Review of provisions related to Preferential Issues under Chapter V of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

1. Objective

1.1. This memorandum seeks approval of the Board to amend SEBI (Issue of Capital and Disclosure Requirement) Regulations, 2018 ("ICDR Regulations") on provisions relating to preferential issues.

1.2. Consequent to the above, amendments would be required in Regulations 158, 159, 160, 162, 163, 164, 164A, and 167of the ICDR Regulations.

2. Background

2.1. Preferential Issue is one of the means available to a listed company to raise capital. SEBI introduced guidelines for preferential issue on August 04, 1994, mandating the manner of pricing of securities (shares, warrants, convertibles), lock-in, validity of shareholders resolution, auditors report etc. These guidelines more or less remained unchanged, except for slight changes made through SEBI DIP Guidelines and SEBI (ICDR) Regulations, 2009 regarding pricing, exemptions for resolution plans etc. These guidelines are now incorporated under Chapter V of the ICDR Regulations.

2.2. SEBI has been receiving several suggestions and representations from market participants and there have been certain market events which now call for a review of various issues pertaining to the provisions of preferential issue like the pricing, lock-in requirements, pledge etc

2.3. The matter was deliberated at the meeting of the Primary Market Advisory Committee (PMAC). PMAC felt that any change in preferential issue guidelines may have wide ranging implications, hence a detailed deliberation is required on the matter and for this purpose, PMAC constituted a sub-group. The sub-group deliberated internally and also had consultations with issuer companies while formulating its proposals for consideration of PMAC.

2.4. PMAC deliberated on the proposals of sub-group and desired that a public consultation may be carried out on core aspects of the recommendations before SEBI takes a view in the matter.

2.5. Accordingly, a discussion paper was placed on the website of SEBI on November 26, 2021 seeking public comments on the proposal of PMAC. The discussion paper is placed at **Annexure-I** for reference.

2.6. Comments have been received from 8 entities including individuals, merchant bankers, law firms, academicians etc. on the PMAC recommendations. Some persons have made additional suggestions as well. The comments relevant to the consultation paper have been analyzed and tabulated at Annexure-II.

2.7. The following paragraphs delve into the existing provisions, issue/concern, recommendations of PMAC, public comments, analysis of public comments (if sought) and finally the proposals for consideration of the board.

3. <u>Applicability of Preferential Issue Provisions</u>

3.1. Existing Provisions

a) Regulation 158 of the ICDR Regulations provides scenarios where the provisions of Chapter V, i.e. Preferential Issue guidelines are not applicable. Regulation 158(1)(a) states that preferential issue guidelines of ICDR Regulations are not applicable in case a preferential issue of equity is being done pursuant to conversion of a loan or an option attached to convertible debt instrument in terms of sub-sections (3) and (4) of sections 81 of the Companies Act, 1956 or sub-section (3) and (4) of section 62 of the Companies Act, 2013, whichever is applicable

b) Section 62(3) of the Companies Act, 2013 deals with increase in the subscribed share capital of a company caused by the exercise of an option attached to the debentures issued or to the loan raised by the company to convert such debentures or loans into shares in the company. Section 62(4) of the Companies Act, 2013 deals with conversion of loan to a company by government into shares

3.2. Issue/concerns

a) Based on the past experiences, some interpretation issues have been noticed w.r.t. preferential issuance referred to under Regulation 158(1) (a) by way of conversion of loan. It is not clear as to whether, such preferential issuance can be done only against the principal amount of loan outstanding as on the relevant date or against the principal amount as well as interest amount accrued thereon, as on the relevant date.

b) Further, as per the existing provisions, pricing and lock-in guidelines are not applicable on preferential issue of equity shares made pursuant to such conversions in terms of section 62(3) of Companies Act, 2013.

3.3. PMAC Recommendation

i. PMAC recommended that preferential allotments need to comply with provisions of Preferential Issue prescribed in Chapter V including guidelines on pricing, and lock-in etc., even in cases where allotment is made pursuant to exercise of an option attached to the debentures issued or to the loan raised by the company, to convert such debentures or loans into shares in the company in terms of sub-section (3) of section 62 of the Companies Act, 2013.

ii. PMAC has recommended that reference to sub-section (3) of section 62 of the Companies Act, 2013 in Regulation 158(1)(a) of the ICDR Regulations granting such exemptions may be deleted so that such issuances shall now have to comply with the provisions of Chapter V.

3.4. Public Comments and Analysis

a) Public Comments

i. Only 1 person has offered comments in the matter who while agreeing with the proposal has sought clarity on whether both principal and accrued interest shall be eligible towards preferential issue.

b) Analysis

i. With the recommendation to make the provisions of preferential issue pertaining to pricing and lock-in etc. also applicable to preferential allotment arising out of conversion of loan in terms of Section 62(3) of the Companies Act, 2013 the same can be considered on the entire portion of loan i.e. principal and interest.

