EBITDA) requirement of INR 1 crore for at least two out of the three preceding financial years before filing the DRHP.<sup>50</sup> Previously, there was no such financial performance criterion, allowing even loss-making or financially unstable companies to raise funds through SME IPOs. By implementing this threshold, SEBI aims to ensure that only businesses with a proven track record of profitability can access public capital, thereby reducing the risk of speculative and non-viable companies listing on SME exchanges.<sup>51</sup>

The amendments also address disclosure and compliance obligations, bringing them more in line with mainboard IPO listings. SMEs will now be required to provide more comprehensive disclosures to investors, thereby improving transparency and reducing information asymmetry. These enhanced disclosures will include detailed financial records, mandatory compliance with governance structures, and disclosure of other risk factors, thereby ensuring that investors have access to the necessary information before making any investment decisions.

SEBI's decision to tighten and refine SME IPO norms is driven by the need to strike a balance between ease of listing for SMEs and robust investor protection mechanism. Therefore, by enforcing stricter eligibility criteria, increasing public shareholding requirements, strengthening underwriting norms, and improving disclosure standards, the regulatory body aims to enhance the credibility of SME listings and foster a more mature and transparent SME capital market in India. These amendments reflect the regulator's ongoing commitment to strengthen the regulatory ecosystem and ensuring that SME IPOs remain a viable yet well-regulated avenue for capital raising.

## GAPS IN SEBI'S REFORM

While SEBI's recent amendments has introduced significant reforms to enhance SME IPO regulations, several key proposals from the consultation paper were ultimately left out. This has raised concerns over unresolved vulnerabilities still plaguing the SME framework. These have been discussed below:

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<sup>50</sup> *Supra* note 32, para. 2.1.

<sup>51</sup> *Supra* note 34, p. no. 18.

**No increase in Application size/ Minimum no. of Allottees etc.**

A key proposal that SEBI has chosen not to implement was the increase in the minimum application size for SME IPOs from ₹1 lakh to ₹2 lakh, with considerations to further raise it to ₹4 lakh. The consultation paper justified this change by citing the fourfold growth in market indices over the past 14 years, arguing that a higher threshold would align investment requirements with overall market expansion and attract investors with greater risk-taking capacity.<sup>52</sup> However, SEBI's decision to not implement this increase suggests an effort to maintain retail investor participation in SME IPOs. Raising the threshold would not have necessarily increased institutional participation but could have concentrated holdings among wealthier investors, reducing liquidity. By retaining ₹1 lakh, SEBI ensures accessibility but leaves smaller investors exposed to SME risks. This decision, while inclusive, does not fully address the need to balance accessibility with investor protection.

Similarly, SEBI also declined to increase the minimum number of allottees in SME public issues from 50 to 200, despite its potential to enhance market liquidity. The consultation paper had argued that a higher allottee threshold would ensure a broader investor base and reduce concentrated ownership risks.<sup>53</sup> However, SEBI's decision to maintain the 50-allottee requirement signals an intent to avoid creating additional listing hurdles for SMEs that may struggle to attract a large enough investor pool. While this ensures that smaller, lesser-known companies can still access public markets, it also means that some SME listings may continue to suffer from poor liquidity, making them vulnerable to price manipulation by a small group of investors.

**10. Absence of Monitoring Agency**

One notable exclusion is the absence of a mandatory monitoring agency for IPO proceeds below ₹100 crore. Given that SMEs, due to their scale, are more vulnerable to fund misallocation, an independent monitoring mechanism could have added an additional layer of accountability. In fact, the SEBI's consultation paper had also recommended lowering the threshold for appointing a monitoring agency from ₹100 crore to ₹20 crore, which would have strengthened regulatory oversight.<sup>54</sup> However, SEBI ultimately did not move forward with it,

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<sup>52</sup> *Id.* p. no. 7.

<sup>53</sup> *Id.* p. no. 10.

