

Discussion paper on 'Proposed modifications to the existing framework for buy back through open market purchase'

Background

- (I) Section 77A of the Companies Act, 1956 contains the basic framework for companies to buy back its own securities. Section 77A (5) provides the methods of buy back .Excerpts from the same are reproduced below:

“The buy-back under sub-section (1) may be -

(a) from the existing security holders on a proportionate basis ; or

(b) from the open market ; or

(c) from odd lots, that is to say, where the lot of securities of a public company, whose shares are listed on a recognised stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange ; or

(d) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.”

- (II) Further, Section 77A (2) (f) gives power to SEBI to frame regulations in this regard. Accordingly, the existing framework for buy back through open market purchase is being reviewed.

Buy back is usually resorted to due to following reasons:

- **Return surplus cash to the shareholders**
- **Support share price during periods of temporary weakness**
- **Increase the underlying share value**

Reasons for review

It has been observed that buy back through open market has failed to achieve its objectives in spirit, due to the following reasons:

- a) Section 77A(4) of the Companies Act, 1956 specifies that every buy back shall be completed within a period of 12 months. Companies, instead of fixing a definitive period for buyback, usually keep the buyback offer open for the entire period of 12 months. However, even after keeping the buyback offer open for

such a long time, there have been instances where companies did not buy a single share or failed to achieve the minimum buyback quantity. It has been observed that the companies place buy orders at their discretion instead of placing them on regular basis and that too at a price away from the market price.

- b) There are no explicit provisions in the Companies Act, 1956 or in the SEBI (Buy back of Securities) Regulations, 1998 regarding the price or quantity for which the company shall place orders for buying back its shares or the periodicity of placement of such orders. Therefore, on which days, for how long and in what quantity the company will buy back its shares is entirely at the discretion of the company's management. This lack of clarity is further burdened with the fact that disclosure is not made to the public shareholders as to how the discretion will be exercised and what are consideration/basis guiding the management in this regard.
- c) It has also been observed that many companies took shareholders/board approval for buyback proposals and in some cases even published public notice but did not take a single step to buy the shares.
- d) The company discloses the maximum price only and eventually purchases the shares near market price which could be significantly lower than the announced price. This may convey a misleading message to the shareholders and to the market. Moreover, buy back from open market has not proved to be beneficial to the shareholders as against the tender offer method in which the company buys back shares at a premium to the market price.
- e) It has been observed that in 75 buyback cases through open market purchases, which closed during the last three financial years (from April 01, 2007 to March 31, 2010), an average of 49.91% of the maximum offer size (as disclosed in public announcement to shareholders) was utilized by the companies for the buy back. This suggests that despite the intention disclosed by companies to their shareholders at the time of making buyback offer, the buyback offer is not used as an opportunity for enhancing the book value of the shares of the company.
- f) In view of the above, the following 'Modifications to the existing framework for buy back through open market purchase are proposed:

Proposed Broad Framework for buy back through open market purchase

1. Minimum buy back quantity:

- 1.1 Pursuant to the order of the Securities Appellate Tribunal dated 26.09.2008 in the matter of Sasken Communications Limited and after observing instances of companies not buying a single share or buying negligible quantity after buy-back announcement, the Merchant Bankers are being advised to ensure that a minimum of 25% of maximum buy-back proposed/disclosed n bought back.
- 1.2 The aforesaid measure has resulted in significant increase in the percentage of buy-back quantity as may be seen from the following table :

Year wise data on Buy-back offers made through Open Market

Purchase method:

<i>Year (Financial)</i>	<i>No. of buy-back offers in open market purchase</i>	<i>Maximum number of shares proposed to be bought back</i>	<i>Actual number of shares bought back</i>	<i>% of actual number of shares bought back</i>	<i>GAP</i>
2007-08	05	565,274,864	35,315,529	6.25%	93.75%
2008-09	46	207,831,628	100,916,878	48.56%	51.44%
2009-10	19	127,777,318	50,262,919	39.34%	60.66%
20010-11	12	117,506,824	71,183,267	60.58%	39.42%

Note: In two cases of buy-back offers in 2009-10, companies failed to purchase even single share as market price was higher than maximum price of offer and hence, excluded from the data.

- 1.3 From the above table, it can be inferred that companies on an average have bought back 49.96% of the maximum quantity proposed for buy-back in the financial years 2009 -10 and 2010-11 after the aforesaid prescription. Taking the above into consideration, **it is proposed to mandate 50% as the minimum quantity.**

2. Maximum period to complete the buy back:

- 2.1. Section 77A(4) of the Companies Act, 1956 prescribes that every buy back shall be completed within twelve months from the date of passing the special resolution or a resolution passed by the Board under clause (b) of sub section (2). It has been observed from the data pertaining to buy back for FY 2009-10 and 2010-11 that the companies on an average, have bought back around 62% of the proposed buyback size. Of the above, around 49% have been bought back in the first 3 months itself.
- 2.2. In view of the above, it can be inferred that the companies may not need such a long period to complete the buyback offer although Companies Act,1956 provides for 12 months. Moreover, it is evident that the companies which were serious about the buyback program have been able to buy back a significant portion of the proposed buyback within first 3 months.
- 2.3. ***Thus, it is proposed that companies complete the buy back in 3 months. To ensure that only serious companies launch the buyback program, it is further proposed that these companies be mandated to put 25% of the maximum amount proposed for buy back in an escrow account.***