3.5. **Proposal for consideration of Board**

i. Considering the aforesaid PMAC recommendation and the public comments received thereon, it is proposed to make the provisions ICDR Regulations applicable to preferential issue of equity shares made pursuant to conversion of a loan (including interest) or an option attached to convertible debt instrument (including interest) in terms of section 62(3) of Companies Act, 2013.

4. <u>Pricing methodology for preferential issues</u>

4.1. **Existing Provisions**

a) Regulation 164 of the ICDR Regulations provides norms for determination of floor price in case of preferential issue of specified securities by an issuer having frequently traded shares as follows:

i. In case of an issuer company which has been listed for more than 26 weeks, the floor price for preferential issue shall be higher of average of weekly high and low Volume Weighted Average price (VWAP) of 26 weeks or VWAP of 2 (two) weeks preceding the relevant date.

ii. In case of an issuer which has been listed for less than 26 weeks, the floor price for preferential issue shall be higher of

a. price at which equity shares were offered in the initial public offer or the value per share arrived at in a scheme of arrangement under Companies Act

b. average of weekly high and low of the VWAP during the period equity shares have been listed preceding the relevant date

c. average of weekly high and low of the VWAP during the period two weeks preceding the relevant date

The floor price so determined is required to be recomputed upon completion of 26 weeks of listing and any difference between such recomputed price and the price paid at allotment, shall be paid by the allottees to the issuer company.

iii. In case of preferential issue of specified securities to qualified institutional buyers not exceeding five in number, the floor price shall be average of weekly high and low of VWAP of two weeks preceding the relevant date.

b) In case of preferential issue of equity shares by an issuer company having stressed assets, the floor price shall be average of weekly high and low of VWAP of two weeks preceding the relevant date.

4.2. **Issue/concerns**

a) Until 2001, weekly settlement cycle was followed in the equity markets for trading and settlement of shares. Given the rising trend of making preferential allotment of shares etc. at a price dis-connected from the prevailing market price, the preferential issue guidelines were introduced in August 1994, wherein, it was mandated that the preferential issue price will be higher of average weekly high and low of closing price for a period of 6 months' period preceding the relevant date or average weekly high and low of closing price for a period of 2 weeks period preceding the relevant date. The said norms were subsequently replaced with higher of average of weekly high low of the volume weighted average price (VWAP) for 26 weeks or VWAP for 2 weeks preceding the relevant date in ICDR Regulations 2009. Similar provisions have been retained in the present ICDR Regulations, 2018 as well.

b) Representations were received stating that the norm of 26 weeks' period is a longer period for determining the floor price of the issue considering the dynamic nature of the market. Further, given that there is a substantial difference in the price determined on the basis of 26 weeks' average vis-à-vis 2 weeks' average, there may not be willing investors to help augmenting the capital raise proposed by an issuer company especially in times of need/ crises.

c) There has been a transition to the rolling settlement cycle since 2001 , beginning with T+5 rolling settlement, then T+3 and to the current T+2 basis. SEBI has introduced a transition from T+2 settlement cycle to T+1 settlement cycle on an optional basis vide circular dated September 07, 2021. Subsequently, Market Infrastructure Institutions in a joint press release dated November 08, 2021 have finalized the roadmap for implementation of T+1 settlement cycle in a phased manner with bottom 100 stocks based on market capitalization being available for introduction of T+1 settlement cycle from February 25, 2022. Given these developments in settlement cycle and the changing dynamics of the market, the existing provisions of pricing with such a long look back period may not be efficient and thus there is a need for review.

d) To determine a suitable look back period, a sample analysis of the price movement of various scrips post preferential issues was carried out. In a majority of the cases, the post preferential issue price of the scrips converged closer to 60 trading days' VWAP than to 26 weeks' VWAP. The 60 trading days VWAP is also used as one of the price points for determination of open offer price, in terms of SEBI (SAST) Regulations.

e) Due to certain recent events involving preferential issue, some concerns were received from the market w.r.t. valuation of scrip where the preferential allotment resulted into change in control. Further, allotment to a single allottee or to some allottees acting in concert of more than 5 % of post issue fully diluted share capital of the issuer company also raised similar concerns. These concerns arise from the fact that the “control premium” which needs to be factored into such type of preferential issue resulting in change of control cannot be captured in the look back period, and the same would be visible in market prices only after the event i.e change in control due to allotment, has already occurred

4.3. **PMAC Recommendation**

Look Back period

a) Replace average of weekly high and low VWAP of 26 weeks with VWAP of 60 trading days and replace average of weekly high and low VWAP of 2 weeks with VWAP of 10 trading days.

