

PREFERENTIAL ISSUE OF SHARES BY INDIAN COMPANIES

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Abstract

The Paper discusses the concept of Preferential issue of shares by a company under The Companies Act, 2013 ('the Act'), Section 62 (1)(c) to 'any person' which has become a very common practice by companies in order to fulfil their financial requirements arising from new projects, debt-equity ratio considerations, working-capital requirements and any other purpose. While discussing the meaning and relevance of the concept, the paper also delves into the application and the regulations and laws governing such. Firstly laws governing preferential issue by listed companies, Secondly we will be dealing with regulations and laws for Unlisted companies and lastly this paper while discussing the regulations and procedures which are to be undergone while issuing such shares will also point out the contemporary issues which encircles the preferential issue of shares and analyses to what extend these issues can be a roadblock in the successful implementation of this process.

Keywords: Preferential share, SEBI, Companies Act, ICDR, demat

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PREFERENTIAL ISSUE OF SHARES

There are three ways in which a further increase in subscribed capital of a company can be done:

- i. Through Preferential Issue
- ii. Issue of shares to employees under an employee's stock option scheme
- iii. A rights issue to the existing shareholders

The Companies Act, 2013 ('the Act'), Section 62 (1)(c) states that the fresh shares can be issued to 'any person' including existing shareholders and employees for cash or any other consideration after a special resolution is passed authorizing the company to do the same.¹ It also states that the pricing of shares issued in a preferential issue should be determined by the valuation report of a 'registered valuer'.² This is further subjected to conditions which may be prescribed at a later stage.³ This type of 'preferential issue' by a company to 'any person' is very broad and it provides a very significant leeway for a company to be able to collect share capital from different sources. Two very pertinent features of preferential issues are:

- i. The allotment is made at a *pre-determined* price.

- ii. The entire of shares is made to *pre-identified* persons.⁴

This in turn paves way for a company to raise money for different purposes by providing it an avenue.

The fulfilment of financial requirements arising from new projects, debt-equity ratio considerations, working-capital requirements and any other purpose can be obtained by using preferential issues.⁵ Generally, a company makes preferential Issues to either a financial institution or a promoter whose goal is to acquire a 'strategic stake' in the company. It also enables equity participation of a person who might find it costly or unfeasible to purchase shares off the market. Moreover a company which may wish to raise share capital at a very short and not having to overburden themselves with formalities and costs of a public issue may find Preferential Issue favourable.

Equity funding via preferential issue is regulated by the Securities Exchange Board of India ("SEBI") through its rules and regulations in cases of 'listed companies'. Amongst other rules and regulations, all the listed companies who wants to make preferential issues are required to abide by the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ('ICDR

¹ Companies Act, 2013, Section 62 (1) (c).

² Id.

³ Id.

⁴ Id.

⁵ Ankur Loona, *Informal Guidance or Informal Ordinance*, LIVELAW, November 24, 2014 available at <http://www.livelaw.in/informal-guidance-informal-ordinance/> (Last visited on 27th, March, 2020).

regulations’). Likewise, all the ‘unlisted public companies’ and the ‘private companies’ in the process of them making preferential have to abide by the procedures which are provided by the companies (Share Capital and Debentures) Rules, 2014 issued by Ministry of Corporate Affairs (‘MCA’).

Preferential Issue is the best method for Companies wanting to raise equity capital economically by minimizing formalities and not having a need to appoint a merchant Banker. This paper has four parts, firstly preferential issue by listed companies. Secondly, unlisted companies and thirdly we will be discussing contemporary issue encircling preferential issues of shares by Indian Companies. The last one contains the concluding remarks.

PART I - LISTED COMPANIES

ICDR regulations, chapter VII deals with the subject of preferential issue by listed companies. The chapter defines preferential issue as “an issue of specified securities by a listed issuer to any select person or group of persons on a private placement basis”.⁶ The definition excludes public issue, rights issue, bonus issue, employee stock option scheme, qualified institutional placement and sweat equity shares from the purview of preference issue. As far as the type of securities is

concerned, it boils down only to ‘specified securities’ which are defined as “equity shares and convertible securities”.⁷ Hence, listed companies which makes preferential allotment of equity shares, share warrants, and other convertible securities under Section 62(1)(c) of the Act are to abide to the procedure of the ICDR regulations.