3. Post buy back obligations

- 3.1. Section 77A(8) states that where a company completes a buy back of its shares or other specified securities , it shall not make further issue of the same kind of shares (including allotment of further shares under Section 81(1)(a)) within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants , stock option schemes , sweat equity or conversion of preference shares or debentures into equity shares.
- 3.2. It is understood that the companies usually launch buyback programs when they have idle cash resources and there are no attractive investment opportunities in the foreseeable future. Section 77A (8) of Companies Act, 1956 prohibited raising additional capital for a period of 24 months which was subsequently reduced to 6 months vide

amendment dated October 23,2001.and the same was only amended in 2001.

3.3. *It is therefore, proposed that listed companies coming out with buyback programs may not be allowed to raise further capital for a period of two years.*

4. Disincentive for not completing the buyback program successfully

4.1. Section 77A(2) of the Companies Act,1956 prohibits only back to back buy backs through board resolution i.e. a company can come for subsequent buy backs through shareholder' resolution.

4.2. *In order to ensure that the companies do not launch buyback programs for stabilizing the share price, it is proposed that companies who are not able to buy back 100% of the proposed amount (or the proposed maximum number of shares) may not be allowed to come with another buyback for a period of at least one year irrespective of the mode of approval for buy back.*

5. Rationalisation of ongoing disclosure requirements:

5.1. The extant regulations prescribe the following disclosure requirements for open market purchase method:

- i. Shares bought back, to the stock exchanges on daily basis by merchant banker as well as the company
- ii. Shares bought back on fortnightly basis and every time an additional 5% of maximum shares on offer were bought back through publication in national daily.
- iii. Disclosure of post buy-back details on completion of buy back through publication in national daily.

5.2. It is noted that other jurisdictions require detailed disclosures regarding the number of shares yet to be bought back, the amount yet to be utilized and the average price paid per share, etc., during the buy-back process. The aforesaid disclosures also form part of the quarterly filings, annual filings, and director's report and along with the disclosure of any material event during the buy-back program by the companies. It appears that

such disclosure requirements have also contributed to the high percentage of buy-back quantity with respect to the proposed quantity in other jurisdictions.

5.3. In view of the same, the following is proposed:

- i. The company shall disclose the number of shares purchased and the amount utilized to the exchanges on daily basis.**
- ii. The company shall disclose the following details regarding the buy-back offer to the exchanges on monthly basis and also include the same while publishing quarterly and annual results –**
 - a. Total number of shares proposed to be bought back in the offer.**
 - b. Cumulative number of shares bought back till the end of previous reporting period and amount utilised for the same.**
 - c. Number of shares bought back during the current reporting period and amount utilised for the same.**
 - d. Cumulative number of shares bought back till the end of the current reporting period and amount utilised for the same (b+c).**
 - e. Number of shares yet to be bought back and amount yet to be utilised.**
 - f. Cumulative number of shares extinguished and destroyed till the end of previous reporting period.**
 - g. Number of shares extinguished and destroyed during the current reporting period**
 - h. Cumulative number of shares extinguished and destroyed till the end of the current reporting period (f+g).**
- iii. It is felt that the current requirement of publishing the disclosures in the news papers on fortnightly basis and every time an additional 5% of maximum shares on offer were bought back only adds to the cost of buy-back program. In view of the above and in view of the same being included as part of quarterly financial results which are published, it is proposed to do away with the requirement of fortnightly publication.**
- iv. In addition, the companies have to disclose on a monthly basis why the proportionate quantity was not bought during the month, wherever applicable.**

6. Limit for open market method:

- 6.1. In open market purchase method of buy-back, which spans over a maximum period of 12 months, the shares are bought back at the prevailing market price, which changes with the market conditions. However in tender offer method, all shares are bought back at a fixed price which is generally at a premium to the market price. Thus, the tender offer method of buy-back is more equitable way of distributing surplus funds with the companies to its shareholders.
- 6.2. It is thus, desirable to encourage buy-back using tender method when larger amount of the company's surplus funds is proposed to be distributed to its shareholders.
- 6.3. In view of the above, it is proposed that ***buy-back of 15% or more of (paid up capital + free reserves) must be only by way of a tender offer method.***

7. Procedure for buy-back of physical shares (odd lot) in Open Market Purchase Method:

- 7.1. The extant provisions provide that provisions pertaining to buyback through tender offer shall be applicable mutatis mutandis to odd lot shares. The physical shares are traded in a separate (Odd Lot) segment on the exchange. The Buy-back program requires companies to buy-back demat as well as physical shares and accordingly the companies place orders in normal as well as odd lot segment. However, data revealed that there is hardly any response in odd lot segment. Physical shares in the system increase regulatory as well as servicing cost for the company. SEBI's efforts have also been in the direction to reduce physical shares in the system. It is therefore necessary to encourage and facilitate participation of shareholders holding physical shares in buy-back program, more so when open market buy-back is more popular among companies.
- 7.2. In tender offer method, physical share certificates are accepted directly and after necessary verifications, the payment is made and the share certificates are extinguished. Whereas in open market purchase method of buy-back, there are many barriers for holders of physical shares to participate in buy-back program which are given below:

- a. Open market process is akin to trading in the secondary market.