<sup>54</sup> *Id.* p. no. 11-12



possibly to avoid imposing excessive compliance costs on smaller issuers. While this decision preserved the flexibility for SMEs, it left investors exposed to risks of fund diversion, particularly in cases where internal governance mechanisms are weak. Similarly, the lack of enhanced disclosure requirements in DRHPs meant that transparency concerns still persists, thereby limiting investors' ability to make fully informed decisions.<sup>55</sup>

## **11. No provision for Post-listing Exit mechanism**

The amendment also did not introduce any post-listing exit mechanism for dissenting shareholders in SME IPOs. Even SEBI's consultation paper had proposed aligning SME IPOs with Main Board standards by allowing dissenting shareholders to exit in cases where a company changes the use of IPO funds or other key terms post-listing.<sup>56</sup> This would have enhanced investor protection and ensured that shareholders are not locked into unfavourable post-listing changes. However, SEBI did not implement this provision, likely to prevent additional complexities in SME IPOs. While this may have streamlined the listing process, it could discourage institutional participation, which is crucial for the long-term stability of SME stocks.

## **12. Disclosure Requirements**

Another critical area where SEBI has opted for a cautious approach is in regard to the disclosure requirements for SME IPOs in the DRHPs. While the regulator has introduced a mandatory period for receiving public comments, it has not mandated any additional disclosure beyond the existing framework. Even the consultation paper recommended enhanced disclosures on senior-level employees, ESIC/EPF details, and merchant banker site visit reports to improve transparency.<sup>57</sup> However, these suggestions were not implemented, meaning that investors may still lack sufficient data to evaluate the credibility of SMEs before investing. Similarly, the absence of a requirement for working capital certifications leaves a gap in ensuring that IPO proceeds are effectively utilized.

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<sup>55</sup> *Id.* p. no. 25.

<sup>56</sup> *Id.* p. no. 26.

<sup>57</sup> *Id.* p. no. 22.

### 13. Lack of Minimum Face Value per Share

The amendment also did not introduce a minimum face value per share requirement, which could have mitigated extreme price fluctuations in SME stocks. The consultation paper by SEBI had suggested establishing a standard face value per share that could help moderate volatility in the platform and prevent speculative trading.<sup>58</sup> However, SEBI decided against this, possibly to retain market flexibility. While this approach allows SMEs to structure their IPOs more freely, it may also expose investors to excessive price volatility.

### 14. Fund Utilization

One of the most significant omissions is the decision not to extend stricter oversight on fund utilization beyond the prohibition on using IPO proceeds to repay promoter loans.<sup>59</sup> While this restriction prevents direct misuse of funds, SEBI did not impose any additional oversight on fund deployment for working capital or capital expenditures, thus leaving ambiguity in how funds may be utilized ultimately. Without clear guidelines, there remains a risk of funds being redirected in ways that do not align with investor expectations.

Overall, while the reforms address several critical issues, the decision to leave these key areas unchanged reflects a cautious approach on the part of the regulator. While this may encourage more SMEs to enter the public markets without excessive compliance burdens, it also means that certain risks—such as weak disclosure norms, lack of exit options, and limited fund monitoring—remain unresolved. Going forward, SEBI may need to revisit these areas as the SME listing framework evolves.

## CONCLUSION

The recent amendments to the SME framework represent a significant step towards improving transparency, enhancing fund utilization, and imposing tighter restrictions on promoters. SEBI has been successful in reinforcing investor confidence in the SME Exchanges through implementing targeted measures that curb speculative trading and ensuring SMEs seeking to receive public funding meet higher governance standards.

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<sup>58</sup> *Id.* p. no. 18.

<sup>59</sup> *Supra* note 36.

However, despite these improvements, there are critical gaps that have been left unaddressed. SEBI has not yet fully closed all the loopholes that allow stock price manipulation, and concerns over post-listing volatility and liquidity constraints still remain. Although certain regulatory changes have increased oversight and accountability on part of SMEs, critics argue that these may inadvertently increase the compliance burdens for smaller businesses, potentially discouraging genuine companies from seeking public listings.

Looking ahead, SEBI must adopt a dynamic regulatory approach that regularly monitors the emerging risks within the SME segment. SEBI must prioritise strengthening the audit procedure and due diligence mechanism, focus on improving the post-listing compliance requirements and increase institutional participation in SME IPOs. Further, ensuring greater transparency in financial disclosures and imposing stringent accountability measures on merchant bankers and auditors would bolster market integrity. However, the long-term success of SME Exchanges hinges on maintaining a delicate balance between accessibility for small businesses and robust investor protection measures. This balance can be achieved only if SEBI remains proactive in adapting its regulations to address the evolving market concerns while ensuring that SME Exchanges remains a reliable platform for raising capital for small and medium enterprises.