72 (1) regulation provides four conditions required to be met by listed issuers:

- i. a special resolution (over 75 per cent of members voting in favour) has to be passed authorizing the company to make preferential allotment to identified persons or group of persons.⁸
- ii. all shares (if any) held by the proposed allottees must be in dematerialized format.⁹
- iii. the issuer must have in its possession the Permanent Account Number (PAN is issued by Income Tax authorities) of all the proposed allottees.¹⁰
- iv. the issuer must have complied with all conditions for continuous listing of shares as given in the listing agreement

⁶ Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 (‘ICDR Regulations’), Reg. 2(1)(z).

⁷ *Id.*, Reg. 2(1)(zi).

⁸ *Id.*, Reg. 72(1)(a).

⁹ *Id.*, Reg. 72(1)(c).

¹⁰ *Id.*, Reg. 72(1)(b).

between the issuer and the stock exchange.¹¹

In addition to this, the issuer is not allowed to make a preferential; allotment of the securities specifies to person(s) who has in the past six months preceding the relevant date of issue¹² sold the equity shares of the company.¹³ A clarification to the 72(2) Regulation was inserted by SEBI (Issue of Capital and Disclosure Requirements) (Fourth Amendment) Regulations, 2010, clarifying the fact that if a group of promoter or promoter(s) already sold their equity shares in the company during the six months before the relevant date, any individual promoter or a group of promoter will be considered ineligible for receiving any preferential allotments from the company.¹⁴ This in turn ensures that the promoter group or promoter(s) are showcasing their commitment toward the company.

Regulation number 72 provides a list of the disclosures that the issuer is required to make in the explanatory notes associated with the agenda of the general meeting which was held in order to put the special resolution regarding preferential issue to vote. The issuer is required to specify the proposals of the promoters, the key management personnel, the directors who wishes to

subscribe to the offer; the objects of the preferential issuance of shares, the allotment time period, present and post – allotment shareholder patterns of the issuer and undertake that the re – computation of the prices of the shares will be made abiding the regulations.¹⁵

Moving forward, it is a requirement under SEBI (Issue of Capital and Disclosure Requirements) (Second Amendment) Regulations, 2013 for the issuer to identify the “the natural persons who are ultimately the beneficial owners of the proposed shares which will be allotted and/or who ultimately control the proposed allottees and disseminate the information at the general meeting”¹⁶. This amendment however is not applicable to listed companies, banks or insurance companies, mutual funds, given, they are recognised as the proposed allottees for it is a difficult task to be able to identify every natural person of these entities. Furthermore it is also a requirement that whenever a promoter or his relatives or his other associates and related entities of promoters receive preferential shares for considerations with anything but not cash, independent valuation should be done by a qualified valuer with regards to such assets.¹⁷ This will help in preventing any collusion

¹¹ *Id.*, Reg. 72(1)(d).

¹² *Id.*, Reg. 71(a). Relevant date in case of preferential issue of equity shares is said to be “the date thirty days prior to the date on which the meeting of shareholders is held to consider the proposed preferential issue”.

¹³ *Id.*, Reg. 72(2).

¹⁴ *Id.*, Explanation to Reg. 72(2).

¹⁵ *Id.*, Reg. 73(1).

¹⁶ *Id.*

¹⁷ *Id.*, Reg. 73(3).

which might happen between the promoter and her relatives in order to incur or gain profit out of such a transaction. These requirements will in turn help the existing shareholders gain information about who is or are the persons behind the company and also to increase transparency in the issue process.