Shareholders have to approach a broker for placing his order on the exchange for participating in the buy-back program. In case holder of physical shares does not have a trading account, which would be most likely as such holders are not active investors, the person has to open a trading account first by complying with KYC norms before order can be placed. Moreover, the window for such purchases may be restricted to few centres,

- b. Due to the fear of bad delivery of physical shares, the brokers too may be reluctant to put through such transactions.

7.3. In order to mitigate the aforementioned problems in open market process, **following changes are proposed –**

- i. **Creation of separate window in trading system for buying physical shares. This window will remain open only during the buy-back program.**
- ii. **Shareholders holding 500 shares or less in physical form will be eligible to tender their shares in this window (It may be noted that the trading in Odd Lot Segment on the exchange is also limited to 500 shares).**
- iii. **Such shareholders may be permitted to tender shares to a broker designated for the purpose by the company, without the need to open a trading account or strict compliance with KYC norms. However, the requirement of PAN/Aadhar may be made mandatory for such shareholders holding shares in the physical form.**
- iv. **The shareholder can tender the shares to the designated broker directly or to the company, who can then put the transaction through the designated broker.**
- v. **Buy-back price for such shareholders may be volume weighted average price (VWAP) of the shares bought (in the normal segment) during the calendar week in which such shares were received by the broker. In case no shares were bought back in the normal market during the aforesaid week, the last week when the company has bought may be considered.**

vi. The Public Announcement shall contain information mentioned above.

8. Removal of restriction on issuance of shares pursuant to Employee Stock Option (ESOP) schemes during the buy-back offer:

8.1 Companies Act, 1956 provides that a company shall not make issuance of shares for a period of six months after completion of buy-back except by way of bonus or in discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares during this period.

8.2 The Companies Act, 1956 is, however, silent about issuance of shares during buyback period. The regulations provide that the companies shall not issue any shares including by way of bonus till the date of closure of the buy-back offer. There have been requests that SEBI may consider relaxing the same at least in respect of Employees Stock Option (ESOP) schemes so that the employees can also participate.

8.3 In view of the above, **it is proposed that the issuance of shares pursuant to obligations arising out of Employee Stock Option schemes may be allowed during the buy-back period subject to the following-**

- a) the shares are not allotted to directors and key managerial personnel of the company.**
- b) there is no acceleration in the vesting period.**

9. Extinguishment of shares in buyback process:

9.1. Companies Act, 1956 provides that the shares bought back shall be extinguished within seven days from the last date of completion of buy-back. The Regulations provides that extinguishment shall be done within fifteen days from the date of acceptance subject to companies ensuring that all shares bought back are extinguished within seven days from the last date of completion as provided in the Companies Act, 1956. The regulations further provide that the companies shall furnish a certificate complying the aforesaid provision and details of the certificates extinguished to SEBI on a monthly basis.

9.2. In open market purchase method which spans over a period of up to 12 months companies generally extinguish within seven to fifteen days of payout during the buy-back period. It is noted that in open market purchase the fifteen days time period for extinguishment and frequent reporting requirements may be one of the reasons for the companies not purchasing frequently from the market.

9.3. In view of the above, **the following is proposed regarding extinguishment of shares in open market purchase method of buy-back-**

- i. **The companies shall extinguish/destroy shares bought back during the month, on or before fifteenth day of the succeeding month subject to the companies destroying the bought back shares in the last month within seven days of the completion of the offer.**
- ii. **As detailed disclosure regarding extinguishment and destruction of shares have been proposed above, the existing requirement of furnishing a separate certificate by the company to SEBI in this regard may be done away with.**

10. Dealing in shares or other specified securities in the stock exchange during the period of buy back.

10.1. Section 19(1)(e) of SEBI(Buy back of Securities) regulations, 1998 reads as under:

“The company shall ensure that the promoter or the person shall not deal in the shares or other specified securities of the company in the stock exchange during the period the buy-back offer is open.”

10.2. This regulation prohibits the promoters of the company in dealing in the securities of the company during the period when buy back is open. This restriction has been imposed as the promoters, being part of the management of the company, are generally in a position to influence the time and price in placing the orders during the buyback period.

10.3. It is proposed to extend this restriction to dealing in the securities of the company in off –market as well.

Public Comments

Comments on the above framework may be emailed on or before January 31,2013 to chitrab@sebi.gov.in/anindyakd@sebi.gov.in or sent by post to:-

*Anindya Kumar Das
Deputy General Manager
Corporation Finance Department - Division of Corporate Restructuring
Securities & Exchange Board of India
SEBI Bhavan
Plot No. C4-A, "G" Block
Bandra Kurla Complex
Bandra (East)
Mumbai - 400 051
Ph: +912226449616*