Valuation report for issuances leading to change in control, etc

b) Any preferential issue allotment resulting in change in control or allotment of more than 5% of post issue fully diluted share capital of the issuer company to an allottee or to allottees acting in concert, shall require valuation report from a registered valuer and the board of the company shall consider the said valuation for pricing.

c) the valuation report / certificate from registered valuer should also cover guidance on control premium.

d) Valuation report shall be hosted on the company’s website and a reference to the same shall be made in the notice for calling a general meeting of the shareholders

Stricter provisions of AoA

e) Further, stricter provisions in respect of pricing of preferential issue, if any already provided under the Article of Association of the Issuer company shall also be considered for pricing in addition to pricing guidelines under ICDR Regulations for the purpose of making any preferential issue.

4.4. Additional suggestion by SEBI- Reasoned recommendation by the CoID

a) Any preferential issue allotment resulting in change in control may be considered pursuant to a reasoned recommendation from a committee of independent directors. The reasoned recommendation shall consider all aspects of preferential allotment including pricing. The voting pattern of the Committee of Independent Directors (CoID) shall also be disclosed. Similar provision is available in SAST regulations for open offer, and in delisting regulations

4.5. **Public Comments and Analysis**

a) Public Comments:

Look back period:

i. Four persons have provided diverse comments on the matter of replacing average of weekly high and low VWAP of 26 weeks with VWAP of 60 trading days and average of weekly high and low VWAP of 2 weeks with VWAP of 10 trading days. Two comments are in agreement with the recommendation of PMAC. One comment suggests that any other pricing should also be permitted subject to shareholders approval. Two commentators have disagreed with recommendation stating concerns arising out of recent volatility in Indian Markets. One comment has suggested that promoters should prefer Rights Issue over preferential allotment.

Valuation report for issuances leading to change in control, etc:

ii. Four persons have provided comments on the matter. Three comments are in agreement with the recommendation. One person has suggested that valuation report should be applicable for all preferential issues. One commentator has suggested that valuation report shall be from independent registered valuer. One commentator has disagreed with the recommendation stating that valuation is not an exact science and some amount of guesswork exists in valuation.

iii. One commentator has agreed with the recommendation that valuation report to provide guidance on control premium while the other has sought clarity of understanding for the base price for such computation

iv. One comment agrees with the recommendation of hosting of the valuation report on the company's website.

Stricter provisions of AoA

v. Two comments received on this. One commentator has agreed with the recommendation of applicability of stricter provisions if any, already provided, under the Article of Association of the Issuer company for pricing in addition to the floor price determined under ICDR Regulations for preferential issue.. The second commentator has merely disagreed without providing any rationale .

Reasoned recommendation by the CoID

vi. Three persons have agreed with the suggestion of reasoned recommendation and disclosure of voting pattern of the Committee of Independent Directors where preferential issue results in change in control One commentator has suggested that the quorum for such meetings of independent directors should be prescribed.

b) Analysis:

While most comments are in support of the proposals, an analysis of the different views expressed are as under

Look back period:

i. As mentioned in the consultation paper, the settlement cycles has reduced significantly from a fourteen day account period trading an settlement cycle in 1994 when the pricing norms were introduced, to the current T+2 .Settlement cycles are further expected to be reduced to T+1 in a phased manner.

ii. An analysis of prices of the scrips of issuer companies that have made preferential issue has observed that the price of such scrips post preferential issue has converged closer to 60 trading days' VWAP than to 26 weeks' VWAP. It is also noted that the norm of 60 trading days VWAP is used as one of the price points for determination of open offer price, in terms of SEBI (SAST) Regulations.

iii. Permitting any other pricing methodology as approved by shareholders, bring in a lot of ambiguity in pricing of the issuance and thus lead to inefficiencies for both the company which is in need for funds and for the preferential allottee. Regulatory oversight on such a method would not be supported by back-testing of data and thus leading to uncertainty Thus, the PMAC recommendation on replacing look back period for the purpose of pricing is an optimal solution reasoned out by data.

Valuation report for issuances leading to change in control, etc:

iv. While it is acknowledged that the valuation report is not an exact science, various tenets of valuation have objectively evolved over time and the valuation norms are continuously being reviewed by IBBI. Therefore, the report submitted by the independent registered valuer shall provide a fair estimate and can be a fair reference point to be relied upon.

v. As regards control premium, in view of the comments received, it is proposed that the guidance on control premium should be over and above the floor price determined in terms of ICDR Regulations.

Stricter provisions of AoA

vi. Stricter provisions, if any, under Article of Association (AoA) shall apply for pricing of preferential issue as no reason for disagreement has been made by the person.

4.6. **Proposal for consideration of Board**

Look back period

a) Replace average of weekly high and low VWAP of 26 weeks with VWAP of 60 trading days and replace average of weekly high and low VWAP of 2 weeks with VWAP of 10 trading days. Stricter provisions in respect of pricing of preferential issue, if any already provided, under the Article of Association of the Issuer company shall also be considered for pricing in addition to pricing guidelines under ICDR Regulations for the purpose of making any preferential issue.