Allotment is required to be completed within a timeframe of fifteen days from the date of such resolution after the resolution is passed.¹⁸ A new special resolution is required to be passed and the process has to be repeated if the allotment could not be completed in 15 days of the special resolution.¹⁹ New shares are required to be in dematerialized format.²⁰

Whether the company who is the issuer listed its share in a stock exchange for less or more than 26 weeks before the relevant date is what the Pricing of shares is dependent upon. If it has been more than 26 weeks after listing, the price of the new shares will not be less than higher among:

“(a) The average of the weekly high and low of the volume weighted average price of the related equity shares quoted on the recognised stock exchange during the twenty six weeks preceding the relevant date; or (b) The average of the weekly high and low of

the volume weighted average prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date”²¹

Disregarding this if the shares of a company which are in the process of issuance are not listed on the stock exchange before a period of 26 weeks from the relevant date, the price of the new shares will not be less than higher among:

“(a) the price at which equity shares were issued by the issuer in its initial public offer or the value per share arrived at in a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956, pursuant to which the equity shares of the issuer were listed, as the case may be; or (b) the average of the weekly high and low of the volume weighted average prices of the related equity shares quoted on the recognised stock exchange during the period shares have been listed preceding the relevant date; or (c) the average of the weekly high and low of the volume weighted average prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.”²²

A company is however not precluded from offering shares at a much higher price. Minimum pricing provisions have been

¹⁸ *Id.*, Reg. 74(1).

¹⁹ *Id.*, Reg. 74(2)

²⁰ *Id.*, Reg. 74(4).

²¹ *Id.*, Reg. 76(1)(a) & 76(1)(b).

²² *Id.*, Reg. 76(2)(a), 76(2)(b) & 76(2)(c).

included in order to prevent any kind of manipulation of the price of shares by either a promoter or anyone who is closely associated with the company. By choosing a longer average of 26 weeks (over 6 months) the regulators prevents any manipulation of price which would have been possible if the period been shorter.²³

For safeguarding the interests of investors and in order to prevent misuse, the ICDR regulations provides for a lock-in period for the shares issued through preferential allotment. A promoter or promoter groups is distinguished from other allottees. The lock-in period for shares issued to promoter or promoter groups is 3 years from when the trading approval was received.²⁴ However, a three year lock-in period is applicable only up to 20% of the issuer's total capital.²⁵ For equity shares above this threshold held by promoters or promoter groups the lock-in period is only 1 year.²⁶ For shares allotted to any person other than promoter a blanket one-year lock in period is imposed by the regulations.²⁷

PART II - UNLISTED COMPANIES

The procedure for allotment of equity shares on preferential basis by unlisted companies is provided in Rule 13 of Companies (Share Capital and Debenture) Rules, 2014. It is applicable to both public and private unlisted companies.²⁸ They define preferential offer as “an issue of shares or other securities, by a company to any select person or group of persons on a preferential basis.”²⁹ Shares or other securities include equity shares, fully or partly convertible debentures and other fully or partly convertible securities. It is expressly provided by Rule 13(1) that such issue should comply with the provision of Section 42 of the Act dealing with private placement.³⁰

Several conditions are laid down by Rule 13(2) that has to be met by an unlisted company before they make a preferential issue. it should be authorised by the Articles of Association of the company.³¹ A special resolution of the members is required to be passed which will authorise the company to make such preferential allotment.³²

A company has to make disclosures in its explanatory statement with regards to the object of the issue, number of shares it is planning to issue, the price at which the shares will be allotted, the basis at which the

²³ Jayanth Rama Varma, *Corporate Governance in India: Disciplining the Dominant Shareholder*, 9(4) IIMB Management Review 5, 10 (1997) available at <http://www.iimahd.ernet.in/~jrvarma/papers/iimbr9-4.pdf> (Last visited on August 21st, March, 2020).

²⁴ ICDR Regulations, Reg. 78(1).

²⁵ *Id.*, First Proviso to Reg. 78(1).

²⁶ *Id.*, Second Proviso to Reg. 78(1).

²⁷ *Id.*, Reg. 78(2).

²⁸ Companies (Share Capital and Debenture) Rules, 2014, Rule 3.

²⁹ *Id.*, Explanation to Rule 13(1).

³⁰ *Id.*, Rule 13(1).

³¹ *Id.*, Rule 13(2)(a).