Valuation report for allotment leading to change in control

b) Any preferential issue allotment resulting in change in control or allotment of more than 5% of post issue fully diluted share capital of the issuer company to an allottee or to allottees acting in concert, shall require a valuation report from an independent registered valuer and shall consider the said valuation for determination of pricing. The floor pricing for preferential issues in such cases shall be higher of ICDR Regulations, valuation report, or provisions of Article of Association, if applicable.

c) The valuation report / certificate from a registered valuer should also cover guidance on control premium. The guidance on control premium shall be computed over and above the price determined by higher of ICDR Regulations or provisions of Article of Association, if applicable.

d) Valuation report shall be hosted on the company's website and a reference to the same shall be made in the notice for calling a general meeting of the shareholders.

Recommendation of CoID for change in control

e) Any preferential issue allotment resulting in change in control may be done only pursuant to a reasoned recommendation from a committee of independent directors. The recommendatory report shall consider all aspects of preferential allotment including pricing. The committee shall also disclose the voting pattern of its meeting. The quorum for committee of independent directors shall be 100%.

5. Lock-in provisions in case of preferential issues

5.1. Existing Provisions

a) The existing lock-in provisions mandate minimum three years lock-in period for promoters/ promoters group for equity shares up to 20% of the total capital of the issuer and any equity shares allotted in excess of 20% are locked-in for a period of one year. For allotment to persons other than promoters, the shares are locked-in for a period of one year. In case of convertibles securities or warrants, allotted to any investor, they are locked-in for a period of one year from the date of allotment.

5.2. Issues/ Concerns

a) The lock-in provisions are essential to ensure commitment towards the company, from the promoters and others to whom securities are allotted on a preferential basis so that they do not offload the shares immediately after receiving the same and take benefit of price arbitrage.

b) SEBI has received representations wherein it has been highlighted that for a company which has been listed for a reasonable no. of years on the stock exchange platform and whose promoters have continued to hold on to their stake all these years, the lock-in of 3 years is onerous and burdensome.

c) SEBI has recently, reduced the lock-in requirements for promoters as well as for persons other than promoters in case of public issues. Accordingly, there maybe a need to rationalise the lock-in requirements for preferential issuances and harmonize the same with lock-in provisions for public issues.

d) Presently there is no specific regulatory framework within the preferential issue guidelines regarding treatment of lock-in for a scenario where there is a change in control pursuant to a preferential issue allotment i.e. a non-promoter becoming promoter post issue. In such a case of an allotment being made to a new shareholder, thereby triggering a change of control or an open offer, it is often witnessed that such an allottee is disclosed as a 'non-promoter' apparently on the ground that change of control has not been executed or completed. There is ambiguity on this aspect

e) Such scenarios need to be covered in the regulations itself wherein, such allottees of preferential issue need to be disclosed as 'Promoter' in the notice for the meeting of shareholders (AGM) and the related information need to be updated accordingly by the company and also clarity may be brought on the lock-in period applicable for such allottees.

5.3. PMAC Recommendations

a) Lock-in for preferential issuance to promoters/ promoter group may be reduced from 3 years to 18 months and for preferential issuance to persons other than promoter/ promoter group, the lock-in may be reduced from 1 year to 6 months on similar lines with the lock-in applicable to Public Issues.

b) Lock in for an allottee who has become promoter due to change in control post allotment of preferential issue should be akin to lock-in requirements applicable for promoters / promoter group i.e. for 18 months.

c) It is also recommended that disclosures be made to shareholders in the explanatory notice for general meeting intimating therein the current and proposed status of the allottee post preferential issue

5.4. Public Comments and Analysis

a) **Public Comments:**

i. Three persons have offered their comments in respect lock-in provisions in case of preferential issue. One person has agreed with the recommendation and another has disagreed with the recommendation stating that such a move will result in lack of confidence in the preferential issue. Another commentator has offered comments not relevant to consultation paper.

ii. All comments are in agreement with the proposal for higher lock-in as applicable to promoters in case a preferential issuance results in an allottee becoming the promoter due to change in control. Further, in respect of the recommendation requiring disclosure to shareholders in the explanatory note to the notice for EGM providing therein the current and proposed status of the allottee post preferential issue, two persons have offered their comments. Both have agreed with the recommendations of PMAC.

b) **Analysis:**

i. The rationale that reduction in lock-in will result in lack of confidence in preferential issue may not be entirely justified. As reasoned out in the consultation paper, a company which has been listed for a reasonable no. of years on the stock exchange platform and whose promoters have continued to hold on to their stake all these years for them, lock-in of 3 years on shares received through preferential issue is onerous and burdensome, while the shares which have been acquired by the same promoter prior to listing of the issuer company at much lower price without the applicability of any pricing formula, are locked in for a period of only 18 months upon listing of those shares. Thus, it may be appropriate to rationalize and harmonise the requirement of lock-in for preferential issue in line with requirements under public issues.

5.5. **Proposal for consideration of Board**

a) Lock-in for preferential issuance to promoters/ promoter group shall be reduced from 3 years to 18 months and for preferential issuance to persons other than promoter/ promoter group, the lock-in may be reduced from 1 year to 6 months in similar lines with the lock-in applicable to Public Issues.

b) Lock in for an allottee who has become promoter due to change in control post allotment of preferential issue should be akin to lock-in requirements applicable for promoters / promoter group i.e. for 18 months.

c) Disclosures shall be made to shareholders in the explanatory notice for general meeting intimating therein the current and proposed status of the allottee post preferential issue.

6. <u>Pledge of Shares</u>

a) Current regulatory framework is silent on the aspect of pledging of the shares acquired by way of preferential issue by the promoters in case the pledge of such shares is required for raising money towards the objects of the preferential issue

6.2. **Issues/ Concerns**

a) Suggestions have been received that there is a need to permit pledging of shares allotted under preferential issue during the lock-in period as a collateral security for a loan granted by a scheduled commercial bank or a public financial institution or a systemically important non-banking finance company or a housing finance company in case the same is one of the terms for the sanction of the loan to the issuer company or its subsidiary(ies) for the purpose of financing one or more of the objects of the preferential issue. Such a provision is already provided for public issue under Regulation 21 of the ICDR Regulations

6.3. **PMAC Recommendations**

a) Specified securities allotted to promoter/ promoter group entities under preferential issue and which are under lock-in, should be permitted to be pledged if the pledge of such specified securities is one of the terms of sanction of the loan granted by the aforenamed lending institutions and the said loan is to be sanctioned to the issuer company or its subsidiary(ies) for the purpose of financing one or more of the objects of the preferential issue

6.4. **Public Comments and Analysis**

a) **Public Comments:**

i. Three persons have offered their comments in the matter. All have agreed with the recommendations of PMAC. Two commentators have provided additional suggestions. One such suggestion is permitting pledge by non- promoter allottees provided the same is required as part of objects of the issue. Another suggestion is pledge should not be permitted in case the company has defaulted or is undergoing CIRP.

b) Analysis:

i. All commentators have agreed with the suggestion of PMAC. Further, w.r.t. suggestions it is noted that in case of public issues as well, pledging is permitted only for promoter entities for the purpose of financing one or more of the objects of the issue and not for entities other than promoter.

ii. As regards disallowing pledging in case of CIRP, it may be noted that, in terms of Section 28 of the Insolvency and Bankruptcy Code, any change in capital structure in case of company undergoing CIRP requires approval of CoC. Further, the promoter is also dispossessed in CIRP. Thus, it may not be prudent to restrict pledging of such shares.

6.5. **Proposal for consideration of Board**

a) Specified securities allotted to promoter/ promoter group entities under preferential issue and which are under lock-in, shall be permitted to be pledged if the pledge of such specified securities is one of the terms of sanction of the loan granted by a scheduled commercial bank or a public financial institution or a systemically important non-banking finance company or a housing finance company and the said loan is to be sanctioned to the issuer company or its subsidiary(ies) for the purpose of financing one or more of the objects of the preferential issue

7. Issuers ineligible to make a preferential issue

7.1. Existing Provision

a) Regulation 159(1) of the ICDR Regulations states that preferential issue of specified securities shall not be made to any person who has sold or transferred any equity shares of the issuer company during the six months preceding the relevant date.

b) There is no regulatory framework ensuring that company making preferential issue has no outstanding dues to the Board, the stock exchanges or the depositories.

7.2. Issues/ Concerns

a) In view of the earlier recommendation to review and reduce the look back period for pricing of preferential issue from 26 weeks (i.e. six months) to 60 trading days, it is felt that there is a need to align the look back period with respect to trading history of prospective allotee.

b) Further, it is desired that, in line with SEBI circular on Scheme of arrangement, issuer company making preferential issue, should clear the outstanding dues to the Board, the stock exchanges or the depositories.

7.3. PMAC Recommendations

a) PMAC has recommended to reduce the condition of ineligibility period for a person who has sold or transferred equity shares, from six months preceding the relevant date to 60 trading days preceding the relevant date.

b) Towards this the practicing Company Secretary or independent Chartered Accountant may provide certification as part of notice to shareholders that allottees have not sold/ transferred equity shares of the issuer company in sixty trading days preceding the relevant date.

c) PMAC has recommended to introduce an additional condition under Regulation 159 stating the issuer entity shall not have any outstanding dues to the Board, the stock exchanges or the depositories.

7.4. **Public Comments and Analysis**

a) **Public Comments**

i. Three persons have offered their comments in respect of reducing look back period for a person who has sold or transferred equity shares preceding the relevant date. Two comments are in agreement with the suggestion. One commentator has disagreed with the recommendation stating that this will give scope to manipulate stock price before the look back period so as to secure a lower pricing.

ii. As regards recommendation to introduce additional condition stating the issuer entity shall not have any outstanding dues to the Board, the stock exchanges or the depositories, three persons have offered their comments. Two commentators have agreed with the recommendation. One commentator has disagreed with the recommendation stating that imposition of late fees or fine should be considered as an alternative. One of the commentators has also suggested that the requirement should not cover any ongoing proceeding/ dispute under appeal and penalty under such ongoing matter.

b) **Analysis**

i. Majority of the commentators have agreed with recommendations of PMAC. The suggestion that the requirement of no outstanding dues to Board/ Stock Exchanges/ Depositories not apply in case of any ongoing proceedings may be accepted. The right to legal remedy cannot be obliterated and should not come in the way of preference issue.