³² *Id.*, Rule 13(2)(b).

shares have been priced, whether any promoter, director or managerial personnel are subscribing to the offer, the names of class or class of persons to whom the shares will be allotted, the time period within which the allotment will take place, details of other allotments made on preferential basis during the current year and the shareholding pattern post-allotment.³³ It has to inform its members if any change in control will result due to such issue at the time of the meeting itself.

Contrary to listed companies, in unlisted companies there is a scope of complete allotment on preferential basis for a time period of up to 12 months which is calculated from the date of the passing of the special resolution.³⁴ The determination of the price of shares will be done by a valuation report which is carried out by a valuer who is registered.³⁵ The price arrived at by the registered valuer cannot be more than the price at which the shares should be offered.³⁶

The assets will be treated as depreciable/amortizable assets if a preferential offer of shares is made on non-cash considerations in accordance with the accounting standards.³⁷

PART III - FURTHER REGULATIONS AND ISSUES

Section 42 of the Act talks about private placement. It further lays down under Section 62(1)(c) conditions to be met for preferential issue of shares. It must be noted that Section 42 is a broader provision which also applies to all other types of securities (like non-convertible debentures) which fall outside the scope of Section 62(1)(c).

It is a requirement that a company will make private placement of shares by issuing a 'private placement offer letter'. Section 42(2) places a cap of fifty on the number of persons to whom such offers can be made in a financial year.³⁸ This cap has, however, been raised to two hundred persons by subsequent regulations.³⁹ Any violation of this cap will result in the offer being deemed as a public offer and all compliance requirements of a public offer shall descend upon the company in such a scenario.⁴⁰

A company cannot make a fresh offer or invitation to offer without either completing allotments pertaining to previous offers or having withdrawn/ abandoned earlier offers.⁴¹ All allotments of preferential issue have to be made within sixty days of receiving

³³ *Id.*, Rule 13(2)(d).

³⁴ *Id.*, Rule 13(2)(e).

³⁵ *Id.*, Rule 13(2)(g).

³⁶ *Id.*, Rule 13(3).

³⁷ *Id.*, Rule 13(2)(j).

³⁸ Companies Act, 2013, §42(2).

³⁹ Companies (Prospectus and Allotment of Securities) Rules, 2014, Rule 14(2)(b).

⁴⁰ Companies Act, 2013, §42(4).

⁴¹ *Id.*, Section 42(3).

the application money.⁴² Money can be collected through cheques, demand drafts or other banking channels and no cash can be collected by companies.⁴³

Offers can be made only to those persons whose names are recorded by the company prior to sending invitations and a complete record of all the allottees along with their names, addresses and contact details have to be filed with the return on allotment to the Registrar. Companies are expressly barred from releasing advertisements about preferential issues and cannot make use of any media or marketing channel to inform public about such offers.⁴⁴

Violation of any of the provisions in Section 42 will result in the promoters and directors of the company being held personally liable. They will not only have to refund all monies to the subscribers within thirty days but also face penalty to the tune of two crore rupees or the amount involved in the offer.⁴⁵

Companies (Prospectus and Allotment of Securities) Rules, 2014 further imposed conditions on private placement of securities which is also applicable to preferential issue of shares. Private placement offer or invitation letter should be issued in Form

PAS-4 which should specifically be addressed to a particular person who in Section 42(7) has been identified by the company as either in writing or through electronic modes.⁴⁶ Application will not be entertained if applied by any other on behalf of such person addressed to. There can be no Offers or invitation to more than two hundred persons in the aggregate in a particular financial year which excludes qualified institutional buyers and employee beneficiary of stock option schemes.⁴⁷

One very important condition is laid down by these rules: the value of offers or invitation to offer made on a preferential basis cannot be less than twenty thousand rupees of the face values of securities on offer.⁴⁸ Payment for subscribing to the shares has to be made from the bank account of the concerned person and the company has to maintain record of the bank transactions.⁴⁹

A full record of the private placement offer has to be maintained by the company in Form PAS-5 and it has to be filed with the Registrar within thirty days of circulating the private placement offer letter.⁵⁰ A return of allotment in Form PAS-3 has to be filed with

⁴² *Id.*, Section 42(6).