7.5. **Proposal for consideration of Board**

a) The condition of ineligibility period for a person who has sold or transferred equity shares of the issuer companies may be reduced from six months preceding the relevant date may be realigned with the look back period suggested for pricing of the preferential issue i.e. 60 trading days preceding the relevant date of the said issue.

b) An additional condition under Regulation 159 of the ICDR Regulations shall be introduced stating the issuer entity shall not have any outstanding dues to the Board, the stock exchanges or the depositories. This condition shall not apply in case there is any proceedings pertaining to such dues pending before a court of law.

8. <u>Preferential issue for consideration other than cash</u>

8.1. **Existing Provision**

a) In terms of Regulation 163 (3), where the specified securities are issued on a preferential basis for consideration other than cash, the valuation of the assets in consideration for which the equity shares are issued shall be done by an independent valuer, which shall be submitted to the stock exchanges where the equity shares of the issuer are listed:

Provided that if the stock exchange(s) is not satisfied with the appropriateness of the valuation, it may get the valuation done by any other valuer and for this purpose it may seek any information, as deemed necessary, from the issuer

8.2. **Issues/ Concerns**

a) ICDR Regulations, 2018 does not specify the different forms of consideration that can be allowed as “other than cash”. Also in the regulatory requirements pertaining to valuation of the assets to be accepted as consideration other than cash, there is no provision regarding making additional disclosure about the valuation of such other consideration that may be accepted by Issuer from the allottee. For eg. : If the consideration is to be accepted in the form of commodities, then it is not specified how the value of such commodities will be calculated and whether a valuation certificate for these commodities needs to be disclosed

8.3. **PMAC Recommendations**

a) PMAC recommended that only swap of shares backed by a valuation report may be considered as “other than cash”

8.4. **Public Comments and Analysis**

a) **Public Comments**

i. Four persons have offered their comments on the recommendation. Two commentators have agreed with the recommendation. Two commentators have disagreed with the recommendation stating that such a provision would deny a public company the ability to buy a business on slump purchase basis by an issuance of shares to the seller or buy technology from licensor against an issuance of shares.

b) **Analysis**

i. The primary concern as highlighted in the consultation paper was w.r.t. valuation of the assets to be accepted as consideration other than cash. Further, there are other means available for buying a business on slump purchase basis such as cash, scheme of arrangement etc. Accordingly, we may not agree with the suggestions made in public comments.

8.5. **Proposal for consideration of Board**

a) Preferential issue for consideration other than cash shall be applicable only in case of swap of shares backed by a valuation certificate provided by an independent registered valuer.

9. Application for in-principle approval to Stock Exchanges

9.1. Existing Provision

a) Regulation 28 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR Regulations) require the listed entity to seek in-principle approval of stock exchanges before issuance of securities.

9.2. Issues/ Concerns

a) Currently, there is no specified timeline for the company to file the application for in-principle approval with the stock exchange. Many a times the issuer companies seek in-principle approval just prior to the preferential issuance which leads to a situation where Exchange during scrutiny of the documents including the notice to the shareholders observe deficient information in the shareholder notice itself which needs to be urgently rectified and such last minute findings adversely affect the preference issue. In any case any late filing of the application leaves little time for the Exchanges to scrutinize the application and suggest remedial measures.

b) This may result in avoidable delays in filings and consequently in approving the application.

9.3. PMAC Recommendations

a) Listed entity must apply to stock exchanges for in-principle approval on the same day as dispatch of AGM/EGM notice to shareholders.

9.4. Public Comments and Analysis

a) **Public Comments**

i. Three persons have offered their comments. Two commentators have suggested that additional 2-10 days may be provided in view of various requirements and documents to be filed with stock exchanges as per their checklist. One commentator has agreed with the recommendation.

b) **Analysis**

i. In view of no current specific provision as to when the company should file the application for in-principle approval, many delays in filings and consequently in approving the application are observed which necessitate further application for condonation of delay. The PMAC recommendation is basically aimed at providing reasonable and sufficient time to stock exchanges to examine the disclosures made in shareholder notice and other aspects of the preferential allotment.

ii. The rationale as provided by commentators are all procedural in nature which can be overcome by careful planning and ensuring proper paperwork before dispatch of the shareholders notice. It is understood that the exchanges have provided a platform in the form of an online portal where companies can upload all such documents. Given these measures in place there may not be need to provide any more time for applying to the stock exchange.

9.5. **Proposal for consideration of Board**

a) ICDR Regulations may be amended to ensure that the application by a listed entity seeking in-principle approval from stock exchanges should be filed on the same day as dispatch of AGM/EGM notice to shareholders.

10. <u>Conditions for Preferential Issue</u>

10.1. **Existing Provision**

a) Regulation 160(c) of the ICDR Regulations mandate that a listed issuer making a preferential issue of specified securities shall ensure that all the equity shares held by the proposed allottee are in dematerialized form

b) Regulation 160(e) of the ICDR Regulations mandate that a listed making a preferential issue of specified securities shall ensure to obtain the Permanent Account Numbers of the proposed allottees, except for those allottees which may be exempt from specifying their Permanent Account Number for transacting in the securities market by the Board

10.2. **Issues/ Concerns**

a) There is a lack of clarity on when these conditions have to be met by the issuer company. There is a possibility that an issuer company may seek PAN details, or confirmation of dematerialized holding only pursuant to shareholders approval thereby delaying the process of allotment.

10.3. **PMAC Recommendations**

a) PMAC has recommended to clarify that the provisions pertaining to the conditions for making a preferential issue should include the conditions related to dematerialization of prior holding and obtaining PAN of the allottee which should be complied with by the issuer company at the time of making an application to Stock Exchanges for in-principle approval.

10.4. **Public Comments and Analysis**

a) One person has commented in the matter. He has agreed with the recommendation.

10.5. **Proposal for consideration of Board**

a) It shall be clarified in the ICDR Regulations that the conditions for dematerialization of prior holding and obtaining PAN of the allottee should be complied by the issuer company at the time of making an application to Stock Exchanges seeking in-principle approval for its preferential issue.

11. Other Recommendations of PMAC

11.1. **Existing Provision**

a) Regulation 163 of the ICDR Regulation deals with disclosures to shareholders in case of preferential issues. Regulation 163(1)(f) requires that identity of the natural persons who are the ultimate beneficial owners of the shares proposed to be allotted and/or who ultimately control the proposed allottees, and the percentage of post preferential issue capital that may be held by them and change in control, if any, in the issuer consequent to the preferential issue etc. should be disclosed to the shareholders.

b) Regulation 163(2) of the ICDR Regulations states that the issuer shall place a copy of the certificate of its statutory auditors before the general meeting of the shareholders convened to consider the proposed preferential issue, certifying that the issue is being made in accordance with the requirements of ICDR Regulations.

c) Regulation 167 (6) of the ICDR Regulations state that the entire pre-preferential shareholding of the allottees (of preferential issue), if any, shall be locked-in from the relevant date up to a period of six months from the date of trading approval.

d) Regulation 162 deals with Tenure of convertible securities. Regulation 162 states that tenure of the convertible securities of the issuer shall not exceed eighteen months from the date of their allotment.

e) Regulation 164(5) of the ICDR Regulation defines frequently traded shares as the shares of the issuer company in which the traded turnover during the twelve calendar months preceding the relevant date, is at least ten per cent of the total number of shares of the issuer.

f) Regulation 164 (4) of the ICDR Regulation states that in case of preferential issue of specified securities is proposed to be made to qualified institutional buyers who are not exceeding five in number, the floor price shall be average of weekly high and low of VWAP of two weeks preceding the relevant date.

11.2. **Issues/ Concerns**

a) Presently, two disclosure requirements are clubbed together in 163(1)(f) viz.

i. identity of the natural persons who are ultimate beneficial owners of the shares proposed to be allotted and/ or who ultimately control the proposed allottees and

ii. the percentage of post preferential issue capital that may be held by them and change in control, if any, in the issuer company consequent to the preferential issue

Many companies have interpreted that percentage of post preferential issue capital is required to be disclosed only in those cases, wherein they have to disclose the ultimate beneficial ownership. Further they have also interpreted that in cases where the allottee is a natural person this requirement is not applicable.

b) With regard to the requirement of placing the copy of statutory auditor certificate before the General meeting of shareholders, it is noted that those in case where company gets approval of the shareholders through postal ballot, and there is no physical meeting shareholders are deprived of the copy of the said certificate. Further, even there is a physical meeting, the shareholders opting to vote through e-voting facility will not have access to said certificate of statutory auditor.

c) Exchanges have highlighted that period between relevant date and allotment of specified securities is currently not covered for the purpose of lock-in. Thus, an allottee can acquire shares from the market after the relevant date till the allotment date of preferential issue, however, such shares bought during the intervening period would not be subject to lock-in.

d) With regard to tenure of convertible securities, it has been noticed that the allottee exercises his/ its option to convert only on the last date of the 18th month. In such cases, the actual allotment of equity shares takes place beyond 18 months but there is no specific time period prescribed within which allotment of equity shares pursuant to such conversion has to be completed.

e) While Regulation 164 (4) of the ICDR Regulation permits preferential issue of specified securities to qualified institutional buyers not exceeding five in number to take benefit of 2 weeks pricing, it is observed that in case of Qualified Institutional Placement under Chapter VI of the ICDR Regulations, at Regulation 179 (2)(b)certain conditions are mandated such as, the allotment shall not be made to qualified institutional buyer who is promoter/ or an entity having rights under shareholders agreement with promoter, veto rights or rights to appoint any nominee director on the board of the issuer etc.