⁴³ *Id.*, Section 42(5).

⁴⁴ *Id.*, Section 42(8).

⁴⁵ *d.*, Section 42(10).

⁴⁶ Companies (Prospectus and Allotment of Securities) Rules, 2014, Rule 14(1)(a).

⁴⁷ *Id.*, Rule 14(2)(b).

⁴⁸ *Id.*, Rule 14(2)(c).

⁴⁹ *Id.*, Rule 14(2)(d).

⁵⁰ *Id.*, Proviso to Rule 14(3).

the Registrar within thirty days if making the allotment.⁵¹

One notable aspect is that SEBI has every now and then amended and modified these regulations with an object to strengthen investor protection and corporate governance. A new proviso to Rule 13(1) has been inserted by The Companies (Share Capital and Debentures) Amendment Rules, 2015, in case preferential allotment of share is being made to its existing members by the issuer to, then it is no more a requirement to make an offer in Form PAS 4 and filing it with Registrar with regards to the fact that a record has to be maintained by a company in the form of Form PAS-5. This reduces the formalities which are required to be abided by unlisted companies in preferential issue which also makes it more economical.

SEBI (Issue of Capital and Disclosure Requirements) (Second Amendment) Regulations, 2013 has brought in significant changes in another instance to the preferential issue regime of listed company. Provisions which deals with lock-in periods, identification of natural persons, mandatory demat issue, restriction on transferability etc. were brought in which have brought about a big change and a significant impact on transparency when it comes to issuing of shares. It has been cautioned by some that it might be difficult to identify natural persons

who are the ultimate beneficiaries and exercise ultimate control.

Detractors are always present and even in this case the current set of rules and regulations governing preferential allotment does not have an exception. Preferential allotment as mere means for raising their stake in their company has generally been in use by promoters in small companies or in companies where promoters exercise considerable control and influence as it is much easier to pass a special resolution for preferential issue. Such power has been used by promoters to issue themselves shares or share warrants which can later be turned or converted to equity share.

Many instances have been there of unscrupulous dealing by investors who benefits from preferential issues by manipulation of prices. They tend to sell their holdings at higher prices in secondary markets and later issues themselves more shares via preferential allotments. They are usually successful in enriching themselves by using unfair means which harms the minority shareholders.

The ICDR regulations, in order to prevent these unscrupulous practices impose a three year lock in period on the shares which are issued to promoters. Moreover, strict pricing regulations are imposed which prohibits

⁵¹ *Id.*, Rule 14(4).

arbitrary law pricing allotment of shares. If promoters have sold their shares in the six months preceding the relevant dates they are disbarred from receiving preferential allotment.

Certain complications are still in existence. The three years period of lock in for shares is only applicable only till twenty per cent of the total shares and above this the lock-in threshold is only twelve months. This provides the promoters with some amount of flexibility if they hold more than twenty per cent of the total capital in a company which in fact is the case with several companies. However many investors which includes private equity investors and due to not being able to withdraw their money during unfavourable times due to lock-in period stipulation might get discouraged..

The six month rule which is prohibiting the selling of shares might be a necessity with regards to the fact that the manipulation of prices might take place but it still is an impediment in the path of the promoters in the infusion of capitals in their companies in emergency situations at short notice. Since then, even if one of them has sold his/her

shares, the others are precluded from receiving preferential allotment. From then, these regulations are applicable to all promoters. This might possibly be particularly harsh to the company and the promoters in times of emergency and urgent financial need which compensated through preferential issue of shares.

PART IV - CONCLUDING REMARKS

Companies Act and SEBI covers all the aspects of preferential issue. Amendment has been done every once in a while in order to provide a remedy for the loopholes and the defects with regards to the mechanism of preferential issues and to curb unscrupulous practices prevalent in the market which are taking advantage if these loopholes. The current issues which surround preferential allotment of shares which are mentioned in this paper earlier are not of a magnitude that can seriously disrupt the transparency and friendly market environment of an investor. Hence, preferential issue of shares by Indian companies takes place in a well-regulated, comprehensive and conducive regulatory environment.