11.3. **PMAC Recommendations**

i. PMAC while deliberating the proposals of the sub-group made certain additional recommendations related to procedural matters for which it did not desire any public consultation

ii. PMAC has recommended that it may be clarified that two requirements in Regulation 163(1)(f) of the ICDR Regulations may be split in two separate clauses for clarity.

iii. As regards placing the copy of the statutory auditor certificate, PMAC has recommended that issuer companies may host the certificate on its website and draw reference to the same in the notice for general meeting to shareholders.

iv. A clarification that the pre-preferential lock-in shall extend to all equity shares acquired before the allotment of preferential issue of shares.

v. In respect of tenure of convertible securities, PMAC has recommended that Allotment of equity shares pursuant to exercise of warrant / convertible security must happen within 15 days after the date of exercise of warrant / convertible security by the allottee (provided that the allottee exercises option to convert within the prescribed tenure).

vi. The reference to 12 calendar months period for defining frequently traded shares should be changed to 240 trading days in order to have consistency in regulation.

vii. In case of preferential issue to QIBs it shall be clarified that that benefit of pricing shall not be applicable for QIBs which falls under promoter / promoter Group category or QIBs having rights under shareholders agreement or voting agreement with promoter, Veto Rights, or right to appoint any nominee director on the board.

11.4. **Proposal for consideration of Board**

a) It may be clarified that two requirements in Regulation 163(1)(f) of the ICDR Regulations may be split in two separate clauses for clarity.

b) The issuer companies shall host the certificate on its website and draw reference of the same in notice for general meeting to shareholders

c) It shall be clarified that the pre-preferential lock-in shall be applicable for all equity shares acquired during the period between the relevant date and the allotment of preferential issue of shares.

d) Disclosure shall be made to shareholders in the explanatory note to the notice to shareholders meeting confirming that report of independent practicing Company Secretary basis the allottees have not sold/ transferred equity shares of the issuer company in the look back period i.e. in sixty trading days preceding the relevant date.

e) Issuer company shall ensure that the allotment of equity shares pursuant to exercise of warrant / convertible security must happen within 15 days after the date of exercise of warrant / convertible security by the allottee provided that the allottee exercises option to convert within the prescribed tenure.

f) The reference to 12 calendar months period for defining frequently traded shares shall be changed to 240 trading days in order to have consistency in regulation.

g) In case of preferential issue to QIBs it shall be clarified that the benefit of pricing shall not be applicable for QIBs which fall under promoter / promoter Group category or QIBs having rights under shareholders agreement or voting agreement with promoter, Veto Rights, or right to appoint any nominee director on the board.

h) **Proposal w.r.t. obtaining certificate for conforming that the preferential issue is being made in accordance with requirements of ICDR Regulation**

i. Regulation 163(2) of the ICDR Regulations require an issuer to place a copy of the certificate of its statutory auditors before the general meeting of the shareholders convened to consider the proposed preferential issue, certifying that the issue is being made in accordance with the requirements of ICDR Regulations.

ii. In terms of Section 204 of the Companies Act, 2013 a company needs to appoint a secretarial auditor, which is a practicing company secretary, to give audit report confirming compliance of applicable laws including corporate governance and various SEBI laws such as ICDR Regulations. Therefore, to ensure objectivity it is desired that a practicing company secretary carries out the due-diligence by providing certificate confirming that the preferential issue is being made in accordance with requirements of the ICDR Regulations.

12. <u>Proposal</u>

a) The Board is requested to consider and approve the proposals at para 3.5, 4.5, 5.5, 6.5, 7.5, 8.5, 9.5 10.4 and 11.4, and related amendments to SEBI (Issue of Capital and Disclosure Requirement) Regulations, 2018. The proposed amendments shall be made applicable for issuers making preferential issue under ICDR Regulation where the board meeting of the issuer company considering the preferential issue is held after the notification of amendments in Gazette.

b) Authorize the Chairman to take consequential and incidental steps to give effect to the decisions of the Board as contained in the draft placed at **Annexure III**.

Date: December 16, 2021 **Jeevan Sonparote**
Place: Mumbai **Chief General Manager**

Annexure - I

Consultation Paper on Review of certain provisions related to Preferential Issue guidelines is a publicly available document and same is placed on SEBI website.

Annexure-II

(This has been excised for reasons of confidentiality)

Annexure-III

Amendments to Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements), 2018 notified on Jan 14, 2022. Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) (Amendment) Regulations, 2022, is a publicly available document and same is placed on SEBI